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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

INTERNATIONAL DEVELOPMENT ASSOCIATION

INTERNATIONAL FINANCE CORPORATION

**COUNTRY PARTNERSHIP STRATEGY
FY07-10**

FOR

REPUBLIC OF AZERBAIJAN

December 7, 2006

**South Caucasus Country Management Unit
Europe and Central Asia Region
The World Bank**

**Europe and Central Asia Region
International Finance Corporation**

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DATE OF LAST CAS FOR REPUBLIC OF AZERBAIJAN

April 29, 2003

CURRENCY EQUIVALENTS

US\$1 = AZN 0.9008 (new manats introduced January 1, 2006)

AZN1 = AZM5,000 (old manats)

GOVERNMENT FISCAL YEAR

January 1–December 31

ABBREVIATIONS AND ACRONYMS

AAA	analytical and advisory activities	IsDB	Islamic Development Bank
ACG	Azeri-Chirag-Deepwater Gunashli	JPIC	Japan Bank for International Cooperation
ADB	Asian Development Bank	JSA	Joint Staff Assessment
ADCP	Agricultural Development and Credit Project	JSAN	Joint Staff Advisory Note
ADDY	Azerbaijan Dovlet Demir Yolu	KfW	Kreditanstalt für Wiederaufbau
APL	adaptable program loan	LIL	Learning and Innovation Loan
BTC	Baku-Tbilisi-Ceyhan	MDG	Millennium Development Goals
CAPSAP	Corporate and Public Sector Accounting Project	MTEF	medium-term expenditure framework
CAS	Country Assistance Strategy	NGO	nongovernmental organization
CIS	Commonwealth of Independent States	OSCE	Organization for Security and Co-operation in Europe
CPIA	Country Policy and Institutional Assessment	PEFA	Public Expenditure and Financial Accountability
CPS	Country Partnership Strategy	PEP	Private Enterprise Partnership, IFC
DRS	World Bank Debt Reporting System	PIFC	Public Internal Financial Control
EBRD	European Bank for Reconstruction and Development	PIP	public investment program
EITI	Extractive Industry Transparency Initiative	PIPE	Public Investment Policy and Efficiency
ENP	European Neighborhood Policy	PPER	Programmatic Public Expenditure Review
ESW	economic and sector work	PRSC	Poverty Reduction Support Credit
FDI	foreign direct investment	PRSP	Poverty Reduction Strategy Paper
FIAS	Foreign Investment Advisory Service	RAMP	Reserves Advisory and Management Program
FSTA	Financial Sector Technical Assistance	RIDIP	Irrigation and Drainage Rehabilitation Project
GDLN	Global Development Learning Network	RMSM-X	World Bank standard macro modeling framework
GEF	Global Environmental Facility	SCP	South Caucasus Pipeline
GNI	gross national income	SOCAR	State Oil Company of Azerbaijan
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit	SOFAZ	State Oil Fund
IBA	International Bank of Azerbaijan	SPPRED	State Programme on Poverty Reduction and Economic Development
IBRD	International Bank for Reconstruction and Development	SPPRSD	State Programme on Poverty Reduction and Sustainable Development
IDA	International Development Agency	TACIS	Technical Aid to the Commonwealth of Independent States
IDF	Institutional Development Fund	UNDP	United Nations Development Programme
IFAD	Int. Fund for Agricultural Development	UNEP	United Nations Environmental Program
IFC	International Finance Corporation	USTDA	U.S. Trade and Development Agency
IFRS	Int. Financial Reporting Standards	WBI	World Bank Institute
IMF	International Monetary Fund	WTO	World Trade Organization
IPSAS	Int.l Public Sector Accounting Standards		

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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

INTERNATIONAL DEVELOPMENT ASSOCIATION

INTERNATIONAL FINANCE CORPORATION

COUNTRY PARTNERSHIP STRATEGY, FY07–10

REPUBLIC OF AZERBAIJAN

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AZERBAIJAN COUNTRY PARTNERSHIP STRATEGY, FY07–10 EXECUTIVE SUMMARY

1. Over the past few years, Azerbaijan has put into place both the infrastructure needed to realize rapid growth in oil and gas exports, and a credible framework to manage the increase in resource flows in a reasonably effective and transparent manner. The World Bank Group has been actively engaged in both tasks – through IFC in building the oil pipelines which are now generating the oil boom, and through IDA in establishing the institutions responsible for safeguarding and using the resources well. As Azerbaijan’s known reserves are more limited than is the case for many other oil exporters, however, the resource boom will also be more shortlived. The challenge facing the Azeri leadership and its international partners will therefore be to use the next 10-15 years very carefully to develop sound growth opportunities in the non-oil economy and achieve sustainable reductions in poverty for current and future generations. To meet this challenge, the government of Azerbaijan is committed to maintain macroeconomic discipline; improve the business environment to encourage investment in the non-oil economy; improve the transparency and quality of public governance; modernize its basic health and social protection systems; transform both its formal and nonformal education and training systems to help its population become better educated and more competitive in an increasingly global setting, and address long-neglected environmental problems. The long-term vision is for Azerbaijan to become a prosperous transit center for energy and goods flowing between Europe and Central Asia.

2. Azerbaijan is just completing a first PRSP period, and is now developing a new State Programme on Poverty Reduction and Sustainable Development (SPPRSD) for 2006–15. The Bank Group’s Country Partnership Strategy (CPS) reflects the objectives of the SPPRSD, which are closely aligned with the vision and challenges mentioned above. The CPS rests on four main pillars:

- **Pillar I: Improving the quality and transparency in public sector governance**, by maintaining a stable macroeconomic framework that makes prudent use of oil revenues; improving public expenditure planning and management; strengthening financial management and procurement systems; establishing proper public sector and corporate governance, accounting, and auditing; creating an administrative and regulatory environment conducive to growth; and strengthening the judicial system.
- **Pillar II: Supporting sustainable and balanced growth of the non-oil economy**, by expanding access to financial services; improving the business environment and through IFC direct investments and technical assistance strengthening the private sector; developing essential infrastructure and services, with special attention to both the rural economy and Central Asia-South Caucasus-Black Sea regional transit routes; and strengthening the financial viability and efficiency of the utility sectors.
- **Pillar III: Increasing the quality of and access to social services**, by expanding coverage of good-quality health care services; developing a modern education system and globally competitive knowledge economy; effectively targeting social assistance; creating a more transparent, affordable, and sustainable pension system; and improving living conditions and economic opportunities for internally displaced people.
- **Pillar IV: Improving environmental management and furthering the climate change agenda**, by cleaning up legacy pollution, reducing carbon emissions, and promoting biodiversity; supporting more sustainable natural resource management in selected areas; and strengthening natural disaster management.

3. The Bank and IDA technical and financial assistance will focus on Pillars I, III and IV, and the Bank and IFC will work jointly on Pillar II. IFC will also continue to oversee the Baku-Tbilisi-Ceyhan (BTC) pipeline and support the development of financial institutions and small and medium-size enterprises. IFC will actively seek direct investment opportunities in general manufacturing and financial markets, as well as focused on assisting local SMEs. Its technical assistance activities will support the improvement of the business environment and corporate governance. Although Azerbaijan is not likely to require balance of payments or budgetary support through development policy lending during the next few years, it has requested that the Bank continue to support the PRSC reform agenda agreed under the previous CAS, through intensive policy dialogue and technical advisory services.

4. Implementation of the public governance and anti-corruption agenda will be closely monitored and prioritized on the basis of a framework prepared by the government with participation of civil society, and in partnership with donors. With regard to the Bank Group's own portfolio, special attention will be given to supervision generally and oversight of fiduciary requirements in particular, largely through strengthening capacity in the Baku Country Office.

5. Azerbaijan has already begun the transition from IDA to IBRD financing, with the first IBRD loan approved in May 2005 and a second in January 2006. Based on continued strong economic growth prospects, IDA is expected to be phased out during this CPS period. While the average range of IBRD lending is established at about US\$250 million a year, actual volumes will depend on the degree of government co-financing and absorptive capacity. IBRD lending will be sequenced so that progress in sector and governance reform can be taken into account in decision-making at each step.

6. Primary risks to achieving CPS objectives include: possible delays or waning consensus in implementing structural reforms; state capture and corruption; deterioration in financial management of oil revenues, disruptions in revenue flows due to volatile energy prices, output or pipeline performance; and deterioration in the political or security environment. These risks are mitigated by a strong emphasis on macroeconomic management and sterilizing excess oil revenues through the State Oil Fund, and continuous efforts at improving relations with neighboring countries. The risks are also mitigated by the strong focus of the CPS on improving governance and financial accountability, diversifying sources of growth, and expanding participation of the civil society in policy making and monitoring. At the same time, it is recognized that many countries experiencing natural resource booms have had difficulty in managing macroeconomic and governance challenges. This CPS is predicated on the belief that Azerbaijan can follow a different path and that the World Bank Group can play a positive role in helping to bring this about. The Board will be informed in the event of any serious deterioration of the economic or governance environment.

The following issues are suggested for discussion:

- Does the CPS provide a well-focused set of activities, both ongoing and new, in support of Azerbaijan's development strategy?
- Does the CPS provide the appropriate mechanisms to further policy and governance support?
- Is the governance framework well balanced between the Bank's requirements and the political and institutional reality of Azerbaijan?

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COUNTRY PARTNERSHIP STRATEGY, FY07–10

REPUBLIC OF AZERBAIJAN

I. Context

1. This Country Partnership Strategy (CPS) for Azerbaijan covers the four-year period from FY07 to FY10. It is a joint IDA/IBRD/IFC strategy. The last Country Assistance Strategy (CAS) was discussed by the Board in May 27, 2003 (Report No. 25790-AZ), based on Azerbaijan's then new poverty reduction strategy, the State Programme for Poverty Reduction and Economic Development (SPPRED). A progress report on the SPPRED was presented to the Boards of the World Bank and International Monetary Fund (IMF) in August 2005. In collaboration with civil society and other stakeholders, the government is preparing the follow-on to the SPPRED, the State Programme on Poverty Reduction and Sustainable Development (SPPRS) 2006–15.

2. Azerbaijan was among the world's leading oil producers in the late 19th century, but during the Soviet period exploitation of Azerbaijan's oil resources was not a high priority and economic policies left little to show for the country's oil wealth and much of its population in poverty. Since independence, oil and gas discoveries have given Azerbaijan new means of combating poverty and developing into a diversified, sustainable middle-income economy in the coming years. Driven by the new oil boom, per capita income rose to US\$1,240 in 2005, up from a post-independence low of just US\$470 in 1995.

3. Azerbaijan's national income will be rising substantially over the next several years, as new oil production comes on stream and international oil prices are higher. A significant part of this income will be leaving the country, however, in the form of repatriation of capital and profits by foreign investors. Moreover, the revenue boom is expected to be relatively short lived, peaking in about 2010 and declining steadily thereafter.

4. Azerbaijan's challenge is to use its oil revenues to stimulate sustainable broad-based growth and ensure the welfare of current and future generations. The economic transition has been complicated by the armed conflict with Armenia over Nagorno-Karabakh, which led to nearly 700,000 internally displaced people (IDPs) and some 250,000 refugees from Armenia, loss of control over some 20 percent of the land area, and disruption of key regional trade and transport links.¹ Over the last CAS period, IDA helped the government establish a meaningful poverty-reduction strategy and supported implementation of important reforms in many sectors. IFC helped finance the Baku-Tbilisi-Ceyhan (BTC) pipeline and upstream oil platform development. Azerbaijan now needs to persevere with key reforms and build on the opportunities provided by its oil revenue. Doing so involves raising the level of development

¹ In addition, about 50,000 Meskhetian Turks and 11,000 people from other countries have sought refuge in Azerbaijan since 1990.

of rural, mainly agricultural, regions and secondary cities relative to the capital area and providing equitable basic infrastructure services across the country.

5. The CPS supports the main objective of the government long-term program to reduce poverty and achieve the Millennium Development Goals (MDGs) by supporting continued high non-oil sector growth while maintaining macroeconomic stability; improving health, education, and infrastructure services; better targeting social protection; improving gender equality; and achieving environmental sustainability.

6. IBRD financing will support a larger development agenda than did the previous CAS, particularly in regard to managing and implementing essential infrastructure projects and environmental remediation. IDA financing will play a critical role in helping the government improve social and rural conditions and support continued structural reforms. IFC is partnering with the private sector to encourage the continued development of the non-oil economy. Examples include the development of the Supplier Finance Facility for SME suppliers, corporate governance and leasing TA and potential investments in financial as well as the food retail sectors. Knowledge-sharing, analytical and advisory activities (AAA), and development partnerships will reinforce investments. In all areas, the Bank Group’s support will focus on improving governance, both public and corporate.

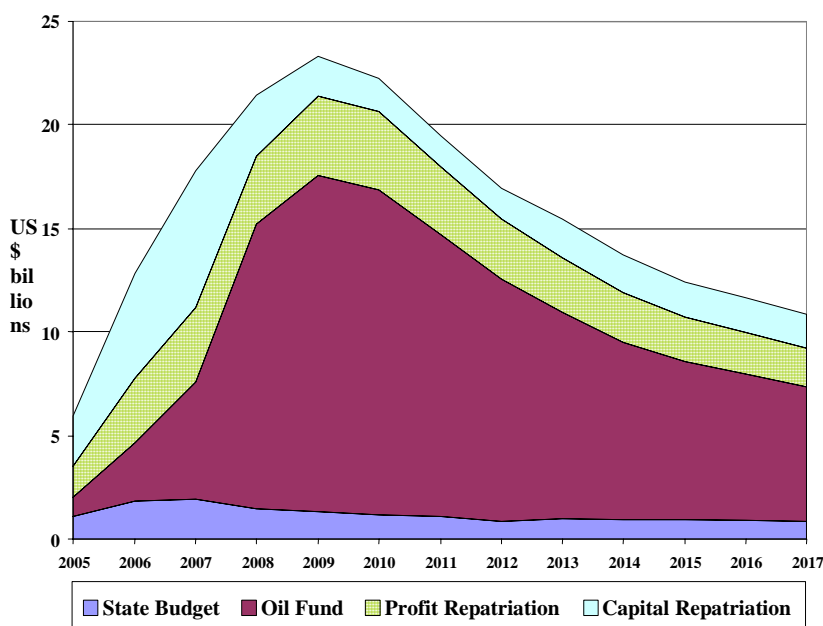
II. Challenges Facing Azerbaijan

a. *Managing Natural Resource Wealth*

7. Azerbaijan’s proven energy reserves stood at 7 billion barrels of oil and 1.34 trillion cubic meters of gas at the end of 2003. International consortia are investing in and operating the new oil and gas facilities based on production sharing agreements with the government. Long-term revenue projections, based on an average oil price of about US\$43 per barrel for the next 20 years, suggest gross revenues of about US\$340 billion from Azerbaijan’s oil and gas fields plus pipeline transit fees before operating costs.

After operating costs, state fiscal revenues are expected to reach about US\$175 billion, of which about US\$20 billion will accrue to the state budget in the form of corporate tax revenues and US\$155 billion will accrue to the State Oil Fund (SOFAZ) in the form of royalties. The oil consortia are expected to rapidly repatriate some US\$40 billion of invested capital, plus profits. Roughly speaking, this implies an annual oil windfall of US\$1,000 per capita for the next 20 years. Unless new oil and gas reserves are discovered, that would be the

Figure 1: Oil Revenues, Profit & Capital Repatriation



Source: World Bank staff estimates

end of Azerbaijan’s oil boom. Managing this rather short-lived and volatile revenue stream in the context of the continuing transition from a post-soviet deteriorated command economy to a modern market economy, while avoiding the competitiveness pressures of Dutch disease and the “resource curse” is a central challenge confronting Azerbaijan.²

b. Reducing Poverty

8. Poverty in Azerbaijan is declining rapidly, particularly in Baku (table 1). At the national level, the proportion of poor people fell from about 44.6 percent in 2002 to 24.0 percent in 2005, a drop of 20.6 percentage points. Extreme poverty fell from 26.9 percent of the population in 2002 to 9.2 percent in 2005. These findings suggest that 1.9 million people lived in poverty in 2005, down from almost 3.3 million in 2002.

Table 1: Estimated Number of People Living in Poverty in Azerbaijan, 2002–05
(percent)

	<i>Total</i>		<i>Baku</i>		<i>Non-Baku Urban</i>		<i>Rural</i>	
	<i>poor</i>	<i>very poor</i>	<i>poor</i>	<i>very poor</i>	<i>poor</i>	<i>very poor</i>	<i>poor</i>	<i>very poor</i>
2002	44.6	26.9	41.6	25.6	48.7	31.5	43.7	24.7
2003	39.7	22.1	34.8	19.3	46.0	27.9	38.4	20.0
2004	28.5	13.4	18.6	8.0	35.4	19.0	29.6	13.0
2005	24.0	9.2	14.7	6.6	27.2	11.9	26.9	8.9
2004-2005	-4.6	-4.3	-3.9	-1.4	-8.2	-7.1	-2.7	-4.1
2002-2005	-20.6	-17.7	-26.8	-19.1	-21.5	-19.6	-16.8	-15.7

Source: Household Budget Survey and Staff estimates.

9. Reasons for the sharp drop in poverty are two-fold. Wages and salaries have more than doubled, with the minimum wage raised fivefold since 2001, albeit from a very low level. There has also been a significant surge in transfer incomes for poorer households. Government social transfers to the poorest 20 percent of households increased more than 35 percent in 2004, while pensions, the main component of the government social program, increased about 44 percent. Remittances from a significant number of Azerbaijanis working abroad are also an important source of households financing and has helped reduce poverty.

10. Systemic reforms to improve the targeting and administration of social assistance and modernize the pension and social insurance system are well underway. A new targeted social assistance scheme was rolled out in July 2006. Its impact now needs to be carefully monitored.

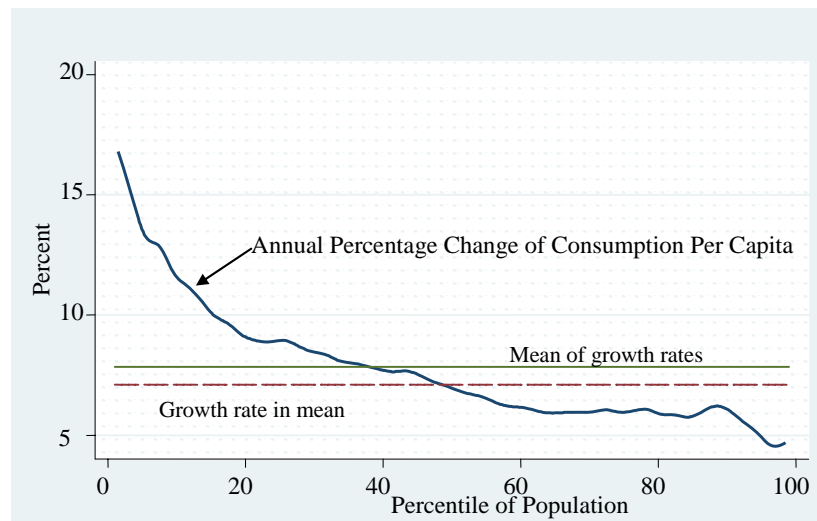
11. Most improvements in welfare have been concentrated in Baku, which saw a 26.8 percentage points decline in poverty during 2002-05 (poverty fell 21.5 percentage points in urban areas outside Baku, and 16.8 percentage points in rural areas). Lack of employment, assets, and commercial opportunities and weaker access to basic health and education services in provincial towns and rural areas are driving factors behind intense rural-urban migration. Lack of reliable electricity and other infrastructure has been a major factor discouraging investment and commercial activity outside Baku. Nevertheless, between 2004 and 2005 poverty in non-Baku urban areas fell by 8.2 percentage points, almost twice as much as in

² The potential negative effects of an inadequately managed natural resource boom are often referred to as Dutch disease. They include: (i) macroeconomic adjustment problems stemming from large foreign exchange inflows; (ii) unbalanced growth, leading to crowding out of the non-petroleum traded goods sector; (iii) waste of petroleum wealth through unproductive public expenditures; and (iv) in some cases accumulation of external debt as the resource boom increases the capacity to borrow.

Baku. While poverty prevalence is not significantly higher among refugees and internally displaced people, these groups are particularly vulnerable, because they lack assets and employment opportunities and are heavily dependent on state transfers.³

12. The growth-incidence curve below suggests that growth has been considerably pro-poor in Azerbaijan during 2002-2005 (figure 2). Growth was positive for all percentiles of the Azeri population with a mean annual growth rate in consumption of 7-8 percent. The poorest decile has enjoyed annual consumption growth of about 15 percent. In general, consumption growth for the poorer deciles is higher than for the richer deciles.

Figure 2: Azerbaijan Growth Incidence Curve, 2002-2005



Source: Household Budget Survey and Staff estimates

c. Improving Social Conditions and Meeting the Millennium Development Goals

13. Challenges remain in the social sectors. Reforms are underway to address inefficient use of resources; weak management, planning, and monitoring capacity at the central and local levels; and difficulty in adapting the educational system to the changing skills requirements of the labor market, but progress has been slow.

14. The education budget has been increased substantially, to 5 percent of non-oil GDP and 17.8 percent of the total budget in 2005. The enrollment rate for compulsory education is high, and the literacy rate is almost 100 percent, irrespective of gender and ethnicity. Beyond age 16, however, enrollment rates drop sharply, with only 13 percent of young adults age 17–24 (9 percent among children from poor families) enrolled in postsecondary educational institutions. Growing inequities in access to education has become an issue. Considerable efforts are needed to foster a globally competitive knowledge economy based on a modern curriculum; higher education brought to international standards; and vocational and adult education/retraining that meets the demands of a modern market economy. The government recently appointed an Education Commission to accelerate progress. The Bank is supporting the government’s efforts through an education adaptable program loan (APL), and plans to step up the engagement during the CPS period.

³ While the dynamics and magnitude of poverty reduction are not questionable, two factors may modify these results: underreporting on the poorest groups and under-evaluation of CPI.

15. A fundamental reform agenda needs to be implemented in the healthcare system. Life expectancy at birth in Azerbaijan – already low - has been declining, as a result of high infant, child, and maternal mortality rates, the high prevalence of noncommunicable diseases, and unhealthy lifestyle choices. The healthcare system does not deliver affordable, good-quality services to meet the needs of the population, and it suffers from very low utilization rates, particularly among the poor. The sector is undermined by major inequalities in healthcare; underfunded, poorly managed, and highly fragmented primary healthcare services; inadequate and inefficient resource allocation (the sector received just 1.6 percent of non-oil GDP in 2005); a healthcare workforce that relies on informal payments to cope with low wages and lacks incentives to provide appropriate care; and a weak governance, legal, and regulatory environment. Recent changes at the Ministry of Health provide an opportunity for moving forward on well-identified and highly needed reforms supported by the sectorwide FY06 Health Sector Reform project.

16. These challenges notwithstanding, the 2005 Millennium Progress Report ranks Azerbaijan as one of the countries that can be placed on the “fast track” for achieving the MDGs (see annex 4). The SPPRED and the SPPRSD are closely aligned with the MDGs. While both health and education were previously severely underfunded, since 2005 the government has committed a larger share of the fast rising budget to the social sectors. Given committed resources, the key is to move rapidly on needed structural reforms within the social sectors. The CPS will play an important role in this respect.

d. Improving Governance

17. Azerbaijan is going through the turbulent transition from an externally controlled non-free soviet republic toward more democracy and pluralism. This process takes place in the situation of the unsolved international conflict, partial occupation of the territory, and significant damage to Azerbaijan’s economy. Against this background, parliamentary elections in November 2005 showed important progress over previous elections, according to observers from the Council of Europe (CoE) and the Organization for Security and Co-operation in Europe (OSCE), although they did not fully meet international standards.⁴ Presidential election scheduled for 2008 will be an important opportunity for making further progress. Constructive and independent media and civil society can be allies to the administration by providing a timely feedback on policies and implementation of government strategies. As noted elsewhere, this is already occurring with respect to the oil sector, where an active external multi-stakeholder group participates in the monitoring of the State Oil Fund. Going forward, a key challenge for Azerbaijan is that the maturation of the political system keeps pace with and supports the rapid economic development. Azerbaijan is more and more recognized in the post-Soviet republics as an important player in international politics able to maintain good relations with different parties. Azerbaijan holds the chair as Secretary General of the Organization for Democracy and Economic Development of GUAM, whose other members are Georgia, Ukraine, and Moldova.

18. Progress has been made in some important areas of governance, particularly in increasing the transparency of oil revenue management. The establishment of SOFAZ⁵ and Azerbaijan's

⁴ Re-elections were held in ten precincts, in which election observers reported irregularities.

⁵ The Governance Framework for SOFAZ is published on its website www.oilfund.az and summarized in the previous CAS, April 29, 2003, Report No. 25790-AZ, p. 8. To a large extent it follows the Norwegian model, with all Oil Fund expenditures mandated to be part of the consolidated budget approved by Parliament, and executed through the single Treasury account. Financial reports are disclosed quarterly, and audited reports annually.

participation in the Extractive Industry Transparency Initiative (EITI) have resulted in an upsurge of activity of a coalition of some 90 nongovernmental organizations (NGOs) monitoring oil revenues and has expanded opportunities for civil society to engage in dialogue with the government.⁶ Azerbaijan has already reported to EITI for the three years 2003, 2004, and 2005 and is in accordance with the EITI Memorandum of Understanding signed in Baku in November, 2004.⁷ However, while the State Oil Company (SOCAR) is participating in EITI, the government has not yet committed to a firm timetable for SOCAR to be audited to international standards as required by the international criteria for EITI. Furthermore, regulatory functions are not separated from commercial ones and restructuring has been slow. In general, corporate governance and financial accountability of state-owned enterprises remain major issues weakening overall fiscal discipline. The CPS is directly supporting the EITI through the Corporate and Public Sector Accounting Project (CAPSAP) and hands-on support to implementation of International Financial Reporting Standards (IFRS) in state-owned enterprises according to the new accounting law. Open Society recently commended Azerbaijan for its leadership role in EITI.⁸

19. Azerbaijan has established an institutional framework to develop and implement a sustainable fiscal policy. The budget preparation process is governed by the Budget System Law drafted in collaboration with the Fund and the Bank. The law introduces multi-year budgeting through the preparation of a medium-term expenditure framework (MTEF) to provide the necessary link with the SPPRED and the public investment program (PIP). Both the MTEF and the PIP are to be submitted to Parliament. The law ensures that the budget provides details on expenditure allocations according to international budget classification. All Oil Fund expenditures (except administrative costs) are included in the annual consolidated budget approved by Parliament. The improvements in the budget system have been further enhanced by the introduction of a single Treasury account and the inclusion of all previously extra-budgetary operations of budget organizations in the budget, including expenditures financed by SOFAZ. Yet, inter-ministerial coordination needs to be greatly improved. The MTEF and PIP are not fully developed yet, and require further capacity building at the Ministry of Finance and the Ministry of Economic Development, while the full participation of line ministries in the budget formulation process will require extensive training. The CPS is supporting the budget formulation process through the Programmatic PER.

20. Less than adequate financial discipline, non-payments, explicit and implicit subsidies, and instances of conflict of interests in the utility and transport sectors constitute serious and difficult problems facing the economy of Azerbaijan. The resulting high economic and social costs are manifested in increasing inefficiencies and consumer losses caused by monopolistic behavior, frequent systems breakdown, as well as direct impact on health and poverty. Previously implicit subsidies to energy utilities were in the order of US\$500 million. These subsidies are now explicitly budgeted for and decreased to about US\$320 million in 2005. Yet, domestic prices on energy products are below international prices, thereby causing a significant opportunity cost for the sector. The CPS will continue to support the government's five-point program set out in the PRSC: moving to cost-recovery tariffs during the CPS period;

⁶ The CPS follows the guidance set out in the World Bank Group Management responses to the Extractive Industries Review.

⁷ Memorandum of Understanding of November 24, 2004, signed between the National Committee of EITI, the local and foreign companies operating in the Extractive Industries of the Republic of Azerbaijan and non-governmental organizations.

⁸ See *Eye on EITI*, Civil Society Perspectives and Recommendation on the Extractive Industries Transparency Initiative, October 2006, Publish What Your Pay/ Revenue Watch Institute.

increasing collections; proper regulation of natural monopolies; financial accountability through adoption of IFRS; and implementing a targeted social safety net to alleviate the impact on the poor. The government is strongly committed to the program. In July 2006 President Aliyev instructed the Cabinet of Ministers to rapidly increase collection rates for public utilities, and directions have been provided. September collection rates had doubled to 83 percent for gas and 70 percent for water.⁹ Meters are rapidly being installed. Tariffs were raised significantly for gas and water. The new Accounting Law requires IFRS. The targeted social safety net started July 1, 2006.

21. The government recognizes the need for civil service reform, but the pace of progress has been slow. Low salaries, poor organization, and weak motivation have undermined the performance of the civil service, despite an educated workforce. The Civil Service Law of 2001 is generally consistent with international standards, but implementation has been slow.

22. Corruption remains a serious problem in Azerbaijan. Despite some improvements in 2005 and in 2006, Azerbaijan still ranks low in Transparency International's Corruption Perceptions Index (130 out of 163 countries in 2006, up from 137 in 2005), and weak governance is widely perceived as an obstacle to doing business. Azerbaijan is ranked 99 in the Doing Business 2007 (out of 175 countries), and five areas need urgent attention: tax rates and administration; customs; licensing regime; and corruption. The Bank/EBRD Business Environment Enterprise Perceptions Survey (BEEPS) in 2005 also indicates that weak governance is widely perceived as an obstacle to doing business, and that corruption in fact has increased since BEEPS 2002. Nevertheless, it should be noted that of the 21 areas of "Problems Doing Business" surveyed in BEEPS, Azerbaijan fares better than the ECA average on 15. In the five areas mentioned above Azerbaijan is worse than the average.

23. The comprehensive State Programme on Combating Corruption was developed in cooperation with civil society and international organizations. The government has undertaken several initiatives such as passing new anticorruption legislation, strengthening anticorruption institutions, and creating an anticorruption office in the Prosecutor General's Office and an anticorruption department in the Ministry of Interior. The use of ATM cards for pension payments has reduced leakage. Improvement also appears to have occurred in the traffic police, where salaries increased fivefold recently and petty harassment seems to have subsided.

24. The Group of States against Corruption (GRECO) under the Council of Europe published its Evaluation Report on Azerbaijan in June 2006. The report commends the progress made on the Programme in adopting new legislation, but identifies several shortcomings in implementation, including limited cooperation and coordination by the various authorities, the need to broaden the adoption of a code of ethics to all public employees, address conflicts of interests, and strengthen liability of legal persons for corruption offences and trading in influence. The Anti-Corruption Network (ACN) for Eastern Europe and Central Asia, based at the OECD Secretariat, issued its Monitoring Report, also in June 2006, with detailed diagnostics and recommendations on speeding up implementation of the State Programme on Combating Corruption and other issues.

25. Critical reform to improve the judicial system has started, with support of IDA. World Bank Institute governance indicators show steady improvement in government effectiveness and regulatory quality. The Bank's comprehensive framework of reform dialogue with the

⁹ September 2006 collection rates for electricity were not available at the time of printing.

government will continue during the coming CPS period. However, progress is slow and the government, supported by international development institutions, needs to and can do more to combat corruption. The proposed CPS projects and AAA are designed to collectively comprise an integrated and comprehensive Governance Action Plan to support these efforts, see the section below on *Governance – a Crosscutting Objective of the CPS*. This includes governance reforms on the sector level. For example, corruption in the health sector is being vigorously addressed through the Health Sector Reform project. Issues in the education sector are being addressed through a series of Education APLs. The Pension and Social Assistance project is helping to minimize leakage of social transfers.

e. Developing the Non-Oil Private Sector

26. Azerbaijan's oil wealth offers significant opportunities to improve the environment for economic growth and create jobs in the non-oil sector. Azerbaijan offers an educated, low-cost workforce for a country at its income level. In addition to oil and gas, Azerbaijan's natural resource endowment includes lead, zinc, iron, and copper ores and a variety of building materials, such as limestone and marble. Within the non-oil sector, agriculture and agro-processing, manufacturing, transit trade and transport, and services such as communications are expected to be drivers of growth. However, complacency, due to the immediate oil wealth could slow down the urgency of necessary reforms in the business environment and hamper competitiveness of non-oil sectors.

27. Agro-processing offers good potential for growth and employment creation. At the moment, only a small number of firms in Azerbaijan process agricultural produce into higher-value products, such as juices, dehydrated fruits, wine, and jams for local and export markets. Key issues to be addressed include weak factory conditions, unreliable power supply and other infrastructure constraints, an unfavorable business environment and significant gaps in supporting industry (for example, collection networks, postharvest facilities, glass containers, testing facilities, irrigation infrastructure). Improved transport links, including transit corridors, are also critical. Even modest savings in time, improvements in quality, and reductions in costs associated with consignment movements could lead to a significant increase in demand in target markets, such as CIS countries and Turkey.

28. Growth potential also exists in activities supplying the oil and gas industry, including basic equipment and machinery, metalworking, a range of technical services, transportation services, food and hospitality services, and upstream chemical and petrochemical industries. Growth in the oil and gas industry is also likely to stimulate demand for a range of value-added telecommunications and networking services. Challenges include the need to meet strict international standards, large capital requirements, large average orders, and stringent delivery requirements, which may be difficult for local producers.

29. Trade flows are likely to increase, as two of Azerbaijan's largest and fastest-growing neighbors - the Russian Federation and Kazakhstan - may join the World Trade Organization (WTO) in the next year. Azerbaijan has set a target of joining the WTO within the next couple of years. The European Union's recent inclusion of the three Caucasus countries in its European Neighborhood Policy (ENP) could create closer trade links with Europe. Increasing purchasing power in the region is also expected to generate stronger demand for goods and services and time-sensitive transport services. A key CPS priority is to enhance the potential for regional transit cooperation to benefit not just Azerbaijan but the region as a whole as well.

30. The long anticipated regional transit corridor has taken off with the completion of the BTC pipeline, through which a million barrels of oil per day will flow from Azerbaijan through Georgia to Turkey, the Mediterranean, and beyond. The South Caucasus Pipeline (SCP) will provide gas to the cross-Turkey system from the large Shah-Deniz field. These mega-projects provide a major transit source and build confidence in cooperation with South Caucasus countries. Improving the road and rail links are logical next steps now underway.

31. Regarding the financial sector, Azerbaijan's banking system remains quite small relative to the size of the economy. Presently 44 banks operate in the country, of which 18 have foreign participation and 2 are branches of foreign banks. Many of these banks have received support from IFC and EBRD, and their performance and the range of services they provide is gradually improving. However, total banking system assets was still only about 18 percent of GDP at the end of 2005—a much lower ratio than the 30–40 percent of GDP in most transition economies in Central Europe. Following the joint IMF-Bank FSAP in 2004, new central bank and banking laws have been enacted. They are broadly consistent with Basle principles, and *de jure* provide for central bank independence and accountability. The report also made several recommendations regarding the International Bank of Azerbaijan (IBA), the country's largest and still state-owned bank. IBA presently accounts for about 49 percent of total banking system assets, down from 53 percent at the time of the FSAP. While this is a positive development, largely reflecting growth of other (mainly private) banks, the dominant presence of one large state bank should be further reduced over time by effectively opening the banking sector to foreign competition by improving the business environment in the sector. Enforcement of prudential regulations has improved with technical assistance from donors. The low capitalization and large open foreign exchange positions potentially make the banking sector vulnerable to shocks, particularly credit quality and exchange rate appreciation. Nevertheless, stress tests demonstrate high resistance of the banking sector against macroeconomic shocks. In general, the banking system should broaden its intermediation of finance to small and medium-size enterprises and to people in rural areas. Improving access to financial services is a key challenge to support savings, credit, commercial activity, and job creation in rural areas.

32. The unreliability of electricity and gas supply remains a constraint to business operation and daily life. One in four firms surveyed in the 2005 BEEPS identified electricity supply as a problem in doing business, and almost 7 percent of total annual sales were lost due to power outages. Some areas of the country receive only a few hours of electricity a day, and there are frequent localized outages and occasional widespread system failures. The gas transmission system also needs large-scale rehabilitation, and gas treatment and storage facilities are inadequate. The sector is far from financially viable. Azerenerji, the state electricity company, depends heavily on SOCAR to provide power plant fuel but lacks the ability to pay for it. Azerigas, the state gas company, is in a similar situation. Explicit subsidies are provided from the state to cover SOCAR deliveries in both cases.

f. Cleaning up the Environment

33. 130 years of oil production on the Absheron Peninsula around Baku has left some 33,000 hectares of oil-contaminated lands. The Caspian Sea is also affected. The bulk of the pollution was created by Soviet era companies that no longer exist, but the pollution has also continued since SOCAR took over in 1991. Examples of poor practice include oil and waste water spilling pouring out onto the ground at drilling sites. Some of the contaminated sites are very

near Baku, and citizens and developers are building homes and apartments on them. This represents a serious health risk and could potentially cause catastrophic fire or explosion.

34. Recently the President has ordered the urgent clean-up of the oil contaminated land. A substantial portion of the estimated 700 million barrels of oil on these lands may be recoverable, and represents a very substantial value. A significant part of the contaminated land also has high potential value for residential and commercial development once it is cleaned up. Issues, however, remain concerning ownership of the contaminated land. Furthermore, efforts are required to ensure that all existing oil operations conform to good international environmental and safety practice.

35. Venting of gas into the air is taking place from older fields in the Caspian. From one field alone about 1 million cubic meters of associated gas is vented into the air daily from wells not equipped with flaring equipment or capacity to pipe the gas. It is expected that this figure may rise to 3 million cubic meters unless new piping and compressor investments are made. This represents an opportunity for Carbon Financing.

36. The Baku sanitation system is in urgent need of reconstruction. Here, and in several other places untreated residential and industrial wastewater is contaminating rivers and the Caspian Sea. Again, this has led to heightened health hazards. Furthermore, the sturgeon population is under pressure.

37. Azerbaijan's high biodiversity results from its location at the convergence of three biogeographic regions (Europe, Central Asia and Asia Minor). The Caucasus mountains area, has been identified by the World Wide Fund for Nature (WWF) as a Global 200 Ecoregion, and by Conservation International as one of the world's 25 biodiversity "hotspots" (the only one in the ECA region). The Caucasus ecosystem profile identified deforestation, overgrazing and hunting as the three greatest direct threats to biodiversity. Underlying causes include poverty in rural areas, the end of importation of wood from other countries, the collapse of natural gas supply systems, political insecurity and the presence of large numbers of internally displaced people. With support of the Bank the government is improving natural resource management and introducing more sustainable economic activities in two mountainous areas of Azerbaijan, in order to enhance the ecological quality and the sustainable productivity of high elevation forests and pastures.

38. Azerbaijan is located in an area of high seismic activity. The country is also susceptible to heavy flooding because of its topography and the water-level fluctuation of the Caspian Sea. Landslides are a high risk during periods of increased precipitation, causing significant damage to human settlements, industry, farms, and roads. The probability of annual economic losses exceeding \$1.4 billion is about 0.5 percent. The probability of annual losses exceeding \$90 million is estimated at about 5 percent.¹⁰

¹⁰ *Preventable Losses: Saving Lives and Property through Hazard Risk Management - A Comprehensive Risk Management Framework for Europe and Central Asia*, Disaster Risk Management Working Paper Series No. 9, The World Bank, October 2004.

III. Macroeconomic Framework

a. *Recent Developments*

39. Azerbaijan's economy has grown rapidly since the late 1990s, particularly in the non-oil sectors (table 2).¹¹ In the past five years, the non-oil economy has outperformed the oil sector, growing at an average annual rate of 12 percent. The non-oil sector currently accounts for 60 percent of GDP and 99 percent of employment. Since 1995 output in the agricultural, commercial, and social sectors has roughly doubled, non-oil industrial output has tripled, output in transport and communication has quadrupled, and construction has increased by a factor of 13.¹²

40. Azerbaijan has exercised sound macroeconomic management in the face of high levels of net foreign direct investment (FDI). Sterilization of oil receipts, together with prudent fiscal policies, has prevented inflation and sustained appreciation of the real exchange rate for most of the period since 1995. Large external current account deficits in 2003-04 were associated with high oil sector imports related to the BTC and SCP pipelines and upstream oil platform development. The deficit was fully financed by FDI

from international oil consortia, and the overall balance of payments recorded a surplus. In 2005 the current account turned into a small surplus (1.3 percent of GDP), as the BTC was largely completed and high oil prices drove up export earnings. Net FDI inflows peaking at 32 percent of GDP in 2003 declined to around 4 percent in 2005 and are projected to turn into large net outflows in 2006-09, as capital repatriation from the oil and gas investments begins.

41. From unsustainably high levels in the early 1990s, the consolidated government deficit without Oil Fund net revenues declined to less than 2 percent of GDP in 2001.¹³ However,

Table 2: Summary of Key Indicators
(in percent of GDP unless indicated otherwise)

	2001	2002	2003	2004	2005*
Real GDP growth (percent)	9.9	10.6	11.2	10.2	26.4
Real Non-Oil GDP growth (percent)	10.4	12.3	15.5	13.4	8.4
Inflation (CPI, period average, percent)	1.5	2.8	2.2	6.7	9.7
GNI per Capita (US\$ Atlas)	660	720	820	950	1240
Current account balance	-0.9	-12.3	-27.8	-29.8	1.3
Net Foreign Direct Investment (US\$ mln)	227	1,067	2,352	2,351	459
Real effective exchange rate (percent, - depreciation)	-6.1	-7.1	-10.8	-3.5	7.5
Consolidated fiscal balance	-0.4	-0.5	-0.8	1.0	2.7
Consolidated fiscal balance, excl. Oil Fund	-1.4	-4.3	-4.2	-2.5	-2.3
Consolidated budget revenues	18.7	27.3	26.8	26.8	26.5
Gross fixed investment	22.9	34.1	52.9	57.7	44.1
External debt outstanding	22.8	24.0	24.0	22.8	15.0
External debt service to exports ratio (percent)	5.3	5.9	6.6	5.3	2.6
Crude oil price (US\$/barrel)	24.4	24.9	28.9	37.7	53.4

Source: State Department of Statistics, Bank and Fund staff estimates. *2005 data are estimates

¹¹ For a detailed analysis of developments in the Azerbaijan economy during this period, see *An Integrated Non-Oil Trade and Investment Strategy (INOTIS)*, World Bank November 2003, and *Public Expenditure Review*, World Bank, December 2002.

¹² Much of the increase in construction is related to the oil sector, but the increase also reflects a housing boom in Baku.

¹³ Consolidated government deficit excluding the Oil Fund is calculated by deducting the revenues and expenditures of the Oil Fund from the consolidated government budget balance.

fiscal adjustment in the 1990s required deep expenditure cuts, especially in the social sectors, which has led to suboptimal health care and education services. With the 2005 budget the government has started to allocate more adequate resources to the social sectors.

42. To avoid Dutch disease, in 1999 the government established SOFAZ as the main sterilization mechanism for foreign exchange inflows. The government has remained committed to exercising caution over the use of the expected oil and gas windfall and to ensuring that it benefits all citizens and future generations.

43. Early 2005 saw an upsurge in inflation (12.5 percent in March 2005, on a year-to-year basis), in part due to higher levels of public spending but also as state-owned enterprises that benefit from higher oil revenues (SOCAR) and access to credit increased spending. A temporary rise in food prices also increased inflation, and the policy of fixing the manat to the U.S. dollar resulted in an expansion of the monetary base. The National Bank's response has been to allow the manat to appreciate by about 10 percent in nominal effective terms and raise the refinancing rate. The Ministry of Finance increased the issuance of T-bills to absorb liquidity. Inflation returned to single digits by fall 2005, and was 10.3 percent in September 2006 on a year-to-year basis.

b. Medium-Term Outlook

44. Azerbaijan's medium-term growth prospects are strong. Real GDP is projected to grow at an average annual rate of about 24 percent between 2006 and 2008, due to continued rapid growth in the oil and non-oil sectors (table 3). The decline in oil-related investments is counter balanced by the government's intensive efforts to rebuild the country's infrastructure and human capital to catch up with more than a decade of deterioration. However, competitiveness of the non-oil sector is likely to be challenged by an appreciating real effective exchange rate due to higher oil revenues and rapid monetary expansion as a result of the fiscal stance.

45. The 2006 budget contains a major fiscal expansion. While nominal GDP is expected to grow at 42 percent, current expenditures are budgeted to increase over 60 percent, and the public investment budget is planned to triple. The non-oil primary deficit is expected to increase from 11 percent of non-oil GDP in 2005 to over 30 percent in 2006.

46. The IMF and the Bank have expressed concern that this rate of public expenditure increase may cause new inflationary pressures. The authorities counter that over the past years, Azerbaijan's economy has been able to absorb FDI of more than 30 percent of GDP a year in connection with the BTC, the South Caucasus Pipeline, and upstream oil development. As these investments end, the government is gearing up for its own large infrastructure investments. The authorities are well aware of the inflation risks and would slow the rate of infrastructure investment and consider other offsetting measures if inflation gets too high. The government is also fully aware that constraints to institutional and absorptive capacity may slow the execution of the large investment program.

47. During 2007-08 government spending is projected to increase by about 35 percent p.a. (in nominal terms) as the reconstruction agenda continues.¹⁴ Elections are scheduled for 2008. From 2009 it is projected that the rise in spending will slow down to about 10 percent p.a. The

¹⁴ Based on estimates from the Bank's sector experts, the projections assume that the reconstruction cost would be in the order of US\$20-30 billion in total spread over 6-10 years. This figure should be seen in comparison with projected government revenues from oil and gas of US\$175 billion during 2006-2024, as noted above.

non-oil fiscal deficit is expected to peak at over 40 percent in 2007-08 and steadily decline thereafter. Such a government strategy would be fiscally sustainable with today's oil prices. It would result in Oil Fund assets reaching about US\$35 billion in 2010. However, the current strategy contains substantial risks of over-heating the non-oil economy, and as experience in other countries shows, the risks of Dutch disease and the "resource curse" are substantial. Inflation is expected to rise to about 17 percent p.a. in 2007-08, before falling back to the ten percent range.

48. Mitigating these risks requires aggressive pursuit of structural reforms, which would unleash domestic resources, reduce operating costs, and increase productivity, to counter the adverse impact of the appreciating real effective exchange rate (REER), see box 1. However, these structural reforms and rebuilding a competitive infrastructure will take some time to have effect. In the short-term the pressures on non-oil competitiveness are mitigated by the fact that the real effective exchange rate has depreciated considerably against other countries since 1995, and that wages are relatively low in international comparison (see box 1). Yet, the trade-off made by the government of temporarily increasing public investment at the cost of higher inflation may lead to suboptimal private sector expenditure behavior formed by expectations of continued domestic inflation. Azerbaijan's experience suggests that monetary policy may not be sufficient to offset the impact of fundamentals on the REER dynamics in the medium term. Therefore the appreciation of the REER can likely not be avoided in any event. Nominal exchange rate appreciation can counteract inflation and these expectations. Both domestic inflation and exchange rate appreciation would lead to a capital loss in domestic currency on accumulated resource revenues denominated in US dollars.

Table 3: Macroeconomic Framework 2006 - 2010

(in percent of GDP unless indicated otherwise)

	2005	2006	2007	2008	2009	2010
Real GDP growth (percent)	26.4	24.6	27.1	19.9	11.6	5.7
Real Non-Oil GDP growth (percent)	8.4	8.9	8.4	8.1	6.8	6.8
Inflation (CPI, period average, percent)	9.7	13.0	17.0	17.0	13.0	10.0
GNI per Capita (US\$ Atlas)	1,240	1,650	2,400	3,330	3,940	4,450
Current account balance	1.3	14.4	21.3	25.0	24.4	21.3
Net Foreign Direct Investment (US\$ mln)	459	-1,539	-4,120	-1,456	-667	81
Consolidated fiscal balance	2.7	7.5	8.5	24.5	27.0	24.7
Consolidated fiscal balance, excl. Oil Fund	-2.3	-7.2	-13.8	-17.8	-16.1	-14.1
Consolidated budget revenues	26.5	40.8	45.3	63.9	64.7	61.4
Gross fixed investment	44.1	39.7	36.6	36.4	36.0	37.3
External debt outstanding	15.0	10.5	8.9	7.9	7.5	7.8
External debt service to exports ratio (percent)	2.6	0.9	0.9	0.8	0.8	0.9
Crude oil price (US\$/barrel)	53.4	65.3	60.1	56.1	52.5	49.1

Source: Bank and Fund staff estimates and projections.

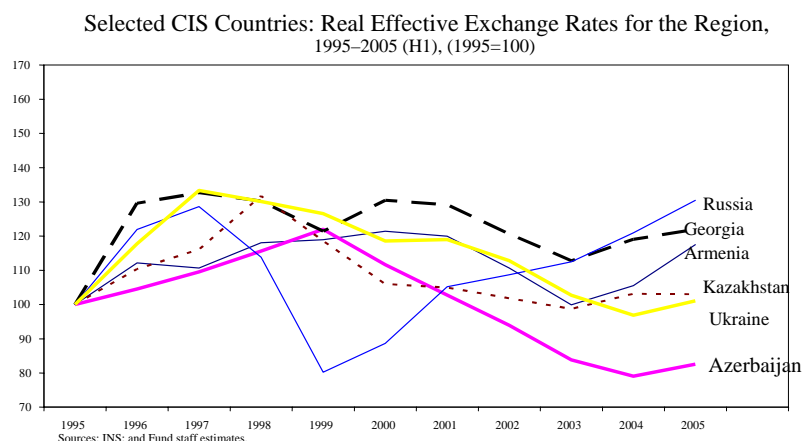
49. High inflation has been shown to have a negative impact on resource allocation, investment incentives, trade, financial intermediation, and, as a result, economic growth. It is potentially more costly than the short-term repercussions on exporters and foreign currency deposit holders related to nominal exchange rate adjustments. Moreover, lower income segments of society likely suffer disproportionately from high inflation. Greater exchange rate flexibility could also support financial market development and discourage purely speculative inflows. However, although nominal exchange rate appreciation could help reduce inflation pressures, prudent macroeconomic and structural policies will be essential. Fiscal restraint by phasing the implementation of the public investment program remains an important instrument for curbing

the inflationary impact of excessive domestic demand. It should be accompanied by a prudent monetary policy framework, geared toward containing upward pressures on the real exchange rate. The main sterilization instrument will continue to be the Oil Fund and restraint on its financing of non-oil deficits.

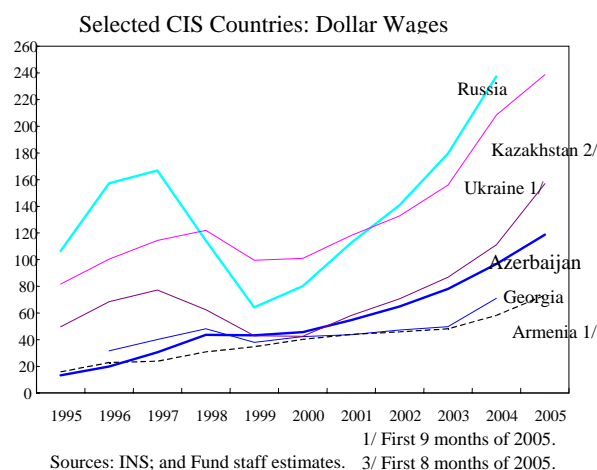
Box 1: Non-Oil Sector Competitiveness

Since the beginning of Azerbaijan’s transition process, three different periods of in the real effective exchange rate (REER) series can be distinguished:

- The REER appreciated steeply, by 46 percent, between January 1995 and September 1998.
- In the immediate aftermath of the Russian crisis, the REER began a depreciation that lasted until July 2004, as a result of which it had fallen to a level 36 percent below its peak of September 1998 and 7 percent below that of January 1995.
- Between July 2004 and November 2005, the REER appreciated by 14 percent, however remaining 27 percent below its peak. Azerbaijan’s REER has remained the most depreciated in the region since 2001.



Fundamental factors will likely cause strong real appreciation pressure. In fact: (i) oil exports are projected to increase by 45 percent on average during 2006-09, reaching about 60 million tons towards the end of the decade; (ii) the external environment is assumed to remain favorable; (iii) investment inflows are expected to continue against the background of Azerbaijan’s ongoing transition to a market economy; (iv) substantially higher government expenditures are expected to lead to demand and inflationary pressures; and (v) large-scale wage increases, induced by government-led increases in the minimum wage will continue to exert cost pressures. [Nevertheless] the wage level in Azerbaijan remains below the average attained in regional comparator countries.



Source: Republic of Azerbaijan - Selected Issues, IMF March 2006.

50. During 2006–07 about a quarter of gross national income (GNI) is expected to leave the country, as foreign investors repatriate capital. While GDP is expected to almost triple in US dollar terms between 2005 and 2009, the production-sharing agreements with the oil consortium call for accelerated capital repatriation when oil prices are higher. Foreign investors are projected to repatriate about US\$8.2 billion in 2006, about the size of GDP in

2004. Adjusted for capital repatriation, per capita GNI in 2005 was US\$920 and is projected to be US\$1,140 in 2006 and US\$1,690 in 2007. The CPS takes account of repatriation in its transition planning for the phasing out of IDA support to Azerbaijan.

c. *Debt Sustainability*

51. Azerbaijan's external debt, about 50 percent of which is on concessional terms, is expected to remain sustainable. External debt, at about 15 percent of GDP, and debt service obligations, at 2.6 percent of exports of goods and services in 2005, are moderate (DRS data). Both ratios are expected to decline further. IDA total debt outstanding from Azerbaijan is US\$525 million, with a debt service to export ratio of 0.1 percent. IDA debt service represented 4.9 percent of total public debt service in 2005 and is expected to increase to 7.3 percent by 2008. In November 2005 Fitch increased its sovereign rating for Azerbaijan on long-term liabilities in both foreign and national currencies from BB- to BB. The rating on short-term foreign currency remained unchanged at B. The long-term rating forecast is "stable." Moody's assigned Azerbaijan a foreign and local currency issuer rating of Ba1 in September 2006.

IV. The Government's Strategy for Reducing Poverty

a. *The Poverty Reduction Strategy Paper (2003–05)*

52. The SPPRED recognized the role of the private sector as crucial to sustaining development and strengthening public social service delivery. Key strategies for reducing poverty and increasing living standards included improving public expenditure management and strengthening the financial and utility sectors.

53. The Joint Staff Assessment (JSA), presented to the Board in May 2003, concluded that the SPPRED presented a credible poverty reduction strategy and provided a sound basis for Bank and Fund concessional assistance. It noted, however, that poor governance and weak implementation capacities were bottlenecks.

54. The Joint Staff Advisory Note (JSAN) on the second Annual Progress Report found continuing evidence of poverty reduction and strong real growth performance. It also noted other areas that require continued attention, such as strengthening poverty diagnostics, enhancing coordination of macroeconomic policies and reducing inflation to single digits, improving the funding and effectiveness of social services, reducing energy subsidies, reforming customs, deepening financial intermediation, improving governance, and addressing the barriers to private sector development, including underdeveloped infrastructure.

b. *The State Programme on Poverty Reduction and Sustainable Development (2006–15)*

55. The SPPRS will continue to pursue similar strategic goals: ensuring economic growth and maintaining macroeconomic stability; creating enabling conditions to improve income-generation opportunities, especially in the non-oil sector, in the regions, and in rural areas; improving the quality of and ensuring equal access to basic health and education services; improving public administration and good governance; improving public infrastructure; reforming the social protection system to better protect vulnerable groups, especially children; improving the live conditions of refugees and internally displaced people; ensuring that government policies and programs in all sectors promote and protect gender equality; and ensuring that all economic development policies, programs, and related legislation respect the principles of environmental sustainability.

56. The SPPRS is aligned with the MDGs and with other programs in Azerbaijan. It sets both general and specific targets. It is intended to be integrated with the Medium-Term Economic Framework (MTEF), Public Investment Program (PIP) and State budget processes. It is based on a broad participatory process involving the government, international organizations, and civil society. It provides for a system of monitoring the implementation and impact of the measures on living standards, and it incorporates gender, youth policy, environmental, and other cross-cutting issues.

V. FY03-06: Track Record and Lessons Learned

a. Achievements of the FY03-05 CAS and Remaining Challenges

57. The experience in Azerbaijan over the past few years generally has been positive. The Bank worked with the government to establish a meaningful poverty reduction strategy and, based on this, provided adjustment credits to support the government in implementing significant reform in individual sectors. The Bank Group strategy to support the SPPRED was organized into four strategic goals: (i) manage the oil boom to maintain macroeconomic stability, avoid “Dutch disease” and facilitate non-oil growth, employment and pro-poor expenditures; (ii) generate jobs and non-oil growth by improving the business environment and access to financial services, building SME support infrastructure, and stimulating agriculture; (iii) improve infrastructure and social services by reversing the decline in social services and assistance and developing energy, transport, and water infrastructure; and (iv) help realize the oil potential to the extent and within the time-frame the SPPRED presumes.

58. The CAS period saw substantial progress in all four strategic directions. Particularly strong results were seen in the first and fourth pillars: managing the oil boom and helping realize the oil potential. GDP grew on average 11 percent per year over the past four years with non-oil GDP growing at 13 percent a year; the BTC pipeline was completed; development of gas fields and other pipelines are on schedule; the Oil Fund is firmly in place, the budgetary framework is being implemented, and the government’s commitment to maintaining high standards of governance and transparency in the utilization of its energy revenues was demonstrated by its groundbreaking participation in the EITI, as the first and only country in the world reporting for 2003 and 2004. However, progress on SOCAR restructuring has been slow.

59. Good progress was also made toward the second goal, although progress was slower in some important areas. Sustained growth was seen in the non-oil sector and progress was made in most areas supported by the Bank, including the financial sector, land market, rural credit, irrigation, and environment. However, considerable work remains to be done to improve the business environment, competition in the banking sector, and eliminate corruption. Progress on privatization and improving the transparency of state owned enterprises has been slow.

60. In the social sectors, IDA had significant impact through the dialogue on pension and social assistance and comprehensive reforms are underway. The government also strengthened its care to IDPs and began seeking sustainable solutions to improving their living conditions and economic opportunities. In the education sector, progress was made in developing new curricula, provision of free textbooks, and monitoring education outcomes. Restructuring continued in the water and energy sectors, although limited progress was made on increasing private sector involvement. The health sector remained an area of serious concern, but time was well spent on completing a Health Sector Review. The change in the ministerial leadership

in 2005 made it possible to move rapidly forward with a major and well-researched Health Sector Reform Project.

61. Table 4 summarizes lessons learned. The CAS Completion Report in annex 3 provides a detailed evaluation of the FY03-05 CAS period.

Table 4: Lessons Learned from the Country Assistance Strategy FY03–05

<i>Key Lessons</i>	<i>Implications for the Bank</i>
Intensive and consistent Bank policy dialogue over a considerable time period played a critical role in building consensus and advancing policy and institutional reforms in a range of areas.	Maintain a consistent policy dialogue. Continued Bank policy dialogue can play a pivotal role in advancing a range of difficult reforms.
Close integration of policy dialogue and investment lending and a closely knit country team enhanced the Bank’s effectiveness.	Ensure close alignment of policy advice, investment lending, and technical assistance. Maintain intensive coordination among Bank Group team members in program content, advice, and project supervision.
The shift toward “programmatic” economic and sector work, rather than traditional large analytical reports, resulted in a series of timely policy notes and workshops.	Expand programmatic analytical work to other sectors to enhance policy dialogue and the dissemination of knowledge.
Regional cooperation and integration has been politically difficult, but it will be increasingly important for the region to sustain growth.	Anticipate and prepare for increasing regional integration and possible regional-level assistance, such as development of the transit corridor.

b. The FY06 Program

62. The objectives of the CAS were successfully continued during FY06, despite Parliamentary elections in the fall of 2005 that brought new ministers to the ministries of finance, economic development, health, and agriculture. The Bank supported major intensification of governance reform with the new Judicial Reform Project (SDR14.8 million [US\$21.6 million]) and the new Health Sector Reform Project (SDR34.3 million [US\$50 million]). The second phase of the Agricultural Development and Credit APL (SDR20.1 million [US\$29.2 million]) was also negotiated, and all three projects were presented to the Executive Board in June 2006. Furthermore, Azerbaijan is now rapidly moving to IBRD status with the Highway-II Project of US\$200 million approved in January 2006. FY06 also saw additional financing of SDR3.5 million (US\$5 million) for the Rehabilitation and Completion of Irrigation and Drainage Infrastructure Project and the restructuring of some undisbursed funds of IBTA-2 for avian flu emergency purposes. IFC invested US\$13.3 million in four projects in financial markets to support leasing and financial intermediation to medium, small and micro-enterprises (SMEs). On the technical assistance side IFC PEP-Central Asia continued working on developing the expansion of leasing and housing finance as well as helping local banks and companies build capacity through its corporate governance project. IFC also continued working with BP on supporting local suppliers through the ACG/BTC SME linkage program.

c. Current Portfolio Status

63. The current IDA/IBRD portfolio consists of 18 projects (16 IDA plus two IBRD). To date total commitments are about US\$940 million, of which US\$423 million remains undisbursed. Eight ongoing infrastructure projects are designed to enhance economic growth. These include

major commitments to rural development, irrigation, water supply, and the highway sector. These commitments will be continued through new operations that will come on board as the current ones expire during the new CPS period. The Bank has also entered into its first IBRD project in power transmission, which will continue for the life of the new CPS. As of June 2006, IFC committed portfolio is US\$49 million and outstanding portfolio is US\$41 million. The portfolio is mostly in the BTC project (63 percent) and financial markets (34 percent), specifically in four local financial institutions.

64. In the social sectors, the Bank is currently providing support for an education APL, a next phase of which is expected in the new CPS. The Health Reform LIL closed this year and is followed on by a sector-wide approach. IDA is also supporting pensions and social assistance reform as well as raising the living standards of internally displaced people through ongoing projects.

65. Generically, there are few problems with project performance and the average FY05-06 disbursement ratio was about 20 percent. The 2005 Country Portfolio Performance Review (CPPR) stressed the importance of strong supervision of TA activities, and of increased attention to project processing to avoid delays.

VI. The Country Partnership Strategy, FY07–10

66. The main thrust of the earlier agenda was helping the government manage and use its oil revenues. The new challenge for the government is to build on the opportunities provided by this revenue to establish a diversified market economy. The CPS is designed to help mitigate the current risks of Dutch disease and the “resource curse.” The Bank will help ensure that oil revenues are used wisely, that institutional and policy reform is undertaken, and that appropriate capacity building and fiduciary oversight are provided.

67. The objective of sustainable and balanced growth involves integrating rural regions and secondary cities with the capital area and securing equitable basic service standards, such as electricity, gas and water supply, and easy access to markets across the country. It also requires regional integration of markets across the South Caucasus, the Caspian, and the Black Sea area. Human development will be a critical element in helping build a competitive diversified economy. Maintaining a clean environment and ensuring prudent use of natural resources is also essential to ensure sustainable growth and to improve health outcomes.

68. Strengthening governance is a key element of this agenda and a crosscutting, high-priority objective of the CPS. The new strategy will improve public sector management and support judicial reform; strengthen the system of checks and balances, external and internal audit functions, and institutions supervising financial markets; and increase local participation and community empowerment.

69. The CPS will support four main pillars (figure 3):

- **Pillar I: Improving the quality and transparency in public sector governance**, by maintaining a stable macroeconomic framework that makes prudent use of oil revenues; improving public expenditure planning and management; strengthening financial management and procurement systems; establishing proper public sector and corporate governance, accounting, and auditing; creating an administrative and

regulatory business environment conducive to growth; and strengthening the judicial system.

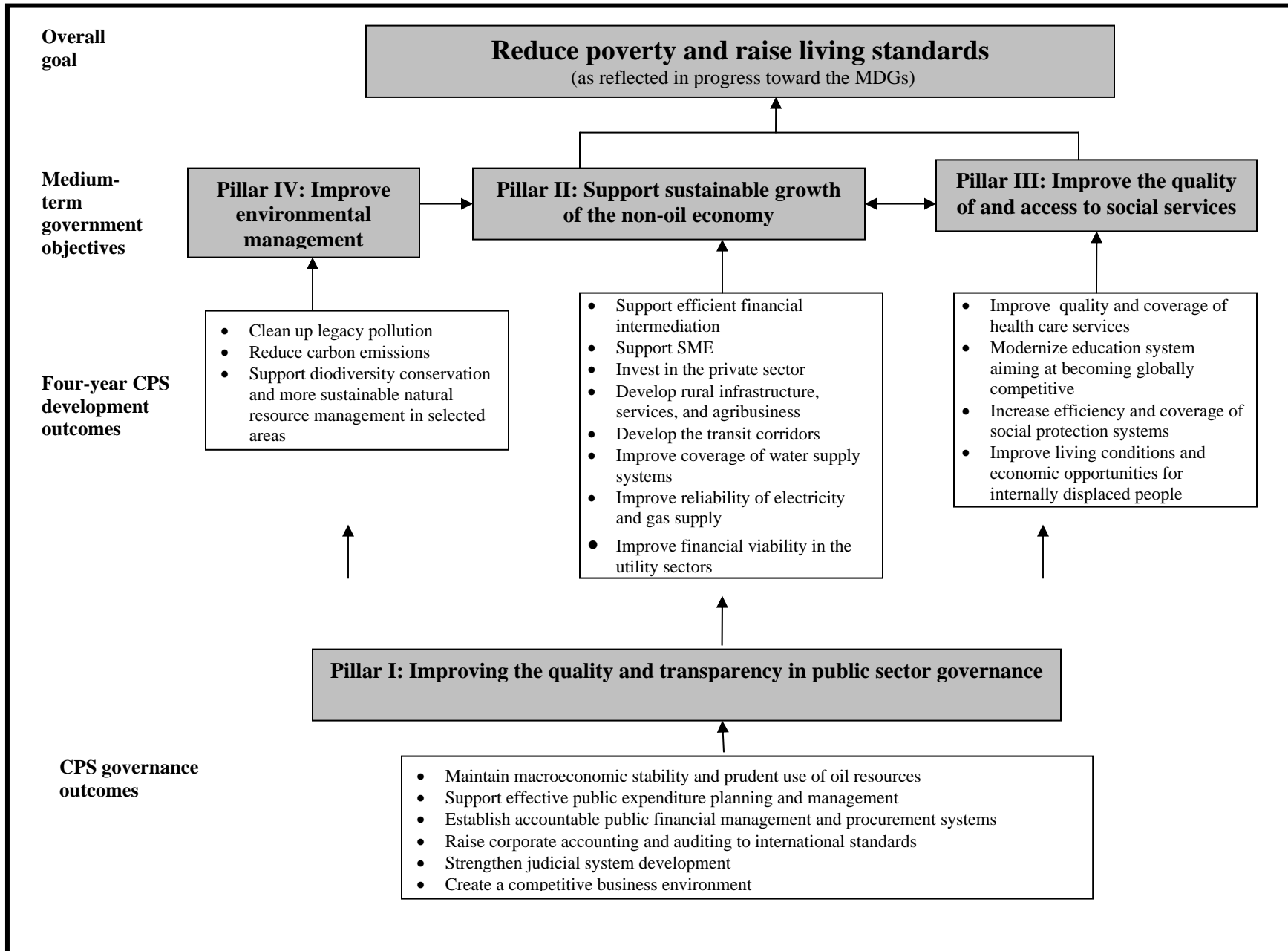
- **Pillar II: Supporting sustainable and balanced growth of the non-oil economy**, by expanding access to financial services; supporting the development of SMEs and investing directly in the private sector; developing rural infrastructure and services; improving the quality of and access to roads and other transit routes; improving the quality and coverage of water and sanitation nationwide; increasing the reliability of electricity and gas supply; and strengthening the financial viability of the utility sectors.
- **Pillar III: Increasing the quality of and access to social services**, by expanding coverage of good-quality health care services; developing a modern and globally competitive education system; effectively targeting social assistance; creating a more transparent, affordable, and sustainable pension system; and improving living conditions and economic opportunities for internally displaced people.
- **Pillar IV: Improving environmental management**, by cleaning up legacy pollution, reducing carbon emissions, promoting biodiversity, supporting more sustainable natural resource management in selected areas, and strengthening natural disaster management.

70. The government and the Bank will continue to implement the reform framework laid out in the PRSC. Although early in the CPS consultation process, the decision was made to discontinue the second and third PRSC operations, as there is little rationale for providing general budgetary or balance of payments support given the rapid inflow of oil revenues, the government has nevertheless affirmed its commitment to the PRSC agenda, which remains the underlying policy framework for the CPS, as summarized in the Results Matrix (annex 1). From a practical standpoint, the CPS selectively supports the implementation of the reform agenda through a combination of the programmatic AAA and reform components of the various investment projects. Table 5 summarizes the reform areas of the PRSC and the main CPS instruments that support their continued implementation. The CPS interventions also form a comprehensive and coherent governance action plan, which is described in section g below.

Table 5: CPS support to the ongoing Structural Reform Agenda

<i>PRSC Structural Reforms</i>	<i>Main CPS Instruments</i>
Macro management	CEM, Quarterly monitoring reports
Prudent use of oil revenues and EITI	CEM, Programmatic PER, CAPSAP
Budget reform, MTEF, PIP	Programmatic PER
Public sector financial accountability	CAPSAP
Improve business environment	FIAS TA
Improve financial sector solidity	Financial Sector Modernization project
Accounting reform incl. SOCAR	CAPSAP
Utility sector reform	Energy and Water projects
Transport sector reform	Transport projects
Health reform	Health Reform project
Education reform	Education APL
Social assistance and pension reform	Social Protection projects
Address environmental responsibilities	Environmental Cleanup and Carbon Emission projects

Figure 3: Objectives and Outcomes of the Country Partnership Strategy in Azerbaijan



a. Pillar I: Improving the Quality and Transparency in Public Sector Governance

71. Weaknesses in basic public service delivery stemming from governance problems and institutional capacity constraints remain important impediments to sustainable development and poverty reduction in Azerbaijan. Addressing these weaknesses is a key medium-term objective of the government's public sector reform program and an important strategic goal of the CPS.

Maintaining a Stable Macroeconomic Framework

72. Macroeconomic management to date has been prudent, preventing Dutch disease. Maintaining macroeconomic stability during the current investment boom and imminent spike in oil revenues remains a challenge. The IMF will continue to assist the authorities in macroeconomic management through close policy dialogue in the context of Article IV consultations and TA. The Fund will take the lead on exchange rate and monetary policy advice. The Bank will support macroeconomic management in the medium term and develop long-term projections for sustainable fiscal and monetary policies under alternative oil price trajectories through just-in-time policy papers and a **Country Economic Memorandum (CEM)**. A two-sector RMSM-X, an elaborate Oil Model, the IMF Financial Programming Model, and monthly time series-based early warning systems will be used to monitor the macroeconomic situation.

Improving Public Expenditure Planning and Management

73. The **Programmatic Public Expenditure Review (PPER)** will support efficient and transparent budgeting and fiduciary arrangement, starting with the state consolidated budget and SOFAZ. Informed strategic priority setting and vertical as well as horizontal accountability to Parliament and civil society is at the core of good governance. Appropriate governance frameworks were established under the previous CAS. They now need to be fully implemented and used.

74. With IDA assistance, the government has established the MTEF and PIP for the budget formulation process. As in other countries, it will take some years to build the capacity to bring these strategic exercises to sufficient quality. During the CPS period, technical assistance and the PPER will support the MTEF and PIP mechanisms to secure financing for priority needs while strengthening the linkage between policy objectives set in the SPPRS and the annual public expenditure programs. With these mechanisms, the government aims to strengthen the coordinating framework for all ministries to operate within a strategically prioritized expenditure framework and a predictable resource envelope. The budget calendar, as stipulated in the Budget Systems Law, entails a much stronger participatory process that includes line ministries and other budgetary organizations. The regulations related to the Budget Systems Law have been adopted, and budget process manuals will be approved. Considerable training will also be undertaken in the Ministry of Finance and other line ministries. The Bank will work closely with USAID through its Public Investment Policy and Efficiency project and with the U.S. Treasury budget advisor. Results of these interventions will be monitored within the Public Expenditure and Financial Accountability (PEFA) self-assessment framework

75. The Chamber of Accounts was established and initial capacity building provided under the previous CAS. Under the CPS, a twinning arrangement will be sought to help the Chamber of Accounts conduct audits of public institutions and connect on line to the new computerized Treasury Information Management System (TIMS), which should be fully functioning in 2007.¹⁵ The capacity to conduct transparent procurement processes will be further strengthened through an **e-procurement** grant from the Institutional Development Fund (IDF). Results will be monitored using the Public Internal Financial Control (PIFC) framework and the CPAR Update.

Strengthening Governance Mechanisms and Increasing Financial Transparency

76. To promote good governance in the financial and the corporate sectors, including state-owned enterprises, the CPS will focus on enabling high-quality financial reporting and accounting and auditing standards through adoption of IFRS and International Standards on Auditing (ISA). Supported by IDA, Technical Aid to the Commonwealth of Independent States (TACIS), and other donors, the government has enacted a new accounting law and started drafting related secondary legislation.¹⁶ **CAPSAP** will also support the transition of corporate financial reporting to international standards, as stipulated in the law, including the hiring of accounting companies and installation of systems such that major state-owned enterprises can comply with these standards. SOCAR is now training the accountants who will implement IFRS and eventually make it possible for SOCAR to have auditing and disclosure to international standards. The Bank is supporting this important transformation and training programs over the next several years, which will also support EITI. Results of this program will be monitored through the CFAA Update and Reviews of Standards and Codes (ROSCs) on corporate governance, accounting and auditing¹⁷. Furthermore, IFC **Corporate Governance Project** will continue to provide in-depth technical assistance to Azerbaijan's joint-stock companies and banks that are interested improving their corporate governance practices.¹⁸ In addition to the general introduction of international best practice corporate governance standards to banks and joint-stock companies, the project will also assist government agencies to improve corporate governance legislation and regulatory framework.

¹⁵ Development of TIMS, based on an IMF-supported design, is supported by IDA. IDA is funding the computer hardware; USAID is funding the software.

¹⁶ This legislation mandates the use of pure IFRS by public interest entities (defined as entities representing a noticeable public interest because of their activity, their size, their personnel or their legal status) and the use of National Accounting Standards (simplified IFRS) by all entities except microenterprises and natural persons, for which a simplified accounting system is sufficient. It also establishes an appropriate framework for the governance of accounting standard setting, under the responsibility of the Ministry of Finance

¹⁷ The Bank and the IMF are also providing technical assistance to the Azerbaijan National Bank, which is in charge of developing anti-money laundering/counterterrorism financing measures, including drafting an anti-money laundering law and creating a financial intelligence unit. The current draft anti-money laundering law, which is expected to be submitted to Parliament soon, is broadly consistent with the FATF 40+9. Consistency of the overall legal framework of Azerbaijan with anti-money laundering/counterterrorism financing measures is being addressed.

¹⁸ Azerigazbank and Azel (Azerbaijan Electronics) have been selected as pilot companies. IFC is working closely with them to revise their corporate documents and improve their governance standards to bring them into line with worldwide best practice.

Reforming Public Administration and the Civil Service

77. A keen interest has developed at the highest levels of government in quickly making Azerbaijan a twenty-first century information society. The State Programme on Development of Communication and Information Technologies, approved by the President in October 2005, outlines a wide range of activities, including e-government. The CPS will support the modernization of public sector administrative systems and organization in close alignment with the state program and the ENP Action Plan.¹⁹ The Bank will support **E-Government and Public Sector Reform** activities in areas such as design and implementation of e-procurement, systems for personnel and financial management, and public service interfaces. It may also support information and communication technology in education and creation of regional information training centers; Internet access centers; special economic zones in order to prevent a digital divide, especially among young people; and development of the information and communication technology sector. The Bank's support would be in the form of analytical work, TA, and possibly project implementation. Progress will be monitored within the framework of the European Commission, Country Policy and Institutional Assessment (CPIA), and World Bank Institute (WBI) Governance Indicators.

Strengthening the Judicial System

78. The **Judiciary Reform Project** is supporting the government's ongoing reform program to improve the functioning of the civil, criminal, and economic courts by strengthening the management capacity of judicial institutions, upgrading court facilities by building and rehabilitating courthouses and providing technology and equipment, strengthening the professionalism of judges and justice sector staff by providing training and upgrading training facilities, and improving citizen access to information. The project seeks to have a measurable impact on a national scale, with special attention to the Baku area, which accounts for about 60 percent of the caseload, as well as other regions that merit targeted attention. Progress will be monitored within the overall framework of Azerbaijan's Council of Europe membership and the Judiciary Reform Project results framework.

Improving the Business Environment

79. Azerbaijan is in the process of joining the WTO. The U.S. Trade and Development Agency (USTDA) is funding a resident advisor to support this process by helping identify and amend areas in legislation that need to be changed and ensure that standards, policies, and practices are in line with WTO mandates. The Bank and FIAS will continue to support this process through policy dialogue and TA for the WTO-consistent regulatory development, such as new investment and competition laws.

¹⁹ The European Commission is leading the efforts on public sector and civil service reform. These reforms will gain considerable impetus as the ENP Action Plan moves forward and the vast range of instruments and experience from EU accession countries is activated. Other donors are leading the support to core civil service reform, such as human resource management and ethics; the CPS focuses on efficient public service delivery and transparency.

80. IFC with FIAS will continue to help improve the business climate and identify impediments to foreign investments. Removing administrative and regulatory impediments to starting and operating businesses remains a high priority objective of the CPS. The Bank/FIAS INOTIS report of FY03 laid out an overall strategic framework and detailed action plans. FIAS is currently advising the government on streamlining of the licensing regime. Another barrier identified in the Doing Business Report in 2006 was “starting a business” which reportedly averaged 115 days. Supported by the PRSC, the regulations for registration of legal entities were streamlined, and the latest Doing Business in 2007 shows a reduction to 53 days. The registry will be computerized under the **Judicial Reform Project**, which will also strengthen economic courts. The **Cadastre and Real Estate Registration Project** will support the establishment of a nationwide immovable property registration system. This project aims to make property rights more secure and better allow real estate to be used as collateral for credit.

81. FIAS will continue to conduct in-depth administrative barriers diagnosis, and work with the government on Doing Business focused and licensing reforms as well as regulatory governance arenas. IFC is also active through PEP-Central Asia, in strengthening the **corporate governance** and building financial intermediaries’ capability. IFC plans to establish a baseline assessment and progress which will be monitored through the SME Surveys and Policy Recommendations. This will further guide CPS policy interventions and the Bank’s **Structural Reform TA** program. BEEPS, FIAS and Doing Business surveys will be conducted regularly to monitor progress on business environment reforms and will further guide CPS policy interventions and the Bank’s Structural Reform TA program.

b. Pillar II: Supporting Sustainable Growth of the Non-Oil Economy

82. Significant investment in infrastructure and transit corridors; continued governance reforms, particularly in the utility sectors; and greater access to financial services will be needed to develop Azerbaijan’s non-oil growth potential. Investments will be needed to support agricultural and other rural commercial activities and help small and medium-size enterprises market their products in highly competitive markets. The CPS will provide support in all of these areas.

Developing the Financial Sector

83. The on-going **Financial Sector Technical Assistance (FSTA)** established the modern payment systems infrastructure, introduced international accounting and financial reporting standards and governance principles in the banking sector, set the basic infrastructure to facilitate credit risk management and started the infrastructure needed for a widespread use of electronic payment instruments. The **Financial Services Development Project** is improving payment systems for the utility bills collection, and access to financial services and basic business infrastructure in smaller urban and rural areas through the postal system. Better financial infrastructure and access will facilitate other government reforms, such as taxes, pensions and social assistance and the postal offices infrastructure will enable the provision of e-government services to citizens and businesses, including those in rural areas.

84. A **Financial Sector Modernization Project** would support implementation of the next phase of reforms in banking, insurance, and capital markets; further strengthening of the

institutional capacity of the National Bank of Azerbaijan; improvement of financial risk management institutions (e.g., credit risk register, pledges/movable property register, mortgage support systems); strengthening of the insurance sector including of the regulatory and supervisory authorities, introduction of surveillance and monitoring systems, and development of infrastructure to improve risk management in the insurance industry; and capital market reforms focused on improving access to equity capital and facilitating entry of foreign equity portfolio investors.

85. IFC has helped establish Azerbaijan's first **microfinance bank**, which is rapidly growing and branching out. **IFC investments and TA** will seek to foster a competitive and dynamic financial market, to develop the non-banking sector, and to help expand the range of financial products. IFC will focus on building the capacity of financial institutions by improving access to finance to local private banks that serve SMEs and supporting establishment of leasing companies. This includes provision of technical assistance for institutional capacity building as well as sectorwide technical assistance, such as leasing and housing finance development and corporate governance. For example, IFC has surveyed and identified gaps in the country's **housing finance system via PEP-Central Asia** and will continue to support the development of this sector in Azerbaijan through follow-up TA and investments.

Non-Banking Sector

86. IFC will continue to support the development of the non-banking sector to increase and diversify financial intermediations to SMEs. IFC will build on its ongoing TA in the leasing industry to support expansion of the industry, including creation of a transparent and attractive legal and tax environment for leasing and increased public awareness; and well as hands-on training in lease origination, underwriting, credit analysis, monitoring and risk management. IFC recently committed US\$30 million to a **leasing facility** for Central Asia (including Azerbaijan), which is intended to provide long-term credit lines to local financial institutions and in partnership with Switzerland's State Secretariat for Economic Affairs, launched a three-year, \$2 million Swiss-funded TA program that aims to increase access to finance and create employment through the development of leasing sector. Under this program, recently IFC has committed loans of US\$8 million to the first leasing transactions by an international development institution in Azerbaijan.

SME Development

87. IFC will continue to work on improving access to finance for SMEs and building their competitiveness through its activities to deepen the financial markets and its continued **ACG/BTC SME Linkage Program**. In order to enable local companies to benefit from international tenders associated with the oil field and BTC pipeline operations, IFC partnered with BP, Statoil and GTZ to pioneer the Linkage Program in 2003. The program delivers training and access to finance through the Baku Enterprise Centre, an entity that reaches out to growing small businesses through a variety of approaches. In 2005 this work led to \$68 million in contracts for local firms. IFC has provided business training to 559 SMEs, increasing these companies' sales not only to BP but also to other companies and sector in Azerbaijan. In June 2006 the Access to Finance Pilot project called the Supplier Finance Facility, implemented through the Micro-Finance Bank of Azerbaijan provided its first supplier finance loan to a local BP supplier, Azmetco, a company specializing in metering services. This latter initiative

is the first step in an important new effort, which will improve access to finance to Azerbaijan's local oil and gas industry supplier and service enterprises. IFC will also seek to invest directly in emerging domestic SMEs in general manufacturing sectors. In its constant effort to improve lending to SMEs IFC is devoting specialized resources to assess this possibility.

Direct Private Sector Investment

88. IFC will continue to actively seek direct investment opportunities in areas such as food retail to support growth and employment in the non-oil sectors. IFC will also seek opportunities to support private sector development to include SOEs privatization and South-to-South investments. For example, IFC is presently considering supporting the establishment of a grocery retail chain in Baku of about 86 stores. The project will introduce the Azerbaijan market to organized food retail in a chain format, and middle and lower-middle income consumers will benefit from the additional convenience, product range, quality and affordability of modern grocery retailing. Furthermore, once the government decides on bringing in the private sector, IFC will also support the transparent privatization of SOEs especially in infrastructure and telecom sectors.

Developing Rural Infrastructure and Services

89. Rural areas account for 40 percent of employment in Azerbaijan. Rural development is therefore key to supporting sustainable growth in the non-oil sectors and reducing poverty. The ongoing **Agriculture Development and Credit Project (ADCP)** is improving land registration and access to rural finance and marketing information. The follow-on **ADCP-II Project** will further increase the earning capacity of farmers and stimulate off-farm commercial activities by strengthening rural financial services, improving market linkages and product quality of rural entrepreneurs and producers, further modernizing agricultural knowledge and information activities, and expanding the pilot real estate registration system.

90. An **Avian Influenza Preparedness Program** is supported by ADCP-II and funds from restructuring of the Second Institution Building and Technical Assistance project (IBTA-2). The undisbursed balance of IBTA-2 of US\$5 million has been allocated to finance emergency needs for avian influenza preparedness. The objective of this program is to minimize the threat posed to humans and the poultry industry and to prepare for and be able to control a pandemic.

91. The ongoing **Rural Investment Project** is increasing rural household access to and use of basic infrastructure by financing demand-driven microprojects. It includes construction or rehabilitation of economic infrastructure (roads, water, electricity) and social infrastructure (schools and health clinics) based on priority needs identified by rural communities.

92. There is an urgent need to rehabilitate irrigation and drainage systems to reverse deterioration and make them more efficient. Nearly all agricultural production in Azerbaijan is irrigation fed. Two ongoing irrigation and drainage projects are improving the effectiveness and financial viability of distributing and managing irrigation water in target areas. The **Irrigation and Drainage Rehabilitation Project (RIDIP)**, which is helping rehabilitate the first 50 kilometers of the Samur-Absheron Canal, will close toward the end of FY07. The **Irrigation System Improvement Project** is helping improve on-farm water management. A

follow-on **Irrigation and Drainage II Project** will expand coverage and support the restructuring, institutional change, and further capacity building of the water resource authority. The new Water Sector Study provides the analytical basis for these activities.

Improving Transit Corridors and Traffic Management

93. Significant Bank investments will be made to improve Azerbaijan's transit corridors. The government plans to spend about US\$1.5 billion to rehabilitate and reinforce major transit highways and secondary roads over the next 10 years, about US\$200–300 million of which may come from EBRD, the Asian Development Bank (ADB), the Islamic Development Bank (IsDB), and bilateral donors. The Bank will use a sector-wide approach to coordinate policy and make investments to help develop the growing transit corridors. The on-going **Highways I and Highway II Projects** are improving access and lower transport costs for goods and passenger traffic moving along the East-West and North-South transit corridors and strengthening the capacity of the Road Transport Service Department to manage road investment and maintenance, including outsourcing of periodic maintenance. A proposed continuation of the series of **Transit Corridor and Traffic Management Projects** will help complete these highways as well as access roads in order to enhance accessibility from villages and small towns. The projects may also address traffic congestion in urban areas and support the installation of modern traffic management systems. Financing in the sector is estimated at about US\$500 million, depending on government cofinancing, and will be phased through a series of road operations. A comprehensive **Transport Sector Review** will underpin the Bank's investment in the sector.

94. Transit corridor projects will also support upgrading the safety and physical capacity of the railway network, which transports large and growing amounts of oil. Tracks will be repaired, and logistics hubs and trade facilitation infrastructure may be upgraded. The **Railway Transport and Trade Facilitation Project** will seek to improve the competitiveness, commercial orientation, and efficiency of the national railway company, Azerbaijan Dovlet Demir Yolu (ADDY). The project will support the first phase of railway modernization (three to four years), including rationalizing the track and rolling stock asset base, increasing productivity, setting up a new legal framework allowing ADDY to operate commercially and to be corporatized, and building up management capacity.

Increasing the Quality and Coverage of Water Supply

95. Very large investments are needed across Azerbaijan to rehabilitate and improve water and sanitation, not only in Baku but in secondary cities and towns. Underpinned by the FY06 Water Sector Study, a series of **National Water Supply and Sanitation Projects** will finance the repair and rehabilitation of water production and distribution and wastewater facilities in selected secondary cities and towns. Through a sector-wide approach they will support Azersu and its subsidiary companies at the secondary town level to improve their capacity, institutional and operational effectiveness, and commercial and financial viability. The proposed series of projects may in subsequent phases broaden the scope from water and sanitation to other areas of urban rehabilitation.

Improving the Reliability of Energy Provision

96. The Bank is providing significant support to improve the reliability and efficiency of energy provision. Together with other donors (EBRD, KfW, IsDB, and the Japan Bank for International Cooperation [JPIC]), it is providing substantial funding to build new generation capacity and rehabilitate generation and transmission systems, helping remedy years of neglect. Through the on-going **Power Transmission Project**, the Bank is upgrading the power dispatch and transmission network, which will help alleviate frequent outages.

97. Expansion of gas storage and treatment facilities would enable Azerbaijan to fully utilize the gas resources that will soon be available from the Shah Deniz gas/condensate field. Azerbaijan currently has two underground storage facilities, located at Galmaz and Garadag. The need for gas storage is expected to increase substantially in order to accommodate the gas flow from the Shah Deniz field, starting in late 2006. The gas transmission and distribution system suffers from decades of low investments and insufficient maintenance. This leads to gas leakage and flaring of associated gas from older oil wells. Investments in rehabilitating the transmission system and upgrading and expanding the treatment plant would substantially improve the cost-effectiveness of the gas system. Such investments may attract **Carbon Fund financing**, since they would reduce emissions of greenhouse gases. Expanded gas storage would help modulate the rigid gas supply flow to meet the daily and seasonal needs of the domestic gas market. To some extent, it would also support export markets. A possible Energy/Gas Infrastructure Project may include financing gas storage expansion, gas treatment plant upgrade, rehabilitation of the pipeline system, and/or other investments in energy supply reliability and efficiency. IFC will look into investment opportunities in these areas should private sector, in particular FDI, interest arise.

Increasing the Financial Viability of the Utility Sectors

98. The government's strategy for improving the performance of the utility sector aims at commercializing and reducing explicit and implicit subsidies of more than US\$500 million. Key measures include promoting increased private participation in the provision of utility services; implementing the medium-term tariff policy for Azerbaijan, which incorporates a transition to full cost recovery for utility service providers; implementation of the new accounting law, which will require that state-owned utilities adopt IFRS; creating an appropriate regulatory environment, initially by strengthening the Tariff Council; and strengthening competition, through a new competition law. The government recognizes the need to ensure that utility services to consumers are affordable. Implementation of a targeted social safety net in July 2006 aims to ensure that the most vulnerable are able to afford essential utility services as prices rise toward and eventually reach full cost-recovery levels. The CPS will actively support these reform efforts through AAA; CAPSAP; sector projects in power, gas, water, transport and possibly other essential infrastructure; and the ongoing Pensions and Social Assistance Project.

c. Pillar III: Improving the Quality of and Access to Social Services

99. With the support of the Bank, the government will expand health care; modernize the education system; target social assistance; improve the pension system; and improve living

conditions and economic opportunities for internally displaced people. A unique opportunity exists during the next ten years to enter Azerbaijan into the globally competitive knowledge economy, and ensure that health and social needs are properly cared for.

Expanding Coverage of Good-Quality Health Care Services

100. IDA has been active in the health sector through a small-scale **Health Reform LIL**, implemented in five pilot provinces, and through the recently completed **Health Sector Review**. Together with the new management at the Ministry of Health, IDA is now supporting a comprehensive sectorwide reform of the healthcare system. The primary instrument is a **Health Sector Reform Project**. Key objectives are to build capacity in the Ministry of Health to guide the reform effort, rationalize and improve the delivery of both primary and secondary service, ensure sustainable health financing and resource allocation, and address longer-term human resource needs in the health sector. The Bank's projects in support of clean water and sanitation and reliable energy will also make an important contribution to the health of the population. A proposed **Environmental Clean-up Project** will alleviate exposure to health hazards. IFC will consider supporting private investment in the sector with reputable and experienced sponsors.

Modernizing the Education System

101. The government intends to accelerate reforms in the education system. The Bank is supporting the government's program through the ongoing **Education Sector Development APL**, which supports systemwide reform to increase learning achievements for all students and improve efficiency in the system. The first phase of the project (2003-07) is focusing on quality improvement (through curriculum reform, teacher development, and provision of textbooks and reading materials); efficiency and financing (through budget reforms, rationalization, and school improvement); equity and access to general education (through school grants in selected less advantaged districts); and management strengthening (through student assessment, management information systems, planning, and monitoring capacity). The **IDA Education Sector Development APL II** will continue the approach and support implementation of successful pilot school rationalization activities across the country. A proposed follow-on project would focus on reform of **Higher Education** to improve the quality and relevance of secondary and tertiary education and expand access. The vision is to enable Azerbaijan to enter the global knowledge economy as a strong and competitive partner. Specific investments could involve demand-driven investment funds that public and private sector education and training institutions can access to adapt their programs to international standards and monitor the relevance and demand for their programs. The Bank may also invest in other areas of developing the knowledge economy in Azerbaijan, such as modernizing public library services and cultural heritage institutions.

Targeting Social Assistance and Improving the Pension System

102. The CPS will support structural reform of the social safety net. The Bank is active in supporting the government's reform program through its ongoing **Pensions and Social Assistance Project**. The project aims to assist the government in better administering social protection programs, making the pension system more sustainable, and building capacity to

better target social assistance benefits to the most vulnerable groups. The project will also help mitigate the social impact of utility sector reform. Follow-on Bank support may help streamlining and improving services to the disabled, including improving capacity for assessing disabilities; developing social care services for other vulnerable groups; improving labor market services; developing and scaling up welfare services to facilitate school-to-work transition for youth and foster their inclusion in society. The project may also help develop a multipillar pension system and, based on the design of the Health Sector Reform Project, a modern health insurance system. Such support could take the form of AAA, TA, and/or a follow-on project. The Bank will continue to benchmark progress in social protection reform and development of social services and safety nets. A **Social Protection Note**, developed jointly with the Ministry of Labor and Social Protection of the Population within the **Programmatic Poverty Assessment**, will evaluate the poverty impact of social transfers and services.

Improving Living Conditions and Economic Opportunities of Internally Displaced People

103. Thousands of internally displaced people and refugees live in dilapidated school dormitories, former hotels, and partly finished public buildings. Thousands of others live in informal settlements that often lack water supply and electricity, schools, or health facilities. Economic opportunities are limited and unemployment is high, especially outside Greater Baku. The ongoing **Internally Displaced People Economic Development Support Project** builds on the experience of the recently completed **Pilot Reconstruction Project** to improve the living conditions of IDPs and enhance their economic opportunities and prospects for social integration. Key elements include financing microprojects for essential basic social and economic infrastructure and temporary shelters and extending finance for microenterprises. If the conflict with Armenia over Nagorno-Karabakh is resolved, a supplement to the CPS will be presented to the Board for possible support to rehabilitation and resettlement.²⁰

d. Pillar IV: Improving Environmental Management and Furthering the Climate Change Agenda

104. The CPS will provide assistance for the environment in two main areas. The first is managing environmental challenges connected with development of the oil industry and broader economic development, especially in coastal areas and including legacy pollution (the brown agenda). The second is addressing sustainable natural resource management (the green agenda). The CPS will also provide disaster management assistance.

Supporting the Brown Agenda

105. The proposed **Absheron Environmental Clean-Up Project**, potentially supported by the Bank, the Global Environmental Facility (GEF), and other donors, will help launch a large-

²⁰ In the event of a peace agreement on Nagorno-Karabakh, the Bank would support emergency reconstruction efforts. Possible assistance could be provided for assessing needs, clearing mines, resettling internally displaced people, rebuilding roads and other infrastructure, and providing basic health and education services. The Bank would review a variety of funding options, including funding through relevant grant programs, establishing a donor trust fund, using government funds, and extending additional IDA credits and IBRD loans.

scale, long-term program to rehabilitate the areas around Baku in order to reduce the threat to the health of area residents and enable reutilization of substantial areas of valuable land. The project will build on the technologies piloted under the **Urgent Environmental Investment Project**, which closed in FY06. The project's major objective is to help put in place regulatory, institutional, and incentive structures to channel private sector investment into recovering oil-contaminated land and to ensure that all future oil production meets international environmental standards. The project could also include direct investment in clean-up of high priority legacy contamination.

106. The Bank's involvement in the sectorwide infrastructure projects will help ensure that such development takes place under clear adherence to international environmental standards and that environmental screening is mainstreamed in Azerbaijan. The **Transport Corridor and Water Projects** will assess and review the impact of the infrastructure on the environment. IFC has taken a leadership role in ensuring environmental screening through its ongoing investment in the **BTC pipeline**; it will continue to ensure environmental compliance in all its investments. The CPS will also provide for **environmental sector work**, particularly in private sector participation in environmental clean-up (which will support the Absheron project) and in standards and regulations governing environmental liability and review (which will support the larger infrastructure agenda).

107. The Bank will actively promote efforts to enable Azerbaijan to reduce greenhouse gas emissions under the **Carbon Financing Facility**. Under the Kyoto Protocol, Azerbaijan could attract financing for reduction in gas flaring, as well as clean technology investments in the energy, industry, solid waste, municipal, and forestry sectors, by selling carbon offsets from projects that reduce greenhouse gas emissions. A **PHRD grant** has recently been signed for the preparation of a **Gas Flaring Project**. Opportunities will also be explored for potential carbon financing associated with modernization of power transmission, gas production, transmission and distribution, and in other areas. To facilitate this work, the Bank may base a technical expert in the Caucasus.

Supporting the Green Agenda

108. The ongoing **Rural Environment Project**, supported by IDA, GEF, and a Japanese grant, aims to improve biodiversity conservation and introduce more sustainable natural resource management and economic activities in two mountainous nature reserves. Bank investments in the irrigation subsector will also provide benefits in terms of rural environmental sustainability. One of the objectives of the ongoing **RIDIP** is to reduce water logging and salinity on 36,000 hectares along the main drainage collectors. The ongoing **Irrigation System Improvement Project** is helping improve on-farm water management, which will also improve water use consistent with environmental land improvement. The new **Irrigation and Drainage II** project proposed for FY08-09 will provide similar support. **ADCP-II** will help train farmers in sound agriculture practices, including practices related to ensuring environmental sustainability of lands.

109. Building on its involvement in the ongoing Caspian Regional Program, the Bank will continue to support the Caspian ecosystem. Together with UNDP, it will examine the potential for a follow-on **GEF Caspian Environment Program** to assist Azerbaijan and other Caspian

countries in implementing policy reforms and priority investments that address sustainable fisheries management, reduction of transboundary pollution, and biodiversity conservation priorities. The program would support capital investments, implementation of policy reforms, strengthening of public institutions, and public participation and donor coordination through a regional technical assistance component, implemented by UNDP and the United Nations Environmental Program (UNEP), and an Investment Fund, implemented by the World Bank. Other GEF opportunities, including Caspian-related pollution and coastal management, will be explored.

Strengthening Natural Disaster Management

110. The CPS includes a comprehensive **Natural Disaster Management Review**. The review will engage the government, private sector, and civil society in a policy dialogue on strengthening the institutional arrangements for risk mitigation and disaster planning; upgrading and refocusing the legal framework for emergency and disaster management; re-equipping, restructuring, and updating hazard monitoring and prediction networks, which do not meet modern standards; and increasing funding for the operation and maintenance of the flood protection infrastructure. The Review will address the status of implementation of the National Disaster Risk Management Strategy and the National Action Plan; identify risks through a comprehensive multihazard risk assessment; identify ways to protect critical infrastructure; and support regional cooperation in risk management, particularly for hazard observations, monitoring, and early warning and dissemination systems. A Disaster Management Project could follow up this review, if the government finds such a project beneficial. The ongoing and proposed series of irrigation projects will address flood mitigation by rehabilitating major canals.

e. Knowledge Sharing, Advisory Services, and Capacity Building

Analytical Work

111. During the last CAS period, the Bank initiated a shift toward programmatic sector work to provide a basis for focused and participatory policy dialogue on key issues. This trend will continue, and additional efforts will be made to increase outreach and knowledge sharing activities (table 6). The AAA and capacity-building program embodies a comprehensive range of diagnostics and monitoring activities through the **Governance Action Plan** (see section g below). **Technical assistance on structural reform** provides a programmatic instrument for continuous high-level dialogue on implementation of the CPS policy framework as a continuation of the PRSC dialogue. The FY07/08 **Country Economic Memorandum** will seek to identify binding constraints to rapid, broad-based investment and growth in the non-oil economy and prioritize macroeconomic policy and structural reform options. **PPERs** will support efficient and transparent budgeting and fiduciary arrangements, as well as greater effectiveness in public service delivery. Fiscal sustainability analysis will regularly feed into the dialogue with the government concerning next year's budget envelope, MTEF and PIP. **CPAR and CFAA updates** will provide assessments of Azerbaijan's fiduciary framework and procurement systems. An in-depth **Water Sector Study** will underpin increased lending in this sector. In **transport** the Bank is working closely with the ADB, which is leading a comprehensive sector review. **Programmatic Poverty Assessments** will continue to support

development of a cost-effective social safety net and strengthen understanding of inequality in income distribution. The Health Sector Review completed in FY05 laid the basis for the Health Sector Reform project. An **Education Sector Review** will focus on improvements in higher education. An **Environmental Review** will further the on-going dialogue on building an effective regime for optimal use of Azerbaijan's natural resources and protection of the environment. During the CPS period the Bank will also explore the possibility of entering into a Joint Economic Research Program with Azerbaijan.

Table 6: Proposed Analytical and Advisory Activities Undertaken by the Bank Group under the Country Partnership Strategy

<i>CPS objective</i>	<i>Recently completed</i>	<i>2006–07</i>	<i>2007–08</i>	<i>2008–10</i>
Improve public sector management and reduce corruption	<ul style="list-style-type: none"> • PPER • BEEPS • Corporate and Accounting ROSCs • Statistical capacity building 	<ul style="list-style-type: none"> • PPER with PEFA Assessment • TA on Structural Reform • TA on the business environment 	<ul style="list-style-type: none"> • PPER with PIFC Assessment • CEM • TA on Structural Reform • BEEPS 	<ul style="list-style-type: none"> • PPER with CFAA/CPAR updates • TA on the business environment • FSAP Update
Support sustainable and balanced growth of the non-oil economy	<ul style="list-style-type: none"> • Energy Sector Review • Agro-processing Study 	<ul style="list-style-type: none"> • Water Sector Review 	<ul style="list-style-type: none"> • Transport Sector Review (with ADB) 	<ul style="list-style-type: none"> • Regional Development Strategy
Improve the quality of and access to social services	<ul style="list-style-type: none"> • Programmatic Poverty Assessment • Education Spending on the Poor • Health Sector Review • PSIA on impact of utility sector reform • PSIA on labor markets 	<ul style="list-style-type: none"> • Programmatic Poverty Assessment 	<ul style="list-style-type: none"> • Programmatic Poverty Assessment • Education Review 	<ul style="list-style-type: none"> • Programmatic Poverty Assessment • Social Sector Review
Improve environmental management			<ul style="list-style-type: none"> • Environmental Review 	<ul style="list-style-type: none"> • Natural Disaster Management

Self-Standing Capacity-Building Activities

112. An IDF grant is helping build a more comprehensive **e-procurement** system. An **Accounting and Auditing Reform** IDF grant is helping implement accounting and auditing legislative reforms, harmonize sources of accounting guidance, and strengthen the Chamber of Auditors. IFC will continue on-going technical and advisory services to improve the business environment, including through **FIAS and PEP** work. The **Financial Sector Technical Assistance Project** is providing technical and advisory services to the government and the National Bank of Azerbaijan to build financial sector infrastructure, support the next phase of banking sector restructuring, and further strengthen institutional capacity at the National Bank.

113. The National Bank of Azerbaijan participates in the **Reserves Advisory and Management Program (RAMP)** conducted by the World Bank Treasury. As part of the

RAMP engagement, which normally lasts three years, Treasury specialists provide on-site consulting and training to National Bank of Azerbaijan staff in various aspects of reserves management. The advisory services are combined with an asset management program designed to support the overall technology transfer objectives of the program.

114. The Ministry of Communications and IT has expressed interest in establishing one or more core pilot **Global Development Learning Network (GDLN) Centers** in Azerbaijan. Several universities with videoconferencing facilities have been identified as potential centers, and the first center is expected to be established in Azerbaijan in 2006. GDLN programming is currently delivered through the Baku World Bank Country Office, covering such topics as youth policy, investment climate, judicial reform, e-government, and accounting training.

Capacity Building under Investment Projects

115. Bank technical assistance in the rural sector helped establish a Rural Policy Unit that has developed a national strategy and investment plan to enhance competitiveness in the agriculture sector. Technical assistance is also being provided to build the capacity of local communities and regional offices of the Agency for Support of the Development of the Agricultural Private Sector to prepare and implement small-scale, community-driven rural investment projects. Technical assistance under the Financial Services Development Project is helping corporatize and strengthen Azeri Post's capacity to serve rural areas. In irrigation technical assistance to the State Amelioration and Irrigation Committee, and District Irrigation Exploitation Units has helped these institutions take initial steps toward increased operational efficiency and improved irrigation management. Bank-funded technical assistance helped reorganize the Absheron Regional Water Company into a joint stock company, strengthen its capacity through a twinning arrangement, and improve its operational and administrative effectiveness. Technical assistance in the power sector is helping improve management of the state power generation/transmission company, Azerenergy, and prepare it for a restructured energy sector. Capacity-building assistance has helped restructure, modernize, and strengthen the management capacity of the Road Transport Services Department of the Ministry of Transport, the main agency responsible for national road development.

116. Technical assistance is being funded to build the capacity of the Ministry of Labor and Social Protection of Population to undertake knowledge-based policy formulation, develop targeting mechanisms, and effectively deliver targeted social assistance. Capacity in the State Social Protection Fund is also being built to improve its ability to efficiently and transparently administer the pension system. Bank technical assistance is helping the Ministry of Education strengthen financing, budgeting, personnel management, and planning in order to improve the use of financial, human, and physical resources in the sector. Technical assistance under the Health Sector Reform Project is stimulating a national dialogue on health reform and primary health care and strengthening the capacity of the Ministry of Health to plan, implement, and evaluate health reforms. In both health and education, the Bank is supporting the Ministry of Finance's collaboration with line ministries in moving to program budgeting, decentralization, IPSAS, and better internal financial control and expenditure tracking. Several Bank projects support statistical capacity building.

f. Financing Scenario and Portfolio Management

117. Azerbaijan is currently an IDA/IBRD blend country. IDA allocations on the basis of IDA's performance-based allocations system are set at SDR53 million (US\$79.4 million) for FY07 and indicatively at SDR34.4 million (US\$51.5 million) for FY08.²¹ Azerbaijan is considered creditworthy to receive IBRD financing of up to US\$250 million a year on average. The government has indicated that this figure should be seen as indicative and that the actual level of IBRD lending will depend critically on several factors, including: the degree of cofinancing provided by the government, the ability of the country to effectively utilize funds, and on the level of timely value-added the Bank Group is able to deliver relative to the government financing projects on its own. For its part, the Bank has indicated that it will pay particular attention to the CPS monitoring indicators in Table 8, which draw on the annual CPIA process, with a higher (or lower) level of IBRD lending associated with faster (or slower) progress toward achieving the targeted outcomes. Azerbaijan's overall CPIA ratings has increased substantially since 2000, especially governance indicators, but remained unchanged from 2005 to 2006 at 3.7. A slight downgrading of scores for macroeconomic and fiscal policies, due to concerns about the very expansive budget stance, was counterbalanced by increases in scores on gender equality and equity in the use of public resources. The portfolio quality is good, with no problem projects or projects at risk in 2005.

118. In the event of any significant deterioration in either economic conditions or the governance environment, IBRD lending would be reduced to a *lower case* of about US\$100 million. In assessing this the Bank would pay special attention to each of the following economic considerations: serious deterioration in macroeconomic stability, inconsistent aggregate demand policies, significant private sector crowding out, and monetary and exchange rate policies that do not target price stability. Such a scenario would be signaled, e.g., by CPIA indicators for macroeconomic management and fiscal policy falling to the 2.5 range or below. Fiscal sustainability analysis will be a recurrent part of the programmatic PER activities. Other signals would include a decline in other relevant indicators available from reputable third parties, including ratings by international rating agencies. The low case would also be considered in the event of a major deterioration of *governance* and increase in the Bank's reputational risk. Particular attention would be paid to serious shortfalls in progress toward implementation milestones under Pillar 1 (public sector management and corruption) of the CPS and the relevant CPIA indicators.

119. A summary of the projects proposed during the CPS period is provided in table 7. It is an all-investment program. It is expected that IDA allocations will be phased out through a managed transition to IBRD-only status during the CPS period, based on Azerbaijan's improved creditworthiness. An appropriate transition period remains critical to ensure that adequate support is provided to governance reforms and the social sectors in areas in which the government finds it hard to borrow on IBRD terms.

²¹ IDA financing beyond FY07 are indicative only. Actual allocations will depend on: (i) the country's own performance; (ii) its performance relative to that of other IDA recipients; (iii) the amount of overall resources available to IDA; and (iv) changes in the list of active IDA-eligible countries.

Table 7: Indicative New World Bank Group Financing, FY07-10
(US\$ million)

<i>CPS Pillars</i>	<i>FY06</i>	<i>FY07</i>	<i>FY08</i>	<i>FY09 and FY10</i>
I. Improving Public Sector Governance and Reducing Corruption 60	Judicial Reform	Corporate and Public Sector Accounting 20	← e-Government and Public Sector Reforms Financial Sect. Modernization 10	30 →
II. Supporting Sustainable Growth of the Non-Oil Economy				
• Agricultural and Rural Development 105	ACDP II Irrigation addt'l Avian Flu	Nat'l Land Title & Registry 30		Irrigation and Drainage II 75
• Transit Economic Development 480	Highways II	Railway Transit and Trade Facilitation 80	Transit Corridors and Traffic Management 200	Transit Corridors and Traffic Management II 200
• Supporting Infrastructure Services 470		National Water Supply and Sanitation 220	← National WSS II and Urban Rehabilitation 200 →	Other Infrastructure TBD 50
III. Improving the Quality and Access to Social Services 95	Health Sector Reform		Education II 40 Social Protection II 10	Higher Education and Knowledge Economy 45
IV. Improving Environmental Management 50 plus potential Carbon Finance and GEF		Gas Flaring [CF]	Absheron Env. Cleanup 50	
			← Other Global Partnerships TBD →	[CF/GEF]
<i>Total IDA and IBRD Financing 1,260 plus Carbon Financing (CF) and GEF to be determined</i>		350	310	<i>(Over Two Years) 600</i>

120. The government has indicated initially that it is able to cofinance 20 percent of project costs, perhaps providing up to 50 percent later on for high-priority projects. The Bank will also be looking to strategic partners, such as EBRD, EIB and the ADB, in the field of infrastructure. The transit corridor and water programs have deliberately been set out as a sequence of separate projects, so that the extension of subsequent projects will depend on the speed of implementation of the previous project. This phased approach will enable the country to avoid excessive commitment charges, and it will allow the Bank and the government to remain flexible to adjust the focus to emerging priorities.

121. As of now, Bank procurement and financial management procedures will be used for all projects, as it is too early to consider the use of national systems. On the other hand, the Bank's dialogue and project designs will be comprehensive and sectorwide. In this way Bank procedures will be leveraged by substantial public funds. The government views this arrangement as a welcome way of safeguarding the proper use of budget resources and leveraging use of the Bank's environment and social safeguard procedures. Special attention will be given to strengthening project implementation and supervision ensuring that recordkeeping is transparent, and Bank standards for procurement and financial management are widely understood and adhered to. The Board will be informed in the event of any systemic deterioration of the economic or social environment.

122. Country financing parameters for Azerbaijan were established in 2005 in consultation with the government. These provide for added flexibility in allowing Bank financing of up to 100 percent and recurrent cost financing on a selective basis, Bank financing of local and foreign costs in any proportion, and Bank financing of local taxes and duties. The additional flexibility should support project implementation and is fully consistent with the approach of the CPS in emphasizing government ownership of the underlying project objectives and target results agreed (see annex 7).

g. Governance – a Crosscutting Objective of the CPS

123. Taken together the CPS AAA and projects described above form an elaborate **Governance Action Plan** and strict monitoring of results and project execution within a coordinated Governance Monitoring Framework. Figure 4 summarizes key dimensions of the governance framework supported by the CPS interventions. In terms of overall *political accountability* the CPS will continue the support to the PRSP/SPPRS process, even though Azerbaijan is rapidly becoming a middle-income country, as well as supporting the implementation of the associated State Programmes. This will help ensure that the government's stated action plan get implemented with proper oversight of civil society.

124. In terms of *effective public sector management*, the CPS AAA will support good macroeconomic and public expenditure planning and management through our continuous policy advice and TA, including a CEM and a sequence of participatory programmatic PERs. Public financial management and procurement will be supported by public sector accounting reform (through CAPSAP), treasury modernization, e-procurement, and updates of the CFAA and CPAR. The CPS will support implementation of Public administrative and governance reform in selected areas of the relevant State Programmes. Reduction of subsidies will be supported through CPS policy advice, accounting reform and investment operations in the

utilities sector. And in the social sectors targeted interventions will further effectiveness of public service delivery.

125. In terms of *checks and balances* within the overall governance framework, the CPS will support judicial reform, the strengthening of external and internal audit functions, and stronger supervisory institutions in the financial markets. The CPS with FIAS will help establish better consumer protection against monopolistic behavior and investors' protection through modern laws and agencies according to international standards. The CPS will also support *civil society and the private sector oversight* through enhanced disclosure, transparency and accountability frameworks, such as EITI, disclosure of Oil Fund, SOCAR and public finances, and structured public/private dialogue on streamlining the business environment. Better corporate governance and financial transparency will be supported through the accounting and auditing reform, while environmental responsibility will be enhanced through Pillar IV of the CPS. This includes support for SOCAR to move to international standards.

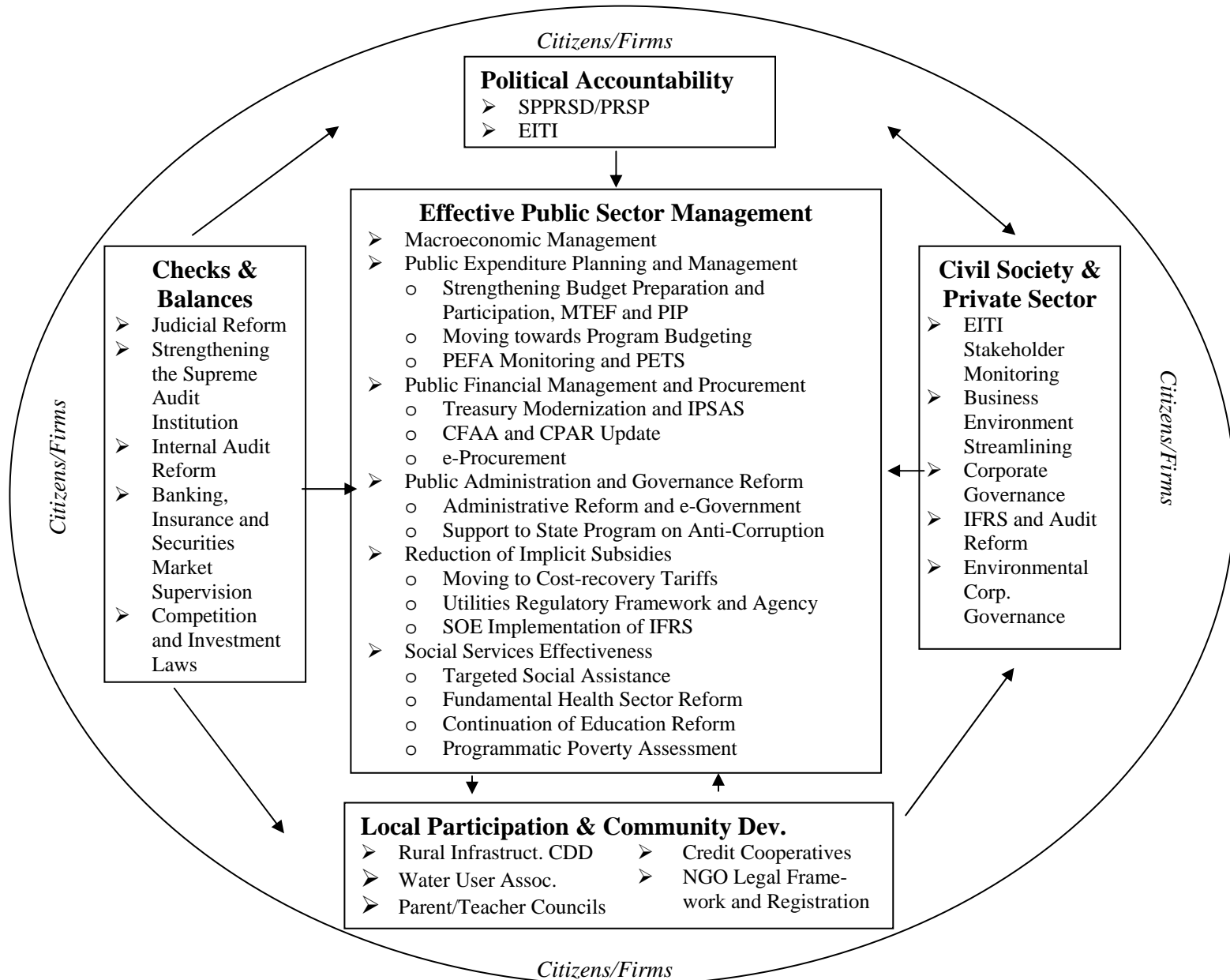
126. In terms of *local participation and community empowerment*, the CPS Pillar II supports, among other things, rural infrastructure community driven development (CDD), formation of water users associations for irrigation, and farmers' credit cooperatives. At the reform level, a new legal framework for NGOs and streamlined registration of legal entities and real estate will be supported.

127. Implementation of the governance agenda will be monitored and prioritized on the basis of *a shared framework* in global partnership with multilateral and bilateral donors, and with government ownership and civil society participation. A Governance Advisory Group will be established to coordinate these activities, derive lessons and identify binding constraints to achieving the objectives of the Governance Action Plan. Special precaution will be taken to strengthen Project Implementation Units (PIUs), transparent record keeping, and safeguarding Bank standards for procurement and financial management of projects. The Governance Monitoring Framework includes, e.g., EITI, PEFA and PIFC programs, Public Expenditure Tracking Surveys (PETS), FSAP update and ROSCs, Doing Business Reports, BEEPS, CPIA, as well as WBI Governance Indicators. The framework is embedded in the CPS comprehensive monitoring and evaluation framework.

h. Monitoring and Evaluation

128. The CPS contains a detailed Results Matrix (annex 1), which defines the four-year development outcomes that Bank Group assistance aims to help achieve. A CPS Mid-Term Review will be conducted two years into the program, at which point any adjustments to the strategy will be made. A comprehensive evaluation of the CPS will be carried out in a CPS Completion Report at the end of the CPS period. This evaluation will assess the extent to which CPS objectives were achieved and draw lessons for future assistance.

Figure 4: Governance Framework supported by the CPS Interventions



129. Progress in implementing the CPS will be monitored through several channels. First, regular reviews of structural reforms will be conducted in the context of the CPS program monitoring and support to implementation of the PRSC policy framework. Second, sectoral reforms and progress reports will be evaluated during supervision of the various Bank investment projects. Third, monitoring of public expenditures will be conducted under the three-year PPER. Fourth, monitoring of progress toward poverty reduction and MDG achievement will be assessed through a Programmatic Poverty Assessment. Detailed monitoring indicators and baselines for health, education, and social protection have been defined. Data from various surveys will strengthen outcome and impact monitoring. The governance agenda is crosscutting and integrated with the Result Framework. Assistance from other donors also supports strengthened monitoring capacity in government agencies.

130. The Bank will continue the current practice of formally reviewing the PRSC matrix (with annual adjustments as appropriate) with the government and reporting on progress and issues. Resources are included in the work program to finance technical work on the policy items concerned. This work will feed into the annual CPS reviews of the overall objectives and intermediate milestones in the Results Framework.

131. A core set of higher level progress indicators are outlined in table 8. In most cases high level baselines and targets for 2010 are based on the published CPIA methodology. These indicators are selected as aggregate measures of macroeconomic stability, governance and transparency on the one hand, and economic and social progress on the other.

i. External Partnerships

132. The Bank has a strong history in Azerbaijan in collaborating closely with other partners, in particular on structural reform. Collaboration will continue during the CPS period in a variety of areas described in annex 6.

133. The Bank and the IMF are coordinating closely on the overall reform program. The fifth review of the IMF-supported PRGF was completed satisfactorily in June 2005, and Azerbaijan has now graduated to surveillance-only status. Critical support is also provided by USAID, the ADB, the European Union, and the Islamic Development Bank (IsDB) for capacity building and economic policy formulation. The EU TACIS has helped modernize the tax system and we are working closely on accounting reform. The Bank is working with USAID on treasury systems and advising the government on the PIP. We have also teamed up with the U.S. Treasury on budgetary reform and is working with EBRD and USTDA on SOCAR restructuring. With DFID and other donors, the Bank is actively supporting the EITI in Azerbaijan and monitoring its implementation. The Bank has joined with the ADB, Switzerland, and UNDP to support the formulation and implementation of the SPPRS. UNDP has been particularly helpful in integrating the monitoring of the MDGs into the recent SPPRED progress report.

134. Azerbaijan was admitted to the ENP in 2005, creating the opportunity for the European Union and Azerbaijan to develop an increasingly close mutually beneficial relationship. Under the ENP, the European Union is expected to contribute more actively to resolution of regional conflict. While the Action Plan is still under discussion, it seems likely that the European Union will play a leading role on the continued implementation of electoral reform on the basis

of the recommendations of the Council of Europe/Venice Commission and the Organization for Security and Co-operation in Europe/Office for Democratic Institutions and Human Rights, as well as improving the organization of the judiciary, with a view to ensuring its greater independence, impartiality, and efficiency. Other priority areas may include improving the business environment; harmonizing laws, standards, and administrative procedures; combating corruption; supporting balanced and sustained economic development; and strengthening EU-Azerbaijan cooperation on energy and transport and integration of markets and networks.

Table 8: Key Progress Indicators under the Country Partnership Strategy

<i>Goal</i>	<i>Progress indicators and interventions</i>	<i>Aggregate indicator</i>	<i>Baseline</i>	<i>Target</i>
<i>Improve public sector management and reduce corruption</i>				
Maintain macroeconomic stability	Formulation of integrated macroeconomic and fiscal framework, with due consideration to development of the non-oil economy including close attention to real exchange rate issues.	CPIA-1 CPIA-2 CPIA-3	4.5 4.5 4.5	> 4.0 > 4.0 > 4.0
Improve public expenditure planning and management	Concrete progress towards program budgeting, including establishment of medium-term functional ceilings; consistency of PIP, MTEF, and annual Budget Law with expenditures prioritized according to sustainable development goals. Improved presentation of the budget.	CPIA-13	4.0	4.5
Increase transparency, accountability, and decrease corruption in public sector	Annual disclosure to EITI; strengthening of internal and external audit; start of e-procurement, and e-government streamlining processes. More civil society participation and voice.	CPIA-16	2.5	3.0
<i>Support sustainable and balanced growth of the non-oil economy</i>				
Improve public utility services and infrastructure	Improvement in infrastructure service quality and coverage. Cost recovery of utility services attained by 2010, with tariffs adjusted periodically and implicit subsidies largely eliminated.	BEEPS Infrastructure indicators	Worse than average for CIS	Average for CIS
<i>Improve the quality of and access to social services</i>				
Improve efficiency, quality, and coverage of health care and education	Improvement in health and education outcome indicators; increased equity in access and affordability of health and education services; implementation of program budgeting in place of norms-based system	CPIA-9	3.0	3.5
Improve efficiency and coverage of social protection systems	Social assistance and social benefits programs targeting bottom consumption quintile of population; fiscally sustainable, affordable, and transparent pension system linking contributions to benefits	CPIA-10	3.5	4.0
<i>Improve environmental management</i>				
Improve environmental management and conditions	Rehabilitation of contaminated areas on the Absheron peninsula and reduction in greenhouse emissions.	CPIA-11	3.0	3.5

j. Consultations

135. In preparation for the CPS the Bank and IFC consulted with a wide range of civil society representatives, business associations, high-level officials from across the government and with parliamentarians that made the development of this CPS a very participatory process (see annex 5).

136. NGO representatives felt that the Bank's expertise and technical assistance on managing oil revenues was critical. Participants welcomed health and education as problematic sectors that warranted priority attention from the international community. Other areas emphasized were SME development and irrigation. Participants expressed general appreciation of their involvement in the government's poverty reduction strategy preparation process but indicated that there was inadequate NGO involvement in the implementation and monitoring of Bank funded projects.

137. During the CPS preparation the IFC consulted with business associations, the NGO Forum, the Entrepreneurship Development Foundation, as well as with entrepreneurs from various sectors such as agribusiness, IT and telecom, tourism and hospitality and building materials. Entrepreneurs expressed great interest in partnering with IFC. Associations requested more IFC direct involvement to help grow SMEs and improving the business environment. NGOs would like to participate more in providing views on projects IFC is involved with.

138. NGOs and business associations would like to participate more in the whole cycle of Bank projects, analytical work and policy dialogue with the government. The voice of the civil society should be accounted for when results of projects are evaluated. It would also create a good example for the government, which - although gradually becoming more open to the civil society - still has to make significant efforts to treat the civil society organizations as partners. The donors raised an issue of the national capacity to implement the CPS infrastructure investment program. There is a risk that the limited capacity combined with political pressure on quick results may lead to compromising on quality.

139. The recent Client Survey reveals a shift in perceptions as to Azerbaijan's major development challenges and the Bank's role. In 2003 the three major challenges identified were poverty (22 percent), the economy (19 percent), and political problems/instability (11 percent). Now the major challenges are seen as the unresolved regional conflict (39 percent), corruption (18 percent), and education (15 percent). The Bank is seen as most effective in: (i) infrastructure; (ii) the financial system (which has significantly risen since the last survey); and (iii) monitoring poverty. The role of the Bank's knowledge services is increasingly valued. The perception that the Bank plays a relevant overall role in Azerbaijan's development remains positive (with a rating of 7 on a 1-10 scale). However, the perception that the Bank's financial resources were its greatest value fell sharply from 38 percent in 2003 to 28 percent. There is a strong feeling that respondents like to work with the Bank (8.5) and that the Bank treats clients with respect (7.9).

VII. Managing Risks

140. The primary risks to the proposed CPS include the following:

- *Risk of delays or waning consensus in implementing key elements of the reform program.* Not having been one of the ‘early reformers’ among the CIS transition countries, Azerbaijan still has a very substantial reform agenda ahead in both the economic and social spheres. The reforms supported by the Bank have been solid during the past five years, but progress has sometimes been slow and not always linear. To mitigate the risks of reforms being deterred and/or delayed, the Bank will support an active outreach process centered on the country’s PRSP, in terms both of substance and of engaging the public in its formulation and monitoring. In addition, the Bank will conduct semestral reviews of progress with respect to the core CPS reforms and monitoring indicators in Table 8, using these not only to track progress but as opportunities for continuing engagement of a wide range of public and private actors around strategic reforms and obstacles that may be impeding achieving them.
- *Risk of state capture and corruption.* Several surveys have evidenced the perception of persistent corruption and state capture in Azerbaijan, which could derail achievement of the development objectives the CPS is supporting. To mitigate this risk, the CPS, through its AAA and projects, embodies a comprehensive governance action plan of political accountability with civil society oversight, effective public sector management, financial accountability and disclosure through strengthening institutions performing checks and balances. Implementation of the governance agenda will be monitored and prioritized on the basis of a shared framework in global partnership with multilateral and bilateral donors, and with government ownership and civil society participation. Special precaution will be taken to strengthen project implementation units, transparent record keeping, and safeguarding Bank standards for procurement and financial management of projects. The Governance Monitoring Framework includes, e.g., EITI, PEFA and PIFC programs, Public Expenditure Tracking Surveys, FSAP update and ROSCs, Doing Business Reports, BEEPS, CPIA, as well as WBI Governance Indicators. The framework is embedded in the CPS comprehensive monitoring and evaluation framework.
- *Resource flow risk.* Volatile energy prices—or unexpected disruptions in pipelines or gas projects—could seriously affect resource flows and public finances, delaying implementation of poverty reduction measures. These risks are mitigated by the State Oil Fund, which cushions the budget revenues from oil exports by smoothing out potential volatilities in the current inflows of oil revenues.
- *Macroeconomic management risk.* As oil revenues start increasing dramatically, so will spending pressures and inflationary pressures. Mismanagement of oil revenues and Dutch disease could slow implementation of the reform programs. This risk should be set against a track record of 10 years of responsible macroeconomic management, including during the boom in inflows of FDI, and the avoidance of large external debt or ill-conceived public investments. Looking forward, the risk is mitigated by the Bank’s and the Fund’s continued policy dialogue on macroeconomic stability and fiscal sustainability.

Azerbaijan's active participation in EITI will be closely monitored and CAPSAP will support financial accountability and transparency of revenues from extractive industries, including SOCAR. The rules for Oil Fund spending are clearly set out in the Budget Systems Law and SOFAZ's regulatory framework. Spending out of the Oil Fund must be part of the consolidated budget approved by Parliament.²² All Oil Fund spending has to go through the single Treasury account. The CPS will monitor adherence to these principles. The dialogue on macroeconomic management and fiscal sustainability will be continuously supported by the PPERs, which are aimed at assisting the authorities to avoid the risk of too high inflation and too rapid or inefficient public spending, including Oil Fund spending. The large infrastructure projects of the CPS will directly support proper management of public funds. The cost of rebuilding the infrastructure of Azerbaijan to modern standards is relatively limited relative to the expected oil and gas windfall. Our emphasis is therefore to continuously staying engaged in macroeconomic management, extractive industries transparency, sound long-term oil revenue management, budget preparation processes, financial accountability, and sound implementation of the public investment program.

- *Regional security risk.* There has been a clear shift toward increasing stability in the South Caucasus over recent years, particularly given developments in Georgia since the 'Rose Revolution', which have enhanced opportunities for cooperation in developing the regional transport and energy corridor. Nonetheless, the potential for renewed conflict with Armenia over Nagorno-Karabakh cannot be ruled out -- nor can the upside potential of a resolution of the conflict during this CPS period. The international community, in particular the Minsk Group of the Organization for Security and Co-operation in Europe, is carefully mediating this issue. Meanwhile, the Bank will continue to assist government efforts to improve the well-being of the population which has been displaced by the conflict.
- *Portfolio management risk.* While the portfolio quality is good and there are no reported outstanding issues, the risk of corruption will be vigilantly addressed. This includes a high level of precaution and supervision of procurement and financial management of projects as outlined in box 2.
- *The likelihood of Bank engagement on the breadth of activities in the CPS is high.* The CPS supports the continuation of our long-term partnership with Azerbaijan from the previous CAS and the PRSC. As noted in the CAS Completion Report (annex 3), all projects proposed in the previous CAS were successfully approved and started. FY06 brought this agenda forward with another four very important projects. The government has shown its strong commitment to move forward rapidly with the reform agenda, including CAPSAP. The e-government and public reform activities will require a flexible and realistic approach

²² The Budget System Law requires that: (i) parliament approve the deficit and expenditure ceilings of the consolidated budget including Oil Fund expenditure; (ii) all expenditures in the consolidated budget (except for expenditures on the management of SOFAZ and its assets) be executed by the treasury, and that all capital expenditures be part of the PIP; (iii) Ministry of Finance to be responsible for the preparation of the consolidated budget; (iv) that extra-budgetary funds not make portfolio investments in domestic commercial activities or issue loans or loan guarantees; and (v) SOFAZ hold equity positions only through highly rated professional portfolio managers in international markets.

in the choice of instruments. Financial sector activities and the infrastructure agenda to a large extent are continuations of well-established sequences of activities. Likewise in the social sectors, the proposed education projects are natural next steps of the ongoing APL, and the successful social protection reform will be continued. On the environmental agenda, the President on September 28, 2006, issued an important decree delineating detailed plans and time schedules for restoring environmental sustainability on the Absheron Peninsular and for the country as a whole. The CPS will directly engage in this program. Azerbaijan has the monetary resources to implement the agenda laid out in the CPS. With the CPS partnership the government wishes to have the Bank as its trusted fiduciary partner to make sure things are done right and public resources not wasted. The challenge for the World Bank Group is to deliver in a timely manner the quality expert advice and project management services that Azerbaijan needs to continue to succeed in its rapid development.

Box 2: Safeguarding the Integrity of the Bank's Portfolio

The World Bank Group has been taking a range of measures to improve monitoring and strengthen governance of its own portfolio, and will undertake additional measures in the CPS.

A Existing Measures to Minimize Corruption Risks in the Bank Portfolio:

- i Maintaining diligent capacity and risk assessments of fiduciary aspects of Bank-financed portfolio through (i) financial management systems assessment (staffing, internal controls, accounting systems, disbursements and auditing arrangements), including risk assessment at country, entity and project level, to ensure funds are used for purposes intended; and (ii) procurement assessment and extensive post reviews conducted to ensure compliance with Bank procurement guidelines; and (iii) financial management and procurement capacity building of project implementing agencies/entities staff to assure adequate project implementation performance.
- ii Ensuring strong financial management and portfolio review functions and responsibilities in the Country Office.
- iii Joint Bank/Government country portfolio performance reviews, and vigilant Bank follow up on implementation of agreed-upon Action Plan to strengthen overall quality of portfolio implementation and performance.
- iv Securing close linkages between the AAA program (particularly the Programmatic PER and Poverty Assessment) and lending support to ensure adequate attention to the efficient and transparent use of public resources and monitoring and evaluation of outcomes.
- v Regular capacity assessment of external audit firms interested in auditing Bank-financed projects.
- vi Continuous support to the accounting, auditing, procurement, supervisory and regulatory agencies through institutional capacity building, legal and regulatory reforms i.e. introduction of new Accounting Law mandating International Financial Reporting Standards for Public Interest Entities including State-owned enterprises to enhance accountability and transparency in financial reporting and capacity building of the Chamber of Accounts, the country's Supreme Audit Institution (SAI).
- vii Vigorous investigation and follow-up to any allegations of fraud and corruption in Bank projects.

B New Additional Measures to be implemented during the CPS Period:

- i Diligent and consistent application of the Governance Action Plan and its principles in all new programs.
- ii Focus on accountability and transparency in corporate and public sectors, through the proposed Corporate and Public Sector Accountability Project.
- iii Further capacity building in procurement capabilities and portfolio review in the Country Office, with HQ retaining oversight and quality control function
- iv Operational reviews of internal controls and key operations carried out every two years, in conjunction with Mid-term reviews.
- v Increased frequency of procurement audits to ensure implementation of Bank procurement guidelines to promote greater transparency in the bidding process and contract award.
- vi Increased supervision resources and intensive projects supervision by Bank staff.
- vii Special emphasis placed on the development of synergies between Bank-financed projects, to develop country-level safeguards with respect to fiduciary arrangements.
- viii Bank support to NGOs serving as catalyst to external monitoring and communication to the public on use of public funds.
- ix Promotion of greater transparency and accountability through disclosure of contract awards and financial information.

Annex 1

Results Matrix for Azerbaijan Country Partnership Strategy, FY07–10²³

<i>Azerbaijan's medium-term development goal supported by the Bank Group</i>	<i>Issues and obstacles hindering achievement of goal</i>	<i>Outcomes the Bank Group expects to help realize during CPS period</i>	<i>Implementation milestones to track</i>	<i>Bank Group inputs and key partner roles</i>
<i>Pillar I: Improving the quality of public sector governance</i>				
1A. Maintain macroeconomic stability and prudently use oil resources	Sustaining prudent management of oil revenues is critical to avoiding Dutch disease and maintaining macroeconomic stability.	Prudent governance framework in Oil Fund maintained (CEM, PER, CFAA Update)	SOFAZ quarterly and audited annual accounts published and in good order (CEM, PER, CFAA Update) [EITI; short-, medium-, and long-term macroeconomic and policy analysis] Formal validation of EITI and follow-up on recommendations [EITI]	<u>Proposed AAA</u> CEM (FY07), PPER, CFAA Update (FY07) <u>Other major donors</u> IMF (Article IV), USAID (PIP, Treasury systems)
1B. Establish effective public expenditure planning and management	Reforms have strengthened budget system, but improvements needed to ensure sustainability, integrity, and allocative efficiency of public expenditure in future	Strategic priority setting and transparent medium-term budgeting based on MTEF and PIP (PER)	MTEF and PIP of increasing quality submitted to Parliament as part of annual budget process (PER) [PEFA, PETS]	<u>Proposed AAA</u> PPER, CFAA Update (FY07) <u>Other major donors</u> IMF (Article IV); USAID (PIP, Treasury systems); U.S. Treasury (Budget systems)

²³ Note: Governance Monitoring Framework are indicated in brackets [].

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1C. Increase transparency and accountability in the management of public resources	Financial accountability framework in public sector requires strengthening to ensure transparency and improved governance. Currently no budgetary organization except the Ministry of Finance performs a proper internal audit function.	Improved transparency and accountability in public financial management (CGA)	Internal audit function reestablished in x number of budget organizations (CGA) [PIFC, WBI] Updated framework on public financial management; NAS introduced for public sector (CGA) [ROSC]	<u>Ongoing projects</u> IDF (procurement), IDF (accounting and auditing), IFC (corporate governance) <u>New projects</u> Corporate governance/ accounting (FY07), e-government (FY08) <u>Proposed AAA</u> Accounting ROSC (FY06), CFAA Update (FY07), CPAR Update (FY07) <u>Other major donors</u> EU TACIS (accounting reform)
	The government has improved procurement procedures and been identifying and correcting breaches of rules. It needs to ensure that transparent and credible procurement practices take root by strengthening monitoring and control and increasing information dissemination.	Strengthened implementation of public procurement laws (IDF grant)	Public awareness campaign implemented (IDF grant) Random reviews of procurement entities conducted to ensure compliance with procurement law (IDF grant, e-Government) [PEFA, CPAR]	
1D. Improve corporate governance, accounting, and auditing in the corporate and financial sectors	The government has enacted a new accounting law and started drafting related secondary legislation. The current need is to strengthen incentives for the enactment and rigorous application of high quality financial reporting, accounting and auditing standards.	Improved corporate financial reporting accounting, and auditing to international standards (CGA)	Progress in SOCAR implementation of IFRS according to time plan. Number of other entities converting to new accounting standards increased from x to y (CGA). [ROSC] Increased quality of audited financial statements as perceived by key user groups (survey data) (CGA) [ROSC]	

<i>Azerbaijan's medium-term development goal supported by the Bank Group</i>	<i>Issues and obstacles hindering achievement of goal</i>	<i>Outcomes the Bank Group expects to help realize during CPS period</i>	<i>Implementation milestones to track</i>	<i>Bank Group inputs and key partner roles</i>
1E. Strengthen the judicial system so that it conforms to international best practice	Further efforts are needed to bring the judicial system in line with international best practice. There is a need to improve human resources technology and court infrastructure.	Strengthened management capacity of judicial institutions Upgraded court facilities, including provision of technology and equipment Strengthened professionalism of judges and justice sector staff	Technical improvements in case management system (JMP). [Council of Europe , BEEPS, WBI] Judges trained and certified, including in making effective decisions in competition and foreign investment (JMP). [Council of Europe , BEEPS]	<u>New projects</u> Judicial Modernization (FY06) <u>Other major donors</u> EU, GTZ, UNDP, USAID, ABA-CEELI
<i>Pillar II: Support sustainable and balanced growth of the non-oil economy</i>				
2A. Expand access to credit and financial services, especially in rural areas	The banking sector is small and has significant structural problems. The state-owned IBA accounts for about 50 percent of total banking system assets. Reach of formal financial services in rural and poor areas is very low. The payment systems operated by NBA do not reach remote parts of the country. Access to credit in rural areas is provided mainly by donor-funded micro-finance institutions.	Improved access of the rural and poorer populations to financial services (PRSC/FSDP/FPSSP) Strengthened payments systems (FSDP/PRSC/FPSSP) Enhanced ANB supervisory capacity, particularly on-site inspection (FSTA) Enhanced operational structure of Kapital Bank and eventual privatization (FSTA) Emergence of leasing industry	Increase in number of financial services access points in regions (PRSC) National Payment System Architecture finalized (PRSC FSDP/FSTA) Improved framework for housing finance (IFC/FPSSP) [FSAP Update]	<u>Ongoing projects</u> FSDP, FSTA <u>New projects:</u> Financial Sector Modernization (FY08) <u>IFC</u> Direct investments and technical assistance in financial and microfinance institutions; technical assistance in leasing, housing finance; Supplier Finance Facility <u>Other major donors</u> IMF, EU TACIS

<i>Azerbaijan's medium-term development goal supported by the Bank Group</i>	<i>Issues and obstacles hindering achievement of goal</i>	<i>Outcomes the Bank Group expects to help realize during CPS period</i>	<i>Implementation milestones to track</i>	<i>Bank Group inputs and key partner roles</i>
<p>2B. Create a competitive business regulatory environment, including by reducing obstacles to starting and running a business</p>	<p>While the government has made good progress in improving some elements of the business environment, important legal and regulatory obstacles continue, including tax administration and business licensing and permits.</p>	<p>Reduction in administrative and regulatory obstacles to starting and doing business (IFC/FIAS)</p>	<p>Periodic surveys of the business-enabling environment. [BEEPS, WBI, Doing Business]</p>	<p><u>Proposed AAA</u> Trade and Investment Study (FY07)</p> <p><u>IFC</u> FIAS Analytical and Advisory Services</p> <p><u>Other major donors</u> EU TACIS, ADB</p>
<p>2C. Develop rural infrastructure and services</p> <ul style="list-style-type: none"> • Improve earnings capacity of farmers • Develop small and medium-size agro-processing enterprises 	<p>Failing rural infrastructure, such as bad roads, deteriorating irrigation and drainage systems, power outages, and unheated schools, imposes very high transaction costs on rural households as they try to integrate into the market economy.</p>	<p>Improved local infrastructure in target areas (RIP).</p> <p>Increased access to rural finance and services (ADCP-II, FSD)</p> <p>Improved land registration system (ACDP-II)</p> <p>Strengthened agricultural knowledge system (ACDP-II).</p> <p>Improved supply of irrigation water and drainage systems in target areas (internally displaced people)</p> <p>Growth in agro-processing small and medium-size enterprises (ADCP-II, Ag. small and medium-size enterprise, IFC)</p>	<p>Modernized research institutes; expansion of Competitive Grant Programs (ADCP-II).</p> <p>Increased number of villages with basic financial services (ADCP-II , FSD, IFC)</p> <p>Increased percentage of potential water users actually receiving irrigation water (IDSMIP).</p> <p>Rehabilitation of the first 50km of S-A Canal (RIDIP)</p>	<p><u>Ongoing projects</u> Rural Infrastructure, Irrigation and Drainage, Irrigation Distribution, Agricultural Development and Credit, Financial Services Development.</p> <p><u>New projects</u> Irrigation II (FY08), ADCP-II (FY06), Land Registration (FY09)</p> <p><u>IFC</u> Leasing and small and medium-size enterprises credit line</p> <p><u>Other major donors</u> ADB, USAID, IFAD, GTZ, KfW, EU TACIS, SDC</p>

<i>Azerbaijan's medium-term development goal supported by the Bank Group</i>	<i>Issues and obstacles hindering achievement of goal</i>	<i>Outcomes the Bank Group expects to help realize during CPS period</i>	<i>Implementation milestones to track</i>	<i>Bank Group inputs and key partner roles</i>
<p>2E. Improve transit corridor</p> <ul style="list-style-type: none"> • Improve trade and transit policy and border operations • Increase capacity to meet rapidly increasing demand on the transit corridors 	<p>Connecting rural areas, accessing international markets, and fully exploiting the transit trade potential requires suitable transport infrastructure able to meet much higher traffic densities. Some 56 percent of the main road network is in a poor state, and about 1,000 kilometers (30 percent) of rail track requires reconstruction. In transport administration, there is lack of delineation between policy and commercial functions. Lack of competition also undermines efficiency and reach of transport services.</p>	<p>New regulatory framework governing transport sector, with policy, regulatory and commercial functions separated (TCPs).</p> <p>Improved access, transit, and safety on sections of AZ's East-West and North-South corridors – road and rail (Highways I, TCPs, RTTF)</p> <p>Improved management, efficiency, and maintenance practices in the national road administration (Highways I, TCPs).</p>	<p>Successful upgrading of Ganja-Gazakh road (Highways I)</p> <p>Commenced upgrading of sections of the Baku-Iran highway (M3) and rehabilitation of the Baku-Shamaxi road (Highways II)</p> <p>Regulatory functions of AzerRail separated from commercial (RTTF).</p> <p>Progress on IFRS in transport sector state-owned enterprises (CGA, RTTF)</p>	<p><u>Ongoing projects</u> Highway I</p> <p><u>New projects</u> North-South Transit Corridor (FY06), Railway and TTF (FY07), North-South Transit Corridor (FY08), East-West Transit Corridor (FY09)</p> <p><u>Other major donors</u> ADB, EBRD</p>
<p>2F. Improve coverage of water supply systems</p>	<p>Significant investments in the water supply system in Baku with IDA assistance have rehabilitated facilities and improved maintenance. In other parts of the country, however, drinking water safety remains a serious concern. Water coverage drops sharply in rural areas, with just 58 percent having access to improved sources of water. Lack of metering undermines collection rates and incentives to inhibit the use of water.</p>	<p>Improved water supply and sanitation networks in targeted urban centers and small towns (NWSS)</p> <p>Improved revenue collections and improved incentives to limit consumption in the water sector (NWSS)</p> <p>Strengthened financial position of AzerSu due to tariffs that cover full costs (NWSS) and corporate governance and accounting (CGA)</p>	<p>Upgraded water, metering and sanitation facilities in selected areas (NWSS)</p> <p>Implementation of reforms in water sector (NWSS) Progress on IFRS (CGA)</p>	<p><u>Ongoing projects</u> Baku Water and Sanitation, Rural Infrastructure</p> <p><u>New projects</u> National Water Supply and Sanitation (FY07), WS/Urban (FY09), Corporate Governance/Accounting (FY06)</p> <p><u>Proposed AAA</u> Water Sector Study (FY06)</p> <p><u>Other major donors</u> ADB, KfW</p>

<i>Azerbaijan's medium-term development goal supported by the Bank Group</i>	<i>Issues and obstacles hindering achievement of goal</i>	<i>Outcomes the Bank Group expects to help realize during CPS period</i>	<i>Implementation milestones to track</i>	<i>Bank Group inputs and key partner roles</i>
2G. Improve reliability of electricity and gas supply	<p><i>Power supply.</i> Financial viability, reliability and coverage outside Baku of the power system are poor. Issues include inadequate generation capacity to meet domestic demand; sub-optimal system operation; inadequate levels of investment and maintenance; inadequate tariffs and collections; and outdated system designs.</p>	<p>Reduced cost and improved reliability of electricity supply through improvements in the high-voltage transmission network (PT)</p> <p>Strengthened financial position of Azerenerji due to tariffs that cover full costs (PTI) and corporate governance and accounting (CGA)</p>	<p>Upgraded electricity dispatch system (PT).</p> <p>Rehabilitation of high voltage transmission lines and selected substations (PT).</p> <p>Management Assistance technical assistance to Azerenerji fully utilized (PT).</p> <p>Progress on IFRS (CGA)</p>	<p><u>Ongoing projects</u> Power Transmission</p> <p><u>New projects</u> Energy/Gas (FY08), Corporate Governance/Accounting (FY06)</p> <p><u>Other major donors</u> JBIC, ADB</p>
	<p><i>Gas services.</i> Azerbaijan has two underground gas storage facilities located at Galmaz and Garadag. However, significant new gas resources will be soon available from the Shah Deniz field. Additional gas storage would enable Azerbaijan to fully utilize these resources and smooth large fluctuations in daily supply levels.</p>	<p>Expanded capacity to supply efficient energy to the region.</p> <p>Strengthened financial position of Azerigas due to tariffs that cover full costs (EG) and corporate governance and accounting (CGA)</p>	<p>Progress in rehabilitation of gas infrastructure (EG)</p> <p>Quality of gas (EG)</p> <p>Progress on IFRS (CGA)</p>	

<i>Azerbaijan's medium-term development goal supported by the Bank Group</i>	<i>Issues and obstacles hindering achievement of goal</i>	<i>Outcomes the Bank Group expects to help realize during CPS period</i>	<i>Implementation milestones to track</i>	<i>Bank Group inputs and key partner roles</i>
2H. Improve financial viability in the utility sectors	Key deficiencies in the utility sector include structural deficiencies and lack of private participation; low collection rates for utility services; noncompensatory tariff levels; and lack of independent utility regulation.	Improved tariff policy in the utility sector Fully functional utility regulatory framework established.	Legislative and intuitional process steps to enact utility sector legislation and implement medium-term tariff policy Restructuring measures implemented in water and gas sectors in accordance with the utility sector reforms Reduction in subsidies to utilities	<u>Ongoing projects</u> Power Transmission <u>New projects:</u> Energy/Gas (FY08), Corporate Governance/ Accounting (FY07), National Water Supply and Sanitation (FY07) <u>Proposed AAA:</u> Accounting ROSC (FY06), Water sector study <u>Other major donors:</u> EU TACIS
<i>Pillar III: Improve the quality of and access to social services</i>				
3A. Improve the quality and coverage of health care services	Despite wide availability of health facilities and providers, access to and quality of primary health care are compromised because of systemic deficiencies, weak skill levels, and low productivity in service provision Continued efforts are needed to reform Soviet-style centralized financing and normative allocation of human, physical and financial resources that has yielded excessive hospital facilities and inefficient tertiary	Expanded coverage of quality primary health care services (PRSC/HRL) Sustainable healthcare financing and resource allocation the health sector (SN/HS)	Health sector reform strategy developed (SN/HS) Improved primary health care access and services in target districts (SN/HS) Public expenditure tracking survey done and MTEF adopted in Ministry of Health (PPER). [PEFA, PIFC, PETS]	<u>Ongoing projects</u> Health LIL <u>Proposed projects</u> Health Sector Reform (FY06) <u>Proposed AAA:</u> Health Sector Review, Programmatic Poverty Assessment, PPER <u>Other major donors</u> UNDP, UNICEF, USAID, USDA, GTZ, WHO

Azerbaijan's medium-term development goal supported by the Bank Group	Issues and obstacles hindering achievement of goal	Outcomes the Bank Group expects to help realize during CPS period	Implementation milestones to track	Bank Group inputs and key partner roles
	level services as well as poorly funded and fragmented primary health care services			
<p>3B. Modernize the education system</p> <ul style="list-style-type: none"> • Improve education outcome indicators • Increase learning achievements for all students to meet the needs of a market economy 	<p><i>Quality and relevance of general education.</i> Key issues include outdated curriculum and teaching methods; poor learning environment, i.e., shortages of materials and poor physical infrastructure; ineffective teacher development and motivation.</p> <p><i>Resource allocation.</i> Expenditures on wages crowd out other essential expenditures, including teaching materials and capital expenditures. Rigidity in budgeting norms prevents local education administrations to prioritize and allocate resources according to local needs.</p> <p><i>Equitable access to education.</i> Schools in rural areas suffer from lower quality as measured by the availability and quality of teachers and basic teaching materials and the physical condition of school facilities.</p>	<p>Improved quality of general education through curriculum reform; teacher education; provision of selective teaching and learning materials and equipment; and school improvement in selected districts (ESDP)</p> <p>Improved allocative and technical efficiency in resource allocation in the education sector (ESDP)</p> <p>Upgraded Schooling Quality in Less Advantaged Rayons (ESDP)</p> <p>Gross enrollment rates of the age cohort 6–16 increased from about 94 percent in 2002 to about 96 percent in 2007 (ESDP)</p> <p>Student-teacher ratio up from 10:1 in 2002 to 12:1 in 2007 in three pilot districts (ESDP)</p>	<p>National curriculum for grades 1-11 developed (ESDP)</p> <p>Establishment of a new System of Student Assessment (ESDP)</p> <p>At least 9,000 teachers trained in-service teacher training programs (ESDP)</p> <p>Public Expenditure Tracking Survey completed. (PPER)</p> <p>New funding formula and mechanism implemented on pilot basis (ESDP)</p> <p>District rationalization plans prepared in three pilot districts (ESDP)</p> <p>Successful implementation of the school grants program (ESDP) [PEFA, PIFC, PETS]</p>	<p><u>Ongoing projects</u> ESDP</p> <p><u>Proposed projects:</u> Education Competitiveness (ECP) (FY07)</p> <p><u>Proposed AAA</u> Programmatic Poverty Assessment</p> <p><u>Other major donors</u> Japan, JBIC, OSI, USAID, UNICEF, SDC, Saudi Fund</p>

Azerbaijan's medium-term development goal supported by the Bank Group	Issues and obstacles hindering achievement of goal	Outcomes the Bank Group expects to help realize during CPS period	Implementation milestones to track	Bank Group inputs and key partner roles
<p>3C. Improve efficiency and coverage of social protection systems</p> <ul style="list-style-type: none"> • Create adequate, financially sustainable and reliable pension systems • Strengthen and more accurately target social assistance to the poor • Minimize negative social impacts of utility sector reforms 	<p><i>Pension system.</i> Key issues include low benefits, due to lax eligibility criteria and low coverage; a complex benefits system difficult to administer; benefits system not linked to contributions; weak record keeping and financial management systems; and involvement of enterprises in benefits administration, which makes monitoring of benefit award and payment difficult.</p> <p><i>Social assistance.</i> In social assistance, key issues include poor targeting of benefits; fragmentation of benefits; low benefit levels due to insufficient resources; weak capacity to analyze, monitor and evaluate policies; and weak administrative capacity to efficiently administer benefits.</p>	<p>A more fiscally sustainable, affordable, and transparent labor (Social insurance) pension system that provides links between contributions and benefits in place (PSAP)</p> <p>Improved accuracy of social transfer targeting: at least 50 percent of the funds allocated to targeted social assistance and social benefits programs accrue to the bottom consumption quintile (PSAP)</p>	<p>Social insurance payments transferred from enterprises to the State Social Protection Fund (PSAP).</p> <p>Significant increase in collections under the general public pension scheme (PSAP)</p> <p>Significant increases in contributors to the pension system (PSAP)</p> <p>All social assistance benefits consolidated into one (PSAP).</p> <p>Implementation of MIS to support means and asset testing (PSAP)</p> <p>Nationwide implementation of a targeted child benefit and targeted family poverty benefit (PSAP).</p>	<p><u>Ongoing projects</u> Pensions and Social Assistance Project</p> <p><u>Proposed AAA</u> Programmatic Poverty Assessment</p> <p><u>Other major donors</u> UNDP, EU</p>
<p>3D. Improve living conditions and economic opportunities for internally displaced people</p> <ul style="list-style-type: none"> • Socially and economically integrate internally displaced people 	<p>The government currently supports internally displaced people with cash grants, food subsidies, and free utilities and is building new housing settlements. However, many internally displaced people live in conditions where infrastructure, housing and service needs are substantial.</p>	<p>Improved living conditions and enhanced economic opportunities and prospects for social integration for internally displaced people (EDS)</p>	<p>Effective operation of micro-lending institutions for internally displaced people (IDPEDS)</p> <p>Effective completion of micro-projects (IDPEDS)</p>	<p><u>Ongoing projects</u> Economic Development Support for Internally displaced people</p> <p><u>Proposed AAA</u> Programmatic Poverty Assessment</p> <p><u>Other major donors</u></p>

<i>Azerbaijan's medium-term development goal supported by the Bank Group</i>	<i>Issues and obstacles hindering achievement of goal</i>	<i>Outcomes the Bank Group expects to help realize during CPS period</i>	<i>Implementation milestones to track</i>	<i>Bank Group inputs and key partner roles</i>
	Economic opportunities are limited and unemployment is high, especially outside Baku.			UNHCR, ADB, WFP
<i>Pillar IV: Improve environmental management</i>				
<p>4A. Improve environmental management</p> <ul style="list-style-type: none"> • Support sustainable natural resource management within the context of rural development and conservation of ecosystems • Clean up oil spills 	<p><i>Natural resource management.</i> While commercial forestry has been banned since 2003, illegal tree cutting continues and forest cover is declining. Significant over-grazing occurs on public lands due to lack of specific legal provisions and no monitoring. The sturgeon stock is dwindling.</p> <p><i>Pollution control.</i> Azerbaijan suffered significant environmental damage during the Soviet era. A relatively developed system of environmental laws, regulations and institutions are in place, but enforcement is weak. Oil-polluted areas pose a serious health hazard and risk ground water contamination, and leakage into the Caspian Sea.</p>	<p>Restoration of ecological health and productivity in two globally significant biodiversity (REP)</p> <p>Restored capacity to produce sturgeon fingerlings (UEI)</p> <p>Approval of viable plan for clean-up of oil spills with responsibilities and ownership rights assigned, as well as the beginnings of the reclaiming of contaminated land.</p>	<p>Establishment of SD National Park and enlargement of OW (REP)</p> <p>Number of environmentally friendly, financially sound small and medium-size enterprises (REP).</p> <p>Development of oil spills clean-up plan (ECUP)</p> <p>Acres of land cleaned up (ECUP)</p>	<p><u>Ongoing projects</u> Urgent Environmental Investment, Rural Environment</p> <p><u>New projects</u></p> <ul style="list-style-type: none"> • Environmental Clean-Up (FY09) <p><u>Other major agencies</u></p> <ul style="list-style-type: none"> • GEF, Carbon Fund

Annex 2

Results Framework and Baselines for the State Programme on Poverty Reduction and Sustainable Development, 2006–15

Strategic Goals

Analysis of the main characteristics of the poverty situation in the country has led to the formulation of the nine strategic goals for 2006–15. These goals are a logical continuation of the previous poverty reduction program, State Programme on Poverty Reduction and Economic Development (SPPRED):

1. Ensure economic growth and maintain macroeconomic stability.
2. Create enabling conditions to improve income-generation opportunities, especially in the non-oil sector, in the regions, and in rural areas.
3. Improve the quality of and ensure equal access to basic health and education services. Reducing income poverty is not enough if public services do not work properly.
4. Improve public administration and governance. Good governance and the continuous evolution of public institutions are internationally recognized as essential to successful integration and competition in the global economic system. Modern states require a capacity for coping with institutional change to ensure strong, transparent, and accountable public institutions, staffed by a professional civil service, guided by appropriate laws, and reinforced by a responsive judicial system.
5. Improve public infrastructure. This is a prerequisite for attracting foreign and local investment and creating jobs while reducing differences in living conditions by guaranteeing the entire population access to basic utilities.
6. Reform the social protection system to better protect vulnerable groups, especially children.
7. Improve the living conditions of refugees and internally displaced people, particularly vulnerable groups that require special attention and policy measures.
8. Ensure that government policy and programs in all sectors promote and protect gender equality.
9. Ensure that all economic development policies and programs and related legislation respect the principles of environmental sustainability.

Main Targets

Targets have been set to measure the achievement of the nine strategic goals (table A2.1). The aim is to achieve these quantifiable outcomes by 2015 by implementing policy measures set out in the five-year action plan attached to this document.

Table A2.1 Targets in the State Programme on Poverty Reduction and Sustainable Development

<i>Target</i>	<i>Baseline year</i>	<i>Baseline</i>
Decrease poverty level to 10 percent and eliminate extreme poverty and food insecurity by 2015.	2005	Absolute poverty level: 29.3 percent Extreme poverty level: 2.2 percent
Increase GDP per capita by 2.2 times by 2015.	2005	AZN1,435.7 (\$1,517)
Increase non-oil GDP by 2.2 times by 2015.	2005	AZN6.9 billion (\$7.4 billion)
Maintain annual inflation rate at less than 10 percent through 2015.	2005	9.6 percent
Increase foreign trade turnover by 1.7 times by 2015.	2005	\$8.6 billion
Decrease unemployment level to 2 percent by 2015.	2003	10.7 percent
Bring eligibility criterion for receipt of social assistance up to national subsistence minimum in phases by 2010, with complete transition to single-family benefits by 2015.	2006	AZN30
Ensure that minimum wage, basic pensions, and unemployment benefits are at least equal to the national minimum subsistence level by 2010.	2005	Minimum wage: AZN30 Basic pensions: AZN 25 Unemployment benefits: AZN 12
Ensure that all boys and girls complete a full course of general education by 2015.	2004	Net primary enrollment rate: 93.2 percent Net basic enrollment rate: 81.1 Net secondary enrollment: 51.1 percent
Maintain gender equality in the general education and improve gender equality in vocational, specialized secondary, and higher education by 2015.	2004	Net primary enrollment rate: 93.1 for males, 93.3 percent for females Net basic enrollment rate: 81.9 percent for males, 80.3 percent for females Net secondary enrollment rate: 51.4 percent for males, 50.8 percent for females Net enrollment rate at specialized secondary schools: 5.1 percent for males, 6.5 percent for females Net higher education enrollment rate: 9.7 percent for males, 8.9 percent for females
Double the number of children completing preschool (including community/family type) before entering primary education by 2015.	2005	20 percent
Ensure access by all school children and students to computers and Internet by 2015.	2005	Number of general secondary school students per computers: 947 Proportion of schools with Internet access: 4.4 percent
Increase proportion of women participating in decisionmaking to 30 percent by 2015.	2006	Proportion of women ministers and committee chairs: 3.3 percent
	2006	Proportion of women heading regional executive authorities: 1.2 percent
	2005	Proportion of women in parliament: 11.2 percent
	2004	Proportion of women in municipal

<i>Target</i>	<i>Baseline year</i>	<i>Baseline</i>
		legislatures: 4.1 percent
	2004	Proportion of female judges: 14 percent
Reduce the gender gap in employment by 2015.	2003	Share in overall economic activity rate: 59.5 percent women, 83.6 percent men Share in overall economic inactivity rate: 68.4 percent women, 31.6 percent men Share in overall employment rate: 41.5 percent women, 58.5 percent men Share in overall unemployment rate: 48 percent women, 52 percent men
Reduce the under-five mortality rate by two thirds by 2015.	2005	9.8 per 1,000
Reduce the maternal mortality rate by three-quarters by 2015.	2005	25.8 per 100,000
Halt the spread of tuberculosis, malaria, brucellosis, and helminthiasis by 2015.	2004	Number of new cases of tuberculosis: 3,673
	2005	Number of new cases of malaria: 243 Number of new cases of brucellosis: 415 Number of new cases of helminthiasis: 71,947
Halt the spread of HIV/AIDS by 2010.	2005	Number of new HIV infections: 928
Increase life expectancy at birth to 76 years by 2015.	2004	72.4 (69.6 male, 75.2 female)
Increase the proportion of the forest areas to total land area to 12.5 percent by 2015.	2004	11.5 percent
Increase the share of protected land area in total surface area to 12 percent by 2015.	2004	7 percent
Decrease by 20 percent the conditional quantity of fuel used for 1 kilowatt of energy for reducing greenhouse emissions in the power-engineering sector by 2015.	2004	386 gram
Maintain increase in carbon dioxide emissions per capita/kilogram at about 10 tonnes by 2015.	2004	3.6 tonnes
Construction of new settlements and houses for refugees and IDPs	2004	35 percent of refugees and IDPs in new settlements and houses
Increase the level of employment among refugees and internally displaced people to the average national employment rate by 2015.	2004	30 percent
Ensure complete satisfaction of the country's energy demands through internal resources by 2015.		
Increase the proportion of households with access to gas up to 85 percent by 2010.		
Ensure uninterrupted, good-quality water supply to the entire population of the Baku-Absheron region by 2015.	2005	60 percent
Create a reliable water supply system in regional towns and villages by using local springs and groundwater sources, and supply 80–85 percent of the population with water through a centralized water supply system by 2015.	2005	35–40 percent
Reconstruct 2,800 kilometers of motor roads in line with international standards by 2015.	2005	n.a.
Ensure supply of heating power to all existing residential and nonresidential buildings by 2015.	2004	Residential buildings: 17.2 percent Schools: 21.5 percent

<i>Target</i>	<i>Baseline year</i>	<i>Baseline</i>
		Kindergartens: 18.8 percent Health facilities: 22.2 percent Social facilities and public administrative buildings: 38.3 percent
Increase number of telephones to 50 per 100 people in cities and regional towns and to 30 per 100 people in rural areas by 2015.	2005	21.2 in cities and regions, 4.6 in rural areas
Increase number of Internet users to 5,000 per 10,000 persons by 2015.	2004	483 per 10,000
Improve governance and the quality of public sector management to align with EU standards by 2015.		n.a.

n.a. Not applicable.

Annex 3

CAS Completion Report, FY03-05

The CAS Completion Report reviews the experience in implementing the FY03-05 Country Assistance Strategy (CAS) for Azerbaijan. The CAS for the Republic of Azerbaijan (Report No. 25790-AZ) was delivered to the Board May 27, 2003, along with the government's poverty reduction strategy document, the State Programme on Poverty Reduction and Economic Development (SPPRED) (Report No. 25593-AZ). The CAS was designed to assist the government in implementing the first phase of the SPPRED. The Completion Report examines the relevance of the CAS to Azerbaijan's longer-term national goals, the achievement of CAS outcomes, and Bank performance in furthering CAS outcomes.

Longer-Term Strategic Goals Supported by the Bank

Azerbaijan faces the challenge of translating its temporary oil boom into sustainable economic growth and poverty reduction. During the past few years, the government has set the stage for a period of large-scale oil and gas revenues. Barring new discoveries, the revenue stream from oil and gas is projected to peak in the next 10 years and to decline thereafter. The critical challenge facing Azerbaijan is thus to ensure prudent and transparent management of these resources so that they are used to stimulate economic growth in the non-oil sector and improve public social service delivery while maintaining macroeconomic stability. The government, with support from the Bank and IMF, established the State Oil Fund (SOFAZ), which mandates a high standard of transparency in managing oil and gas revenues. A large proportion of revenues is being saved for future generations in the form of foreign financial assets, a politically difficult decision in a country with serious infrastructure and public service gaps, a high poverty rate, and pressing immediate needs.

To reduce poverty, the government with the SPPRED set medium-term goals of facilitating an enabling environment for growth of income-generating opportunities; maintaining macroeconomic stability; improving the quality of and equity in access to basic health and education services; improving infrastructure (including roads, delivery of utility services, communications, irrigation); reforming the system of social protection to give more effective protection to the vulnerable; and improving the living conditions and opportunities for refugees and internally displaced people. The Joint Bank-Fund Staff Assessment Note (JSAN) of the SPPRED concluded that the strategy is credible, that its broad policy priorities are appropriate and consistent with the multidimensional nature of poverty reduction, and that it reflected the need for balanced growth through development of non-oil sectors and a reduction in the differences in development between Baku and the rest of the country.

The FY03-05 CAS was closely aligned with the SPPRED. During FY03-05 Azerbaijan's main challenges were to maintain stability in the face of high levels of foreign investment into the oil sector, establish the institutions to enable proper management of oil revenues expected from FY06 onward, improve the environment for growth in non-oil sectors, and increase access to and the quality of public social services.

The Bank Group strategy to support the SPPRED and help achieve sustainable poverty reduction was organized into four strategic goals:

- Pillar I: **Manage the oil boom** to maintain macroeconomic stability, avoid Dutch disease, and facilitate non-oil growth, employment, and pro-poor expenditures.
- Pillar II: **Generate jobs and non-oil growth** by improving the business environment and access to financial services, building support infrastructure for small and medium-size enterprises, and stimulating agriculture.
- Pillar III: **Improve access to services** by reversing the decline in social services and assistance and in infrastructure.
- Pillar IV: **Help realize the oil potential** to the extent and within the time-frame the SPPRED presumes.

Both the government's strategic goals and the Bank's CAS objectives remained relevant throughout the period of the CAS. Given the difficult experience of many countries in managing resource booms, the emphasis on helping to fully realize the oil potential while promoting prudent management of the revenue flows was highly relevant. Stimulating development of non-oil sectors, such as agriculture, agro-processing, manufacturing, transit trade, and logistical services, is also essential to create employment and ensure sustained economic growth after oil reserves are depleted. Key elements of improving the environment for investment and growth in non-oil sectors are governance, removing impediments in the regulatory and administrative environment, and improving infrastructure and utility services. Azerbaijan inherited relatively good social indicators from the Soviet era, but these deteriorated during the 1990's. The challenge is to turn this situation around and develop a system that meets modern needs.

Bank Group Assistance Instruments

Bank assistance comprised intensive policy dialogue through adjustment lending and AAA, complemented by investments in infrastructure, the social sectors, and rural development. Recognizing that a window of opportunity existed before major oil and gas revenues would come on stream, the Bank Group's overall strategy has been to promote an intensive dialogue to strengthen governance, help define and prioritize policy reforms, disseminate international development experience, and provide high quality technical expertise and know-how in designing and implementing public investment projects.

The CAS laid out a base case scenario in which the Bank would lend \$163 million (\$123 million in IDA and \$40 million in IBRD funds) through nine projects. All nine projects were delivered, and a smooth transition from IDA-only to IDA/IBRD blend status was achieved (table A3.1). The first IBRD loan went to the Board in FY05. The CAS also laid out a high-case scenario, with enhanced PRSC lending and IBRD lending in infrastructure. Azerbaijan fell short of meeting the high-case triggers, mainly because of inadequate progress in restructuring the State Oil Company of the Azerbaijan Republic (SOCAR), as discussed below. Country performance was sufficient to increase Azerbaijan's performance-based IDA

allocation, and a 10th project for internally displaced people was approved. IFC committed \$66 million (3 percent equity and 97 percent loans) of its own funds to nine projects and arranged \$61.43 million in syndications, mainly in the financial and oil sectors. IFC also supported a regional project that will benefit Azerbaijan, a \$30 million leasing facility for Central Asia, intended to make leasing a viable alternative to private sector.

There was a clear shift to a programmatic approach in both lending (via APLs and PRSCs) and AAA (such as the programmatic PER and Poverty Assessment). Adjustment lending, closely integrated with individual sector loans and programmatic AAA, was used to spearhead sectoral reforms. Bank investment lending was also used to leverage larger investments by the government, the private sector, and other donors.

Projects funded during the CAS period benefited from a range of AAA on non-oil sector trade, investment, and trade facilitation; public expenditures; poverty; fiduciary and procurement systems; education and health; energy and other infrastructure; and the financial sector. Much of IFC’s advisory work in Azerbaijan focused on creating opportunities in the non-oil sectors, including through improved financial intermediation to support private sector growth and growth of small and medium-size enterprises. Other program highlights included a leasing development project, a corporate governance program, a linkages program for small and medium-size enterprises, and a FDI conference organized to focus global attention on the progress of economic reforms and the future investment potential of Azerbaijan in non-oil sectors. FIAS has provided advisory services to Azerbaijan’s Investment Promotion and Advisory Foundation and consulted on improving Azerbaijan’s investment legislation. As noted in the CPS above, during FY06 the strategy was continued through an active AAA program and four major new projects were approved.

Table A3.1 Bank Lending Projects in Azerbaijan, FY03-05

<i>Active projects FY03-05</i>	<i>Approved projects FY03-05</i>
Farm Privatization (closed FY04)	Baku Water Supply (Supplement)
Gas Rehabilitation (closed FY03)	Education Sector Development APL
Institution Building technical assistance (closed FY03)	Irrigation Dist Sys and Mgmt
Education Reform (closed FY04)	Rural Investment
SAC II (closed FY04)	Pension and Social Assistance
Urgent Environment Investment	Financial Services Development
Pilot Reconstruction	Economic Development Support to Internally Displaced People
Agriculture Development Credit	PRSC I
Health Reform LIL	Power Transmission
Baku Water Supply	Rural Environment
Financial Sector TA	
Irrigation/Drainage Rehab	
Cultural Heritage PRSV	
IBTA 2	
Highway	

Achievement of CAS Objectives

Overall Poverty Reduction

At the national level, the proportion of poor people declined from 44.6 percent in 2002 to 24 percent in 2005, a decline of 46 percent (table A3.2). The proportion of people living in extreme poverty declined from 26.9 percent of the population in 2002 to 9.2 percent in 2005. These findings based on comparable Household Budget Survey (HBS) data suggest that 1.9 million people lived in poverty in 2005, down considerably from almost 3.3 million in 2002. Growth has been pro-poor, with consumption increases of the poorest decile at twice the average, see figure 2 in the CPS above. Wages and salaries have increased significantly, with the minimum wage raised fivefold, albeit from a very low level. There has also been significant surge in transfer incomes for the poorer households. In 2004 government social transfers increased by over 35 percent among the poorest 20 percent of the households from their level in 2003. Pensions, which are the main component of government social program, have increased by about 44 percent for the poorest quintile during the same period.

A3.2: Estimated Number of People Living in Poverty in Azerbaijan, 2002–04
(percent)

	<i>Total</i>		<i>Baku</i>		<i>Non-Baku Urban</i>		<i>Rural</i>	
	<i>poor</i>	<i>very poor</i>	<i>poor</i>	<i>very poor</i>	<i>poor</i>	<i>very poor</i>	<i>poor</i>	<i>very poor</i>
2002	44.6	26.9	41.6	25.6	48.7	31.5	43.7	24.7
2003	39.7	22.1	34.8	19.3	46.0	27.9	38.4	20.0
2004	28.5	13.4	18.6	8.0	35.4	19.0	29.6	13.0
2005	24.0	9.2	14.7	6.6	27.2	11.9	26.9	8.9
2004-2005	-4.6	-4.3	-3.9	-1.4	-8.2	-7.1	-2.7	-4.1
2002-2005	-20.6	-17.7	-26.8	-19.1	-21.5	-19.6	-16.8	-15.7

Source: Household Budget Survey and Staff estimates.

Pillar I: Managing the Oil Boom

Macroeconomic management over the CAS period was commendable. The government was highly successful in maintaining macroeconomic stability. Despite large and potentially destabilizing capital inflows, a stable real exchange rate was maintained and inflation was contained to single digits through most of the CAS period (table A3.3). External debt fell from 24 percent of GDP in 2002 to 15 percent in 2005. Higher revenues and relatively cautious increases in expenditure yielded an average fiscal surplus of 0.6 percent of GDP between 2002 and 2005. The current account deficit rose sharply, from 1 percent of GDP in 2001 to 30 percent of GDP in 2004, due to higher oil sector imports related to BTC construction and upstream oil platform development. However, this deficit was financed by FDI and the overall balance of payments recorded a surplus. In 2005 the current account turned to a surplus of 1.3 percent of GDP. Given the increase in gross fixed investment, from 23 percent of GDP in 2001 to 58 percent in 2004, macroeconomic management has been remarkable. In late 2004/early 2005, inflation spiked, due in large part to insufficient flexibility in the exchange rate in the face of large capital inflows and higher public expenditures. In the second quarter of the year, the government, in consultation with the Bank and the IMF, introduced greater exchange rate flexibility and increased interest rates to bring

about a reduction in inflation. An anti-inflation decree with a wide range of structural measures was adopted. End-period inflation for 2005 is estimated at about 5.5 percent.

The Bank made effective contributions toward building the institutional framework to manage the oil boom. With Bank assistance the government has put in place a framework that has enhanced Azerbaijan's capacity to manage its oil revenues. A range of critical institutions for efficient and transparent oil revenue management have been established, operationalized, and strengthened, including SOFAZ, the Chamber of Accounts, the Public Investment Appraisal Division at the Ministry

Table A3.3: Summary of Key Indicators
(in percent of GDP unless indicated otherwise)

Item	2001	2002	2003	2004	2005*
Real GDP growth (percent)	9.9	10.6	11.2	10.2	26.4
Real Non-Oil GDP growth (percent)	10.4	12.3	15.5	13.4	8.4
Inflation (CPI, period average, percent)	1.5	2.8	2.2	6.7	9.7
GNI per Capita (US\$ Atlas)	660	720	820	950	1240
Current account balance	-0.9	-12.3	-27.8	-29.8	1.3
Net Foreign Direct Investment (US\$ mln)	227	1,067	2,352	2,351	459
Real effective exchange rate (percent, - depreciation)	-6.1	-7.1	-10.8	-3.5	7.5
Consolidated fiscal balance	-0.4	-0.5	-0.8	1.0	2.7
Consolidated fiscal balance, excl. Oil Fund	-1.4	-4.3	-4.2	-2.5	-2.3
Consolidated budget revenues	18.7	27.3	26.8	26.8	26.5
Gross fixed investment	22.9	34.1	52.9	57.7	44.1
External debt outstanding	22.8	24.0	24.0	22.8	15.0
External debt service to exports ratio (percent)	5.3	5.9	6.6	5.3	2.6
Crude oil price (US\$/barrel)	24.4	24.9	28.9	37.7	53.4

Source: State Department of Statistics, Bank and Fund staff estimates. *2005 data are estimates

of Economic Development, and the early phases of an MTEF for budget preparation and execution. Extrabudgetary resources have been integrated into the state budget, which has been published since 2003, in accordance with the new budget law. Government Finance Statistics Manual (GFSM) classification has been adopted. All SOFAZ expenditures, except for operating expenditures, are incorporated as part of the annual consolidated government budget presented to the Parliament for approval. The Ministry of Finance publishes quarterly budget execution statements that include the use of the Oil Fund. SOFAZ also publishes quarterly financial statements as well as annual reports audited according to international standards. Bank advice was provided to strengthen the fiduciary framework for governance in public entities and in the private sector via auditing and accounting reform, and reform of public procurement.²⁴ A new procurement law was adopted and new accounting legislation based on IFRS enacted for private and public sector entities.

While good progress has been made, a substantial agenda lies ahead in further strengthening key institutions. Progress in creating capacity in government auditing has been slower than expected. The Chamber of Accounts has been established and staffed, but its capacity and access to information are limited, restricting the scope of its activities. Transparency in procurement practices is also not yet widespread. Line ministries do not adequately participate in the MTEF process, and the capacity of the Public Investment

²⁴ During the CAS period, the Bank prepared a *Country Financial Accountability Assessment* and a *Public Expenditure Review* in FY03. A *Country Procurement Assessment Report* was completed in FY02.

Appraisal Division needs to be further strengthened. Technical assistance programs in these areas by a range of donors are continuing. The real test of these institutions will come during the next CPS period, when large-scale revenues begin to flow. Experience suggests the need for gradual but consistent implementation along with extensive consensus building on reform issues, many of which represent substantial shifts from current practices. A long-term time horizon is essential, given the multilayered and compartmentalized structure of government in Azerbaijan and comparative weakness of the media and civil society.

Pillar II: Generating Jobs and Sustainable Growth outside the Oil Sector

The non-oil sector grew 13 percent a year during 2002–04, far exceeding the benchmark of 5–7 percent a year (table A3.4). Non-oil exports rose from US\$259 million in 2002 to US\$766 million in 2005, an average annual growth rate of 43 percent. Such high non-oil export growth, low inflation, low relative wages, and the most depreciated REER in the region (see box 1 in the CPS), are all strong indications that Dutch disease was avoided during the CAS period. The Bank and IFC worked closely with the government to support interventions to improve the business environment, strengthen the financial sector, promote agriculture, and diversify economic development to the regions beyond Baku. Employment growth in the construction, transport, and communications sectors was 3-5 percent per year. With a decline in agricultural employment (which accounts for 40 percent of the workforce), however, official data indicate that overall employment grew just 0.4 percent a year.²⁵ A better measure may be the growth in private consumption, which increased on average by 7-8 percent p.a., while the poorest decile enjoyed twice that growth, see figure 2 in the CPS on Azerbaijan's track record of pro-poor growth. Minimum wages rose more than five times between 2002 and 2005 (from \$6 to \$33 a month), and average wages rose substantially as well. The result of these wage increases was to raise the real incomes of the large majority of the population employed outside the energy sector, including teachers and health workers. The Bank made substantial contributions to growth in the non-oil sector through analytical work, close policy dialogue, and investments in the financial sector, rural sector, and infrastructure, as discussed below.

IFC supported local companies by building the capacity of financial institutions and small and medium-size enterprises. IFC's advisory work focused on creating opportunities for local suppliers to the major oil and gas development projects active in the region. The centerpiece of this strategy is the ACG/BTC Small and Medium-Size Enterprise Linkage Program, which provides capacity building to local small and medium-size enterprises that do business with international oil companies. Other IFC technical assistance included a leasing development project and a corporate governance program. These programs are working to improve the country's overall investment climate through policy dialogue, training and public awareness campaigns, in addition to increasing investment attractiveness of local joint-stock companies and banks.

²⁵ Information on employment and the labor market in Azerbaijan is weak. Although labor market issues are a serious concern in Azerbaijan, where unemployment and underemployment are high, the Bank has had little success in engaging the government on these issues and agreeing on a strategy and work plan.

Table A3.4 GDP Growth Rates, by sector, 2002-05
(percent)

<i>Sector</i>	2002	2003	2004	2005 ^e
GDP	10	11	10	26
Non-oil GDP	12	16	13	8
Industry	4	6	4	57
Agriculture	6	6	5	8
Construction	82	48	41	2
Trade	6	9	9	10
Transport			4.5	11.5
Communications	10	11	36	36
Other services	8	12	11	11

Source: 2005 State Budget Package Document and Bank Staff estimates.

Despite some progress, continuing efforts are needed to improve the business environment. Azerbaijan scored better than the average ECA country on 15 of the 21 “Problems Doing Business” indicators in the 2005 BEEPS. It scored below average on corruption, business licensing, customs and trade regulations, tax administration, tax rates, and electricity. At least 25 percent of respondents identified these areas as problems (other problem areas included the cost of and access to finance). Perceptions in each of these areas except electricity have worsened since the 2002 survey. This deterioration may be related to the transition in Presidential power in 2003-2004, and as such transitory. WBI Governance Indicators show steady progress during the CAS period on government Effectiveness and Regulatory Quality, areas where the Bank has influence, while progress in areas where the Bank has less leverage has been mixed.

At the beginning of 2005, according to *Doing Business*, it took 115 days to start a business in Azerbaijan—three times as long as in the average country in the Europe and Central Asia Region. This figure was reduced to 56 days in May 2005, when the regulations for registering legal entities were streamlined. The cost of dealing with licenses fell from 1,326 percent of per capita income to 977 percent in 2005, but is still almost twice the regional average.

With Bank advisory assistance, the government has begun addressing these issues.²⁶ Income tax on businesses was reduced from 27 percent in 2002 to 24 percent in 2004, tax-exempt income was raised by 50 percent, and the three-tier tax system was consolidated into two tiers. Azerbaijan has joined the Kyoto Convention on Simplification and Harmonization of Customs Procedures, and preparatory work has begun to adjust the country’s customs code. A new anticorruption law has been enacted, and the President has decreed an elaborate State Programme for Combating Corruption. However, progress has been slow. The FY06 Judicial Reform project is helping to strengthen governance in the court system and facilitate citizens access.

²⁶ Bank Group AAA included the benchmark annual Doing Business survey, INOTIS, the Transcaucasus Tourism Initiative IDF (FY05), and the Trade Facilitation TA/policy notes (FY04). A Bank/IMF Financial Sector Assessment Program was completed in 2004.

Prudential norms and increased competition have been introduced in the financial sector. The Bank worked closely with the IMF to help the government encourage consolidation as well as competition in the financial sector. During the CAS period there have been significant improvements in the legal and regulatory framework for the banking sector, as well as in supervisory practices. The new Banking Law and the new Law in National Bank of Azerbaijan were enacted in 2005 and address the key issues identified by the FSAP. A number of new prudential regulations in line with BIS standards have been issued, a CAMEL-based bank rating systems has been introduced, the prudential reporting systems improved and there is now systematic off-site surveillance. The quality of on-site supervision has also improved. IFRS was implemented in all banks. National standards for banks governance were established, internal controls and audits strengthened, and a credit reporting system became operational in May 2005.

The Banking sector was characterized by very strong growth, from about USD 994 million at end 2003 to USD 3.12 billion in mid-2006. The competition in the banking sector is increasing, but the dominance of the state-owned International Bank of Azerbaijan (IBA) continues to be a problem (although the dominance has been reduced from 80 percent in 2000 to about 50 percent of the total banking assets and about 20% of the total capital as of mid 2006). In 2003 the 44 private banks had 96 branch offices, while state-owned IBA and Kapital Bank had 125 branch offices. At end 2005, the number of branch offices of private banks had increased 2.8 times to 270. Efforts to expand access to financial services outside Baku are moving forward under the new Bank-financed **Financial Services Development Project**. As the smaller domestic banks continue to grow and become stronger, the market position of IBA is expected to decline more quickly in the next couple of years. Furthermore, IBA's previous monopoly on credit cards has now vanished through the IDA-supported introduction of a second card system owned by the association of private banks. The issue of the privatization of IBA and Kapital Bank remains open. One reason is that it has been difficult to find interest from fit and proper investors.

IFC supported four financial sector projects designed to channel funds to the small and medium-size enterprise sector. IFC assistance included follow-on credit lines to two local banks that IFC support has helped transform into sustainable competitive financial institutions with the capacity to support small businesses. IFC has also provided assistance to the banks to reduce the risks associated with lending to smaller businesses by implementing credit review and portfolio management tracking systems and by training branch managers, loan officers, and credit analysts.

IFC was instrumental in establishing the first and only commercial microfinance bank in the country, the Micro Finance Bank of Azerbaijan. IFC's initial \$1.75 million equity investment and recent additional \$3 million loan to the bank has helped built confidence in the banking sector and introduced commercial microfinance techniques to Azerbaijan. Nineteen microfinance institutions now operate in the country, with an overall credit portfolio of \$52 million and more than 64,000 active clients, 39 percent of them businesswomen. The total amount of microfinance loans, which range from \$100 to \$125,000, is expected to reach \$200 million by end-2005.

Farm privatization was completed, and rural credit systems are being developed. Under the Farm Privatization Project, which closed at the end of 2003, land titling and registration models were piloted that were subsequently adopted countrywide. The farm privatization of the late 1990s is considered among the most successful in the CIS. With decentralization of land transaction services under the **Agricultural Development and Credit Project** (ADCP), the number of registered land transactions reached 10,000 in 2004, far exceeding the CAS target of 3,000 transactions a year. The ADCP also supported access to credit for more than 20,000 rural borrowers, far exceeding the CAS target of 7,000. While the credit unions are still young, most show signs of operational viability. A follow-on ADCP-2 was approved in June 2006, while enlarging the real estate registration to country-wide coverage was separated out as a self-standing project for FY07 due to its size.

Rehabilitation and construction of irrigation and drainage infrastructure under two Bank projects resulted in a significant increase in crop yields in the target areas. A **Rural Investment APL**, focusing on community-based management of infrastructure by rural communities, municipalities, and water users associations, was also commenced during the CAS period.

For Azerbaijan these are new concepts that are taking root slowly; the CAS period saw progress in deepening and broadening recognition and acceptance of the key role of grassroots organizations in the rural sector. To facilitate this process, the government adopted new legislation that simplifies the process of registering legal entities, including NGOs, and established a legal registry. Notwithstanding these important achievements, the agenda in the rural sector remains large, with much work remaining to be done to improve access to credit, markets, and infrastructure.

Bank AAA in the rural sector included a study of a marketing and agro-processing issues and a study of the rural impact of utility price changes.

Several initiatives have been undertaken to reduce pollution and strengthen natural resource management. Azerbaijan's national environmental priorities were defined in the 1998 National Environmental Action Plan, which has since gained increasing attention from both the public and the government. The Bank has placed emphasis on building capacity in the Ministry of Environmental and Natural Resources. Although continuing institutional weaknesses exist, the ministry is gradually taking a leading role in national policymaking.

Under the regional Caspian Environment Program, a National Caspian Action Plan was developed that has received strong donor support. The **Urgent Environmental Investment Project** helped build a sturgeon fingerling hatchery to help restore the stock of sturgeon in the Caspian Sea. Six million fingerlings were produced in its first year of operation, with an eventual target of 15 million a year. The project also demonstrated several onshore oilfield cleanup methodologies and mercury removal methods by cleaning up a heavily contaminated area.

The Council of Ministers approved a Hazardous Waste Management Strategy in 2004 to mitigate the environmental impacts of oil production. A National Monitoring Department

was established to track pollution emissions, and an Agency for Management of Toxic Wastes was created to coordinate waste disposal.

Further Bank support is being provided under the **Rural Environment Project**, approved at the end of the CAS period, which focuses on improving forest and pasture management and biodiversity conservation. Work has also begun on establishing a mechanism to address legacy pollution and begin preparation of a proposed Absheron Peninsula Environmental Cleanup Project for the next CPS period.

Pillar III: Improving Infrastructure and Social Services

Azerbaijan is on track to reach most of the MDGs. During the CAS period the MDGs were largely integrated into the SPPRED (see annex 4). The Bank worked to improve the statistical basis for benchmarks and monitoring progress in achieving them. A close partnership through the Programmatic Poverty Assessment strengthened Azerbaijan's capacity for poverty analysis.

Notwithstanding this progress, analytical gaps remain, notably the absence of regular labor market surveys and insufficient understanding of the economic status of internally displaced people. In health the discrepancy between government statistics and survey data make it difficult to determine whether progress is being made in reducing under-five and maternal mortality. To achieve the MDG on ensuring environmental sustainability, Azerbaijan needs to give higher priority to improving drinking water sources, especially in rural areas.

Good progress was made in providing free textbooks and piloting student assessment as steps toward improving access and quality in the education system. The gross primary education enrollment ratio increased from 98.6 percent in 2001 to 102.4 percent in 2003; the gross upper secondary enrollment rate rose from 43.2 percent in 2001 to 70.5 percent in 2003. Higher education enrollment dropped slightly, from 13.4 percent in 2001 to 12.2 percent in 2003.

While CAS targets were broadly met, the education system continues to be plagued by rigidities, inefficiency, and informal payments. The government has adopted a comprehensive reform program and appointed an Education Commission to accelerate progress in implementing the agenda.

The Bank is continuing to help this process. It approved an **Education Sector Development APL** during the CAS period, supported by an Education Sector Note (FY03). To improve equality in opportunity in basic education, the Bank supported efforts to provide children in grades 1-5 with free textbooks. (According to government data, this target was achieved in both 2003 and 2004.) A Department for the Assessment of Pupil's Achievement was established in 2004, and a pilot assessment in math and the Azeri language was conducted for 1,900 children in grade 5. Under **IBTA-2** a study on financing of education, public education expenditure, and education priorities was prepared and training in expenditure analysis was provided.

Table A3.5 Key Social Indicators in Azerbaijan, 2001–03

	2001	2002	2003
Life expectancy at birth	71.9	72.2	72.3
Gross primary enrollment rate (percent)	98.6	98.8	102.4
Gross upper secondary enrollment rate (percent)	43.2	63.4	70.5
Gross higher education enrollment Rate (percent)	13.4	12.5	12.2
Maternal mortality rate (per 100,000 live births)	25.4	19.9	18.5
Infant mortality rate (per 1,000 live births)	12.5	12.8	12.8

Source: Government of Azerbaijan, *SPPRED Progress Report, 2005*.

Primary healthcare service delivery was improved in target areas, although systemwide reforms are still required. Azerbaijan has taken steps toward reversing the spread of tuberculosis by expanding DOTS coverage, and its first HIV/AIDS grant funded by the Global Fund has been approved.

Due to limited government commitment to the broader reform agenda and governance issues, Bank objectives for the CAS period in the health sector were limited to improvements in health service delivery in pilot districts.

The **Health Reform LIL** was successful in improving access to healthcare services in five pilot districts. The number of patients at improved primary health care facilities in the target districts rose by 65 percent and patient satisfaction rose from 34 percent to 61 percent. The project was not, however, able to convince key stakeholders to adopt reforms on a wider scale. Health expenditures rose from 4.8 percent to 5.4 percent of public expenditures but there was little rationalization of expenditures, including right-sizing of the number of hospitals. Although adequately endowed in terms of facilities and staff, the healthcare system continues to suffer from very low utilization rates, particularly among the poor. Experience in the health sector to date indicates that little reform can take place without an adequate governance framework, political will, and buy-in from key institutions involved. When the leadership in the Ministry of Health changed in 2005, the Bank was ready. The comprehensive *Health Sector Review* (FY05) defined the main elements of the comprehensive reform program which are now being pursued through the FY06 Health Sector Reform project.

Social protection transfer levels were increased and systemic reforms are imminent. Dialogue on social protection reform advanced significantly during the CAS period, supported by the **Pension and Social Assistance Project**, a PSIA of the *Impact of Utility Price Changes*, and intensive work on poverty statistics and mapping. Both pensions and social assistance payments are being paid on time and there are no apparent arrears. The President approved a pension reform agenda to address both policy and administrative deficiencies. A computerized individual record system for pensioners is being developed and effective January 1, 2005, the minimum pension amount was increased to AZM 125,000 per month, equivalent to the minimum wage at the time. Social benefits were also increased. A new targeted family/poverty benefit scheme was introduced on July 1, 2006. This will also help compensate for the impact of planned future utility price increases.

The government's strategy toward internally displaced people's has been increasingly oriented toward long-term sustainable improvement rather than "temporary" solutions. The government is increasingly taking the initiative on programs to promote sustainable livelihoods for internally displaced people. SOFAZ has significantly increased resources to refugee settlement (\$47 million in 2004). Average per capita income among internally displaced people slightly exceeded the overall population average (table A3.6). Bank assistance since 1995 was focused through the **Pilot Reconstruction Project**, which built transport, energy transmission, and other infrastructure in war-affected areas, enabling about 36,000 internally displaced people to return to their places of origin. It also established a targeted social fund, which has financed about 190 micro-projects, with an average cost of about \$35,000, for a total of about 160,000 beneficiaries. In light of additional IDA resources becoming available due to improving country performance, the Bank added an FY05 follow-on **internally displaced people Economic Development Support Project**, which is scaling up the social fund. There remains, however, a need to better integrate internally displaced people issues into the overall poverty analysis and sectoral programs and improve data in this area to gauge progress more clearly.

Table A3.6 Monthly Income and Consumption Expenditures of Refugees and Internally Displaced People (AZM per capita)

<i>Item</i>	<i>2002</i>	<i>2003</i>	<i>2004</i>	<i>Percent change, 2002–04</i>
<i>Income</i>				
Refugees/internally displaced people	185,772	199,076	217,127	16.9
Overall	179,107	187,880	207,558	15.9
<i>Consumption</i>				
Refugees/ internally displaced people	163,350	172,071	217,358	33.1
Overall	164,788	175,863	215,595	30.8

Source: World Bank/Government of Azerbaijan HBS

Transport sector management has been strengthened and rapid development of the road network is underway. The government has embarked on an ambitious investment strategy in the transport sector to address critical bottlenecks in developing the non-oil sector and in improving economic opportunities and access to social services outside Baku. Significant budgetary resources have been allocated to road development and are being complemented by strong donor support. The Bank made contributions to institutional strengthening in the Ministry of Transport, Highways Administration, and other transport-related institutions. Budget increases for road maintenance have exceeded the 10 percent a year target and there has been increasing competition among suppliers and contractors. A functional classification of the road network was completed and a Pavement Management System to analyze and prioritize road projects has been operational since January 2005. Work is underway to rehabilitate sections of the East-West highway and several rural road maintenance contracts have been completed under the **Highway Project**. The program provides a balanced approach to: upgrading major highways to 4 lanes; rehabilitating some national and regional roads; and rehabilitating a part of the secondary and local network. A

second Highway Project for the North-South transit corridor was approved in FY06. While good progress is being made in roads, significant additional investment and maintenance is required, with 81 percent of arterial roads still in poor/bad conditions. Moreover, considerable work remains ahead in other transport sectors, including maritime transport, railroads, aviation, as well as customs. The 2006 BEEPS reported that the percentage of firms seeing transport as a problem doing business has increased since 2002. Through dialogue on trade facilitation, the Bank helped achieve some progress in developing a public/private dialogue on trade and transport issues and in improving cooperation on these issues with neighboring Georgia.²⁷ Regional cooperation on a larger scale is still constrained by political factors, however.

Some steps were taken in reducing energy subsidies, increasing utility tariffs, and improving water supply in Baku, although the reform agenda in the utility sector remains large. In energy and other utility sectors, the Bank focused on structural reform, improving governance and financial performance, cutting subsidies, and improving the safety and reliability of services. According to the 2006 BEEPS, the percentage of firms seeing telecommunications and electricity as a problem doing business declined from 9 percent and 30 percent respectively in 2002 to 5 percent and 25 percent in 2005. Progress was made in removing implicit energy subsidies, both through better collections and through making indirect subsidies explicit through the budget process. The overall level of energy-related subsidies declined from 7.7 percent of non-oil GDP in 2002 to 6.5 percent in 2004 and is projected to further decline to 4.7 percent in 2005. Gas tariffs were quadrupled in 2004 and water tariffs doubled in order to move closer to cost-recovery. Survey data in Baku show improvement in drinking water safety, although it remains a serious concern in other parts of the country. Rehabilitation of the main water treatment plant in Baku under the **Baku Water Supply project** is nearly complete, improving source quality.

Yet, low quality of utility services, lack of metering and inflated norms hampers bill collections and the financial viability of the companies is questionable. The financial condition of the utility sector remains weak and increased metering and an improved regulatory framework is needed for electricity, gas and water entities to become commercially sound. Progress toward privatization or increased private sector involvement in utilities has also been slower than anticipated. Limited data also prevents an accurate assessment of improvements in service delivery in the water or energy sectors. There have been no repeats of the nationwide electricity blackout of 2002, but system reliability remains fragile with frequent localized outages and occasional widespread system failures. The government has now started very major investments in power generation and transmission. Further commitment was shown in July 2006, when President Aliyev instructed the Cabinet of Ministers to increase collection rates for public utilities within three months at all cost. September collection rates doubled to 83 percent for gas and 70 percent for water.²⁸ Meters are rapidly being installed. As mentioned, tariffs were raised significantly for gas and water. The targeted social safety net started July 1, 2006, which eventually will allow for adjustment

²⁷ Key components of this dialogue included Bank AAA on *Building Competitiveness: An Integrated Non-oil Trade and Investment Strategy (INOTIS)* (FY03) and the *Trade and Transport Facilitation Study (FY03)*.

²⁸ September 2006 collection rates for electricity were not available at the time of printing.

of tariffs to cost-recovery levels. The new Accounting Law requires IFRS for all utility companies.

Pillar 4: Realizing the Oil Potential

The objective of Pillar 4 was to facilitate and finance oil and gas development, and ensuring that the projects' social and environmental impact is mitigated. Development of Azerbaijan's oil sector has proceeded on schedule, fueled by some \$8 billion in investments during 2002-05. The ACG Phase 1 upstream project achieved first oil in February 2005 and is now producing approximately 136 thousand barrels of crude oil per day. Various factors led to a delay in the completion of the extremely complex construction of the BTC pipeline by more than a year. The BTC Company began filling the pipeline in Azerbaijan with crude oil in May 2005. Oil reached Ceyhan by May 2006. The first phase development of the Shah Deniz gas field is progressing on schedule and with construction of the South Caucasus Pipeline gas exports are expected to commence in 2006. With these developments, the oil sector is projected to grow at 60 percent a year during 2005-07. After 2007 growth is expected to gradually slow and then start declining over the medium to longer term.

The Bank Group played a catalytic role in helping realize the oil potential. The Bank Group played a key role in helping realize the oil potential, not just in marshalling financing for the oil field project and BTC pipeline development, but also in taking the lead to ensure maintenance of the highest social, environmental and safety standards. IFC supported the second stage of development of the ACG Phase 1 oil field in Azerbaijan and the associated BTC pipeline in FY04, with loans of \$61.43 million for its own accounts and syndicated loans of \$31 million. IFC has also been instrumental in conducting multi-stakeholder meetings in the country, convening local people, nongovernmental organizations, and others to hear concerns about the BTC pipeline's route and other issues. Regular monitoring of the project continues by multiple independent entities including NGO groups in Azerbaijan and IFC's environmental and social staff. During the BTC construction, IFC staff accompanied both the environmental missions (which occurred four times per year) and the social missions (which occurred twice a year). IFC also interacts on a regular basis with engineering monitors, who work on behalf of the lenders group, and with the Caspian Development Advisory Panel, which advises BP on their work in the region. As discussed in the first pillar, IDA played a major role in helping Azerbaijan put into place adequate institutions for transparency in revenue tracking and utilization, centered on the Oil Fund, budget systems, MTEF, and the PIP. These institutional reforms played a critical role in creating the enabling governance framework necessary for international oil companies and banks to commit the long-term, large-scale financing for the project.

The comprehensive monitoring framework has led to early identification of issues, which the lenders and civil society have worked with the project to resolve. IFC has also encouraged BTC to include civil society in the monitoring framework, which BTC has been able to do so effectively in Azerbaijan. IFC sits on the Steering Committee that reviews quarterly progress. Furthermore, IFC has dedicated a staff based in Baku identifying, implementing and monitoring linkages projects under the ACG/BTC SME Linkage Program. To date, linkages have included supply chain technical assistance to improve the ability of

potential suppliers to win long-term contracts and access to business services delivered through the BP Enterprise Center, and the Energy Bus to disseminate information on energy-saving and alternative energy technologies (4,486 households participated in the demonstrations). The program illustrates IFC's effort to create more opportunities for smaller local businesses. IFC's Corporate Citizenship facility has also dedicated \$200 thousand in co-funding to help sponsors build the capacity of civil society in the region.

Although not an explicit objective of Pillar 4 of the CAS, a substantial challenge remains in restructuring SOCAR, which has an equity investment in all oil and gas joint ventures in the country, conducts its own production and refining operations, and dominates the domestic oil and gas markets. During the CAS period a major corporate restructuring consolidated SOCAR into 8 divisions from previously 171 business units. Several non-core assets were separated from SOCAR in view of the preparation of their privatization. There is still a need to separate SOCAR's commercial and regulatory functions and improve the transparency of its operational activities and financial reporting. A management company was hired and has advised SOCAR on implementation of the action plan. The 2004 Accounting Law, enacted with the support of the PRSC, stipulates that SOCAR and all other state-owned enterprises should file and disclose according to IFRS by 2008. While this deadline may be optimistic, given the complexities involved, good progress is being made according to SOCAR's action plan. To begin implementation of an action program on financial and corporate restructuring of SOCAR was a high-case trigger of the CAS, but not a condition for satisfactory implementation of the baseline. Supported by the PRSC, the agreed action plan got underway.²⁹

5. Outcome Assessment and Contribution to Results

Outcome: Satisfactory

The CAS period saw substantial progress in all four strategic directions. Particularly strong results were seen in the first and fourth pillars: managing the oil boom and helping realize the oil potential. GDP grew an average of 11 percent per year over the past four years with non-oil GDP growing nearly 13 percent a year; the BTC pipeline is nearing completion; development of gas fields and other pipelines are on schedule; the Oil Fund is firmly in place; the budgetary framework is being implemented; and the government's commitment to maintaining high standards of governance and transparency in the utilization of its energy revenues was demonstrated by its groundbreaking participation in the EITI, as the first country in the world to report for 2003, 2004 and 2005. Good progress was also made toward the second and third goals, although progress was slower in some important areas. Sustained growth was seen in the non-oil sector and progress was made in most areas supported by the Bank, including banking competition, land market, rural credit, irrigation, and environment.

²⁹ The CAS high-case trigger on SOCAR was also a core conditionality of the PRSC and was met as a prior action. See the Azerbaijan PRSC Program Document, April 19, 2005, table 4 on p. 34, and pp.27-29.

Table A3.7. CAS Outcome Assessments, by Objective

<i>Objective</i>	<i>Outcome</i>	<i>Explanation</i>
Pillar I: Manage the oil boom	Satisfactory	Commendable macroeconomic management; substantial improvements in institutions required for transparent oil revenue management. The real test of these institutions, however, will be in the next CPS period, when substantial oil revenues come on stream.
Pillar II: Generate jobs and non-oil growth	Moderately Satisfactory	Sustained non-oil sector growth; good progress in most areas supported by the Bank, including much more banking competition and stronger enforcement of prudential regulations, as well as progress on land market, rural credit, irrigation, and environment. However, further progress is needed to improve the small and medium-size enterprise/business environment.
Pillar III: Improve infrastructure and social services	Satisfactory	Azerbaijan is on track to meet most of the MDGs. Good progress was seen with Bank interventions in education, social protection reform, and targeted health care. Systemwide reforms of the health sector are now underway supported by the Health Sector Reform project, which was based on the Health Sector Study completed during the CAS period. Road development is proceeding rapidly; reforms in energy and utilities are underway with rising tariffs and collections, and renewed commitment from the government.
Pillar IV: Realize oil potential	Satisfactory	High levels of investment attracted into oil sector; all major projects on track for completion; oil growth projected at 60 percent a year over next few years. Although not an objective of the CAS baseline, major SOCAR restructuring took place and implementation of IFRS is underway.

However, considerable work remains to be done to improve the business environment, competition in the banking sector, and eliminating corruption in order to fully realize non-oil growth and employment creation potential. In the social sectors, IDA had significant impact through the dialogue on health, pension and social assistance and comprehensive reforms are underway. The government also strengthened its care to internally displaced people and began seeking sustainable solutions to improving their living conditions and economic opportunities. In the education sector, progress was made in developing new curricula, provision of free textbooks, and monitoring education outcomes. Restructuring continued in the water and energy sectors, although limited progress was made on increasing private sector involvement. The government has recently showed renewed commitment in these sectors.

Sustainability: Likely

Continued momentum on reforms, underpinned by rising oil revenues makes the sustainability of these outcomes likely. Primary risks to the sustainability of achievements to date include a delay in implementing structural reforms due to non-reformers and vested interests; a deterioration in financial management as oil revenues increase dramatically; disruption of resource flows due to volatile oil prices or delays in oil pipeline construction; and a deterioration in the political or security environment. Mitigating factors include an active PRSP process; an emphasis on macroeconomic management, Oil Fund integrity, strategic long-term oil revenue management, sound budget preparation processes, and financial accountability; a SPPRED/CPS emphasis on diversifying the sources of growth and expanding participation in the economy; broadening dialogue with civil society; commitment to furthering the democratic process; and a shift toward establishing stable relationships with neighboring countries. All five projects that closed during the CAS period (Farm Privatization, Gas Rehabilitation, IBTA, Education Reform and SAC 2) were judged to be “likely” or “highly likely” to be sustainable by OED.

Bank Performance and Contribution

Strong policy dialogue and closely integrated sectoral lending made substantial contributions toward advancing Azerbaijan’s strategic objectives over the CAS period. IDA’s policy dialogue has been a key facilitator of change in the country’s transition to a growing market economy. The Bank Group was able to maintain a constructive dialogue around the PRSCs even in the absence of urgent funding gaps. The Bank did not “push through” a financing package without the government’s demonstrated credibility toward accelerating the reform agenda. SAC-II and PRSC-I provided an integrating and consensus-building platform for a wide range of reform measures that would have been difficult to undertake individually. Reforms were prepared in close collaboration with key implementing agencies and managed to create a new vision and agenda for development as expressed in the SPPRED. Particularly important was the Bank’s partnership with the IMF and other donors in formulating and implementing a coherent set of policies. Such a strategy required a high level of coordination among Bank team members in program content, ESW and mission timing. The formula for success was a tightly knit country team creating synergy and leverage between the high-level reform agenda and supporting sector projects. Supervision of SAC-II, for example, was felt as a responsibility by the whole country team. The Bank and IFC teams managed to build new relationships and trust between Azerbaijan and the Bank. The Country Office played a crucial role in the dialogue with the government.

Portfolio performance indicators remained satisfactory throughout the CAS period. All nine new lending projects targeted for the CAS period were delivered and a tenth project was made possible by higher performance-based IDA allocations. Altogether, twenty five projects were active during the CAS period and a satisfactory portfolio status was maintained. Currently, all projects in Azerbaijan under implementation are rated satisfactory. The portfolio disbursement rate was satisfactory, averaging 18–20 percent per year over the CAS period. Of the six projects that closed during the CAS period, all were rated satisfactory on completion except one—the Gas Rehabilitation Project, which was judged successful in rehabilitating infrastructure in a sustainable manner, but not in promoting the wider reform

agenda in the gas sector. Follow up reviews by IEG rated this and two others as unsatisfactory. In the Education LIL, the project was successful in training in interactive teaching, but IEG felt that the curriculum development and evaluation components were unsuccessful. In the Urgent Environment Project, IEG noted that while some urgent physical targets were met (like the hatcheries) other components were less successful, particularly on the environmental clean-up. IEG rated Bank performance satisfactory in all projects, except the Gas Project, in which Bank performance was rated as “unsatisfactory” because of the assumption that the project in itself would provide sufficient leverage to carry out gas sector reforms. Not until SAC-II leveraged high-level policy dialogue did gas sector reform take off. In addition to the above, all four of the projects closed in FY06 were rated satisfactory at the time of closing, though the IEG review has not yet taken place. All projects and ESW reviewed by QAG were judged “satisfactory” with the exception of the Education Sector Note, in which formal dissemination was assessed as unsatisfactory. The general message of completion reviews was that it was important to have a sense of realism about the pace of change and maintain flexibility in implementation. It was also important to pay attention to building institutional capacity and to clarify legal and fiduciary responsibilities early on.

A positive shift toward programmatic AAA was made. The CAS period saw a shift in ESW away from long studies toward shorter programmatic policy notes, produced within a longer term phased schedule, to provide a basis for a focused and participatory policy dialogue on key issues. The Programmatic Public Expenditure Reviews and Poverty Assessments are being carried out in the form of individual modules, tailored with greater flexibility to the interests and needs of policy makers. Likewise, the 2004 Energy Study “Issues and Options Associated with Energy Sector Reform” is a compilation and synthesis of a series of shorter studies on individual energy sectors and issues that formed the basis for intensive dialogue with stakeholders in the energy sector. The World Bank Institute focused on an on-going South Caucasus regional program on fiscal decentralization and development of local government capacity over the past two years and on PRSP dialogues among the CIS-7 countries.

The Bank collaborated closely with other partners, particularly in structural reform areas. On the overall reform program there has been close coordination between the Bank’s support through the SAC-II and PRSC and the IMF-supported Poverty Reduction and Growth Facility (PRGF). The fourth review of the PRGF was completed satisfactorily in December 2004 and the program has come to conclusion in 2005. The ADB, the European Union, and the IsDB for capacity building provided critical support. The EU TACIS also helped on modernizing the taxation system. The Bank worked as one team with USAID on Treasury Systems, PIP and utility regulatory reform and teamed up with US Treasury on budgetary reform. The Bank worked closely with EBRD and USTDA on SOCAR restructuring. The Bank has also joined with ADB, Switzerland, and UNDP to support the formulation and implementation of the SPPRED. The latter has been particularly helpful in integrating the monitoring of the MDGs into the recent SPPRED progress report. An intensive three-way dialogue between the Bank, IMF and the government, and close cooperation supported achievements in the macro/financial management/governance environment with other donors, especially the European Union and USAID. See annex 6 for highlights of this collaboration.

Borrower Performance

Prudent macroeconomic management and commitment to implementing the SPPRED were key factors behind successful outcomes, although reforms in some areas have been slow. The government has chosen to work with the Bank on furthering reforms, strengthening governance and accountability, and opening Azerbaijan up to the market economy not because of financing needs, but because it feels it benefits from the Bank's advice. Strong ownership of the SPPRED has led to development of comprehensive reform agendas in a range of areas that are being gradually implemented. Azerbaijan's CPIA ratings rose significantly over the CAS period. Borrower performance was judged by OED to be satisfactory or highly satisfactory in all projects closed during the period except for the Gas Rehabilitation Project. Relatively few problems were experienced with counterpart funding. In some areas, the pace of structural reform was somewhat slower than had been hoped for, in part due to the political transition that took place early in the CAS period. As a result, Azerbaijan remained in the Base Case throughout the CAS period, rather than moving into the High Case. The government and Bank team had hoped that a significant acceleration in the pace of structural reforms in the utilities sector and trade/business agenda would permit disbursement of PRSC-I and an IBRD Energy Infrastructure loan in FY04, and a second PRSC in 2005. Instead, the reforms moved forward slowly, and the Energy Loan and PRSC-I only went to the Board at the end of the CAS period.

More needs to be done to improve project processing and effectiveness and civil society participation. The government in Azerbaijan remains compartmentalized and government decisionmaking procedures are complex. As a consequence, project preparation and negotiations are delayed and there have been some long lags between project approval and effectiveness, with the risk of undermining timely implementation. The government has also shown limited acceptance of international TA, resulting in delays in implementation and analytical gaps that hamper the monitoring of performance. As a result, 6 out of the 8 projects that have closed or are scheduled to close during the CAS period required extensions. In addition, implementation in several projects has been delayed by procurement issues and there is a need to carefully continue to ensure Bank standards of transparency in all projects. Civil society development and participation are also lower than in some countries at a comparable level of economic development and greater efforts to engage civil society groups in the development and implementation of reforms and investment projects are essential.

Exogenous Factors

There were no significant exogenous shocks over the period of the last CAS that affected the achievement of outcomes. The country benefited from higher than expected oil prices throughout most of the period. A political transition, when President Heidar Aliyev died in 2003 and his son Ilham Aliyev was elected as the new President period impacted the CAS. The transition resulted in some delays in moving forward with economic reforms, but President Aliyev's November 24, 2003, Decree and subsequent follow-up has since provided important impetus to reforms. CAS implementation did not have any unintended negative impacts that the team is aware of.

6. Lessons and Implications for Future Partnership Strategies

- *Consistent Bank assistance over a considerable time period helped build a consensus and advance policy and institutional change in Azerbaijan.* Continuous and long-term Bank engagement in policy dialogue combined with related investments and accompanying technical assistance, helped produce improved governance and transparency in oil revenue management as well as significant policy and institutional reforms in a number of sectors. Adjustment lending combined with technical support and advisory services proved particularly effective in helping the government formulate and implement policy reforms as well as overcome vested interests.

Implications: Stay consistently and constantly engaged in the policy reform agenda over the medium-term. Continued Bank engagement through policy dialogue can play a pivotal role in advancing the remaining reform agenda needed for Azerbaijan to consolidate its recent gains and ensure sustainable growth and poverty reduction.

- *The Bank's policy dialogue, knowledge, and technical expertise continue to be in demand in Azerbaijan.* The government has recognized that the value of Bank assistance goes well beyond the financing involved and welcomes continued Bank support even as energy revenues rise sharply and Azerbaijan enters Middle Income Country status.

Implications: Policy dialogue as well as technical and knowledge services will increasingly comprise the Bank's main value added in Azerbaijan and it should be ensured that such support is timely, relevant, and high quality.

- *The emerging challenge in Azerbaijan is to develop the means to stay fully engaged in the policy dialogue in the absence of urgent balance of payment needs and PRSC lending.* With a reduced need for balance of payment lending and the phasing out of IDA allocations for Azerbaijan, a key question is how the Bank can continue to stay fully engaged in the policy dialogue. Unlike some Middle Income Countries, Azerbaijan has a continued need for structural reforms to accelerate improvements in the business environment and further encourage growth in the non-oil sectors.

Implications: Develop alternate methods to remain engaged in critical policy issues in the absence of PRSC lending, including greater use of knowledge work as an entry point. Broad dissemination and greater involvement of civil society in knowledge-generating activities can help foster greater understanding and consensus around key reform areas.

- *Close integration of policy and investment lending and a closely knit country team enhanced the Bank's effectiveness.* A key lesson learned from the Gas Rehabilitation project was that the investment credit instrument in itself did not provide sufficient leverage to bring about difficult restructuring and pricing reform. The conditions attached to SAC-II were more effective in tackling such sector issues.

Implications: Ensure close integration of policy dialogue and investment lending and an intensive level of coordination among Bank team members in program content, advice, and project supervision.

- *The shift toward "programmatic" ESW during the CAS period resulted in a series of timely policy notes and workshops.* The programmatic approach to ESW has enabled both

in-depth “core” studies as well as shorter, themed or purpose-driven outputs and more consistent policy dialogue than one-off studies are able to provide. This, for example, has led to much improved poverty analysis.

Implications: Continue and expand programmatic analytical work to other sectors to enhance policy dialogue and dissemination of knowledge.

- *Complex administrative and decisionmaking procedures in Azerbaijan frequently cause implementation delays.* Projects in Azerbaijan continue to suffer from undue delays in project effectiveness and implementation.

Implications: Anticipate administrative and decisionmaking bottlenecks in all activities and enhance efforts to engage high level facilitators and broad buy-in at all levels to speed up implementation.

- *Continued areas of weak information undermine analysis and decisionmaking.* In several areas, such as the health sector and the labor market, the absence of accurate data undermines analysis and the establishment of meaningful objectives and monitoring indicators.

Implications: Enhance technical and advisory assistance in areas where information capacity remains weak. A comprehensive review of the labor market is an important element of better understanding and addressing the employment-generation goal.

- *While regional cooperation and integration has been politically difficult, it will be increasingly important for the region to sustain growth.* Clear economic opportunities exist in greater regional cooperation and integration, including in energy flows, trade and transportation. While the region remains politically volatile and continued tensions exist in some areas, there are signs of progress toward more stable economic and political relations among countries in the region, which is likely to open up significant opportunities for cross-border interventions.

Implications: Anticipate and prepare for increasing regional integration and at the appropriate time, engage in regional-level assistance, such as development of the transit corridor.

Table A3.8. Progress toward Azerbaijan's Long-Term Development Goals (SPPRED)

<i>Goal</i>	<i>Current status</i>
Maintain macroeconomic stability, and avoidance of Dutch disease	Instruments for efficient and transparent oil revenue management (State Oil Fund, Consolidated Budget, MTEF, Long Term Strategy for Using Oil Revenues, Public Investment Program and Chamber of Accounts) are being built and beginning to operate. The government was successful in maintaining a GDP growth rate of 11 percent, a stable real exchange rate and single digit inflation throughout most of the CAS period, despite large and potentially destabilizing capital inflows. While economic management over the CAS period has been prudent, the acid test of the new instruments will come during the next CPS period, when large scale revenues begin to flow. The 2006 budget expansion has raised concerns, but so far inflation has not spun out of control.
Facilitate an enabling environment for growth of income-generating opportunities.	Annual growth in the non-oil sector was strong at 13 percent a year over the past four years. The non-oil economy has seen sustained growth but job creation cannot be tracked because of inadequate statistics on labor market and employment issues. Moreover, a large part of economic activity is still in the informal sector. Substantial improvement in CPIA and BEEPS indicators since 1999, but business environment still needs close attention. The 2005 BEEPS highlighted persistent issues with the licensing regime, as well as tax and customs administration. Corruption is still widely perceived as a constraint to doing business.
Improve the quality of and equity in access to, basic health and education services.	In education, progress was made in developing new curricula and monitoring education outcomes, although at a slower pace than had been anticipated. The health sector faces serious access and equity problems, but dialogue is promoting awareness of the need for reform. Inadequate statistics make it difficult to set realistic targets in the health sector, and to monitor progress in meeting MDGs.
Improve infrastructure, including roads, delivery of utility services, communications, irrigation.	Piped water is available to about 95 percent of the people in Baku, 83 percent of those in other urban areas, and only 11 percent of those in rural areas. Similarly, some 73 percent of urban residents have access to adequate sanitation compared with only 36 percent in rural areas. Electricity services have improved considerably after distribution became privately managed. Transport and telecom is among the fastest growing sectors. Mobile penetration level end-2005 was 23.8 percent. Percentage of farmers receiving more than 75 percent of required irrigation water increased from 1 percent in 2002 to 35 percent in 2004. While these improvements are significant, quality issues still persist. Furthermore, progress has been made toward financial sustainability in the utility sector through improved collections, and tariff increases. While financial sustainability in the utility sector is gradually improving, further structural reforms, including greater private sector involvement, are needed.
Reform social protection to give more focus to the vulnerable	Minimum pensions and benefits have been raised and are paid on time. Significant progress has been made on pension reform. A new targeted social assistance system went into effect in July 2006. At the same time, minimum wages rose almost fourfold between 2002 and 2005 and average wages rose substantially. Poverty, while still high, is decreasing rapidly.
Improve the living conditions and opportunities of the refugees and internally displaced people population.	The Oil Fund and IDA provided resources to improve living conditions and economic opportunities for internally displaced people . According to HBS data, internally displaced people are not poorer as a group relative to the rest of the population. Following nearly a decade of Bank engagement in this sector, the government has increasingly taken the initiative to promote sustainable livelihoods for internally displaced people .

Table A3.9 Azerbaijan Country Assistance Strategy Completion Matrix, 2003–05

2003 CAS objective	CAS performance monitoring indicators	Current status
GOAL 1: MANAGE THE OIL BOOM		
<i>1a. Develop Institutional Capacity to Manage Revenues</i>		
<p>Improve capacity for budget preparation and execution of strategic priority setting with a medium-term Expenditure Framework.</p>	<ul style="list-style-type: none"> • All state and extrabudgetary resources integrated into state budget. • Budgets after 2003 prepared, published, and executed according to new budget law. • Public investment Appraisal Division at Ministry of Economic Development established and staffed. 	<ul style="list-style-type: none"> • Extrabudgetary resources have been integrated into the state budget. • Since 2003 all budgets have been prepared, published, and executed according to the new budget law. • Public Investment Appraisal Division at the Ministry of Economic Development established and Public Investment Program prepared in 2004 and 2005. • Early phases of MTEF for budget preparation and execution in place. • The 2006 budget expansion has raised concerns, but so far inflation seems to be under control.
<p>Introduce transparency in operation of the SOFAZ.</p>	<ul style="list-style-type: none"> • Regular publication of quarterly financial and budget execution statements of SOFAZ • Internationally acceptable audits of SOFAZ carried out and published. 	<ul style="list-style-type: none"> • Regulations on the operations of SOFAZ prepared. Governance and management framework for SOFAZ adopted. • Internationally acceptable audits of SOFAZ carried out and published annually. • Regular publication of SOFAZ financial/budget execution statements. • All SOFAZ expenditures except operating expenditures are incorporated as part of the annual consolidated government budget presented to the Parliament for approval.
<p>Strengthen public procurement procedures, strengthen auditing system on budget resources, continue reforms in accounting and regulation of private sector development.</p>	<ul style="list-style-type: none"> • Regular audit reports of the Chamber of Accounts indicate compliance with the Budget Systems Law, the Procurement Law, the MTEF, and the PIP. • Regular procurement audits. 	<ul style="list-style-type: none"> • Fiduciary framework for governance in public entities and private sector strengthened through auditing and accounting legal reform and reform of public procurement. • New procurement law adopted (scheduled for implementation in 2008) and new accounting legislation based on IFRS enacted for private and public sector entities (scheduled for implementation in 2009). Experts view implementation dates set as optimistic stretch targets. • Although the Chamber of Accounts has been established and staffed, its capacity and access to information are limited, thereby restricting the scope of its activities. Further strengthening is needed.

2003 CAS objective	CAS performance monitoring indicators	Current status
<i>Ib. Maintain Macroeconomic Stability</i>		
Maintain macroeconomic stability and prevent Dutch disease.	<ul style="list-style-type: none"> • Appropriate macroeconomic framework. 	<ul style="list-style-type: none"> • Satisfactory macroeconomic framework maintained in accordance with IMF program, CAS triggers, SAC-II and PRSC.
<i>Ic. Improve Poverty Monitoring</i>		
Improve poverty monitoring, statistical capacity, and policy design based on greater input of locally produced research on poverty and household welfare.	<ul style="list-style-type: none"> • Updated poverty assessment. • Regular consultations on poverty data and analysis. 	<ul style="list-style-type: none"> • Programmatic poverty assessment has been on track with regular consultations on-going. The Bank and government now use common criteria for the definition and measurement of poverty, and the poverty assessment is updated regularly. Yet, the HBS still needs improvement, and labor market data are weak.
Improve institutional capacity at Ministries of Health and Education for analysis and targeting of health and education spending.	<ul style="list-style-type: none"> • MTEF and PIP aligned with SPPRED priorities. • Increased confidence in accuracy and reliability of official statistics, including ability to monitor progress toward MDGs for health. 	<ul style="list-style-type: none"> • Only limited progress in improving health data has taken place and monitoring progress toward health MDGs remains difficult. However, agreement reached with new minister on appropriate monitoring of health indicators. • Line ministries do not adequately participate in the MTEF process and the capacity of the Public Investment Appraisal Division needs to be further strengthened. Substantial technical assistance programs are now in place. • Education financing has been decentralized and improved. However, significant delays in developing new funding formula and mechanism.
GOAL 2: CREATE JOBS AND NON-OIL GROWTH		
<i>2a. Develop Financial Sector</i>		
Restructure and privatize state owned banks, and increase the regulatory capacity of the National Bank of Azerbaijan	<ul style="list-style-type: none"> • No majority state ownership in the banking system. • No banks in unstable financial condition • Improved confidence in banking system as measured by increased savings. • Increase of banking markets as measured by growth of banking sector assets to GDP. • Proportion of banking sector using IAS rises to over 90 percent. 	<ul style="list-style-type: none"> • IBA is still the dominant bank, but its share of total banking assets fell to 49 percent in 2005 (according to IMF data). • Banking supervision has been strengthened. New banking legislation and prudential regulations compliant with international standards in effect. FSAP finding indicate that the National Bank of Azerbaijan on-site inspections generally meet the BIS norms. Further strengthening is needed. • Total savings increased 163 percent between 2002 and 2004. • Banking sector credit to economy rose 145 percent between 2003 and 2005. However, sector remains small: at end 2003, banking system assets were 17 percent of GDP, compared with typical banking sector assets of 30–40 percent of GDP in transition economies in Central

<i>2003 CAS objective</i>	<i>CAS performance monitoring indicators</i>	<i>Current status</i>
		Europe. <ul style="list-style-type: none"> • International accounting and financial reporting standards adopted by more than 90 percent of banking sector.
Consolidate banking system and encourage entry of strategic investors and foreign banks.	<ul style="list-style-type: none"> • Minimum capital increase to €5 million strictly enforced. Number of banks drops to less than 38. • Total value of short-term finance increased by 100 percent. • Total volume of investment finance increased by 200 percent. • Average interest rates for trade finance drop by 20 percent. 	<ul style="list-style-type: none"> • Minimum capital requirements have been increased to \$5 million as of January 2006; the number of banks has been reduced to 44. • Total value of short-term finance increased by 145 percent between 2002 and 2005. • Total volume of investment finance increased 114 percent between 2002 and 2005. • Restrictions on foreign banking capital fully eliminated as of January 2004. However, HSBC elected to close its office citing lack of business. Several new international banking joint ventures have established. • Interest rates on trade finance dropped 100–200 basis points.
Develop banking infrastructure, including by creating a small-value payment system, introducing deposit insurance, and stimulating noncash transactions	<ul style="list-style-type: none"> • Reduced cost of financial service and improved profitability of banks. • Bank fees for processing payments decrease 25 percent. • Use of noncash payment mean rises by more than 500 percent. 	<ul style="list-style-type: none"> • FSAP assessment confirmed that large-value payment system (RTGS) and small-value batch payment system meet BIS norms for systemically important payment systems. • Cost of services as measured by the interest rates on bank credits fell on average by 100–200 basis points, at the same time average profitability of banks as measured by rate of return on banks assets rose on average by 1 percent (possibly due to increased competition in the system). • Bank fees for processing payments decreased by 2 percent. • Use of noncash payment means rose by more than 150 percent. • Percentage of cash settlements declined by 3.4 percent 2003 and 5 percent in 2005
Promote expansion of banking network by establishing financial institutions in the regions and creating conditions for development of microcredit institutions to provide loans for individuals and small and medium-size enterprises .	<ul style="list-style-type: none"> • Number of banks with branches outside Baku increases from 2 to 10. • Number of bank branches outside Baku increase from 50 to 75. • Number of postal access points to financial services increases to more than 600 postal offices. • Total number of access points to financial 	<ul style="list-style-type: none"> • In 2005, 160 bank branches were based in the regions, with at least 10 banks participating. • 55 credit unions have been licensed. 29 credit unions and some 1100 operating Borrower Groups were supported under Bank projects, reaching over 20,000 farmers. • There are now 19 microfinance institutions with an overall credit portfolio of \$52 million and more than 64,000 active clients, 39 percent of them businesswomen.

2003 CAS objective	CAS performance monitoring indicators	Current status
	services outside Baku increases tenfold.	<ul style="list-style-type: none"> • Project is under implementation to increase number of access points for financial services outside Baku to include 1,200 post offices. • IFC supported four financial sector projects designed to channel funds to the small and medium-size enterprise sector. • IFC was instrumental in establishing the first and only commercial microfinance bank in the country, the Micro Finance Bank of Azerbaijan.
<i>2b. Develop the small and medium-size enterprise/private sector</i>		
Support action program to facilitate access to markets by small and medium-size enterprises, and strengthen entrepreneurship rights protection.	<ul style="list-style-type: none"> • Increase in private sector share of the economy by 7.5 percent. • Improvement in results in next BEEPS. • IFC supported four financial sector projects designed to channel funds to the small and medium-size enterprise sector. • ACG/BTC Small and Medium-Size Enterprise Linkage Program 	<ul style="list-style-type: none"> • Share of private sector in GDP has risen from 71.8 percent in 2001 to 76 percent in 2005 (according to SCC data). • Key barriers to business development identified, import tariffs reduced; new antimonopoly and investment laws drafted. • Azerbaijan fares better than CIS average on 15 of 21 “Problems Doing Business” indicators in the 2005 BEEPS. • Despite improvements in the business environment reflected in CPIA and BEEPS, Azerbaijan still scores poorly on international ratings.
Stimulate structural changes and technological progress in small and medium-size enterprise sector, and accelerate regional entrepreneurship development.	<ul style="list-style-type: none"> • Increase in number of jobs in small and medium-size enterprise sector by 10 percent • Increase in FDI in non-oil sector by 60 percent between 2002 and 2005, or 20 percent yearly (on average). • Increase in value of small and medium-size enterprise exports by 10 percent. • Increase in value of production by rural small and medium-size enterprises by 20 percent. • Increase in share of FDI in non-Baku non-oil sector by 15 percent. 	<ul style="list-style-type: none"> • Non-oil sector growth averaged 13 percent a year during the CAS period, well exceeding the benchmark of 5–7 percent a year. However, only limited increase in number of jobs in small and medium-size enterprise since 2002 according to official statistics. • FDI in non-oil sector rose from \$79.3 million in 2001 to \$322 million in 2004 (SCC data). • Increase of 3–5 percent in jobs in construction, transport, and communications, although employment in agriculture declined. • According to government estimates, the State Programme for Development of Regions has contributed to the creation of over 340,000 jobs over the last couple of years. • Non-oil exports to GDP rose from 4.2 percent of GDP in 2002 to 7.6 percent in 2004. Average 30 percent growth per year in 2004–05. • FDI in non-Baku non-oil sector increased by 10 percent.

<i>2003 CAS objective</i>	<i>CAS performance monitoring indicators</i>	<i>Current status</i>
<i>2c. Develop the agriculture and rural sector</i>		
<p>Promote agriculture and rural development by creating a transparent and functioning land market and sustainable rural financial system, improving entrepreneurial and technical skills of farmers, improving basic infrastructure, and spurring private involvement in agro-processing.</p>	<ul style="list-style-type: none"> • Number of land transactions registered reaches at least 3,000 a year. • Pilot unified real estate registration system established and tested. • 7,000 farmers and rural entrepreneurs have access to financial services through borrower groups and credit unions. • 250 rural financial institutions established. • 75 percent of farmers benefiting from advisory services use improved practices and demonstrate improved farm management. 	<ul style="list-style-type: none"> • Transparent and functioning land market established through creation of Regional Land Cadastre Offices. • A total of 31,500 land transaction have been recorded, including 10,000 in 2004 and 12,000 in January–September 2005 • Pilot unified real estate registration system has been established and tested under ADCP. • As at end 2005, there were 29 credit unions and some 1,100 operating Borrower Groups, reaching more than 25,000 farmers. Almost all borrowers under ADCP credit line showed increase in income and 90 percent reinvested profits for business expansion. • Some 55 percent of the farmers in targeted regions have been reached by the Regional Advisory Centers through a variety of extension services. 65 percent of farmers with increased knowledge; 54 percent adopted many of the improvements recommended by advisory services; 76 percent with increased family incomes with 35 percent who had not received advisory services (as of mid-2005). • 19 microfinance institutions established with an overall credit portfolio of \$52 million and over 64,000 active clients.
<p>Improve delivery of irrigation water; promote farmer-managed tertiary irrigation and drainage infrastructure.</p>	<ul style="list-style-type: none"> • Completion of Samur-Absheron Canal and Mail Mill Mugan collector. • Maintenance of 80 percent of required level within water users associations supported by IDSMIP. • Amended law on amelioration and irrigation enacted. • 300 water users associations legally established. • Crop yields increase by 10 percent in areas with legally established water users associations. 	<ul style="list-style-type: none"> • Headworks on the Samur River completed and work on the SAC canal ongoing. MMC drainage system completed. • Completed secondary canals have allowed for adequate irrigation water to reach the boundaries of the Water Users Associations. • Only very limited emergency maintenance carried out by water users associations, for example when canal is fully blocked. • Law on amelioration and irrigation enacted. • 585 water users associations have been legally established. • Percentage of farmers receiving more than 75 percent of required water (measured in number of irrigations) increased from 1 percent in 2002 to 35 percent in 2004. • Evidence of farmers changing cropping pattern to more commercial crops in areas that have benefited from irrigation rehabilitation: Between 2000 and 2004, area under cereals reduced from 80 to 51 percent, area under fodder crops increased from 1 percent to 18 percent, and area under apples increased from 7 percent to 16 percent.

<i>2003 CAS objective</i>	<i>CAS performance monitoring indicators</i>	<i>Current status</i>
GOAL 3: IMPROVE INFRASTRUCTURE AND SOCIAL SERVICES		
<i>3a. Improve the quality of education services</i>		
Improve the quality of education, links to labor market, efficiency in allocation and utilization of resources, and education finance monitoring of quality and access.	<ul style="list-style-type: none"> • National center for student assessment established and staffed by 2004. • Completion of pilot sample-based reliable assessment of grade 4 student achievement in mathematics and Azeri language. 	<ul style="list-style-type: none"> • Department for the Assessment of Pupil's Achievement was established in 2004. • Pilot assessment in math and Azeri language conducted for 1900 children in grade 5. • Ministry of Education plan has been approved to reform curriculum, textbooks and educational management.
Improve quality of opportunity in basic education by providing free textbooks to school children.	<ul style="list-style-type: none"> • At least 90 percent of children in grades 1–5 have free textbooks in core subjects. • General education enrollment ratio increased from 94 percent in 2001 to 98 percent in 2005. • Enrollment rates of population 17 year and older increased from 13 percent in 2001 to 15 percent in 2005. 	<ul style="list-style-type: none"> • Gross primary enrollment ratio is 102.4 percent. • Gross upper secondary enrollment rate rose from 43.2 percent in 2001 to 70.5 percent in 2003. • Over 90 percent of children in grades 1–5 provided with free textbooks in both 2003 and 2004. • Higher education enrollment increased from 13.4 percent in 2001 to 18 percent in 2005.
<i>3b. Improve the quality of and equity in access to basic health services</i>		
Significantly improve delivery of primary health care services in pilot districts, promote acceptance of health reform objectives by major stakeholders, achieve measurable improvement in health outcomes in pilot district, and increase and better targeted public health financing.	<ul style="list-style-type: none"> • Primary health care centers in all pilot districts are fully staffed, equipped, and provided with essential drugs. • Increase in 40 percent in number of patients seen at reformed primary health care facilities. • Increase of 20 percent in patient satisfaction in access to and quality of health care in pilot districts. • Health expenditures increase to 6 percent of government expenditures by 2005. 	<ul style="list-style-type: none"> • Limited Bank objectives due to weak ownership of reforms. • The number of patients at improved primary health care facilities in the target districts rose by 65 percent and patient satisfaction rose from 34 percent to 61 percent. • Accomplishments limited to pilot projects that improved access to and quality of primary health care in selected districts. • ESW and intensified dialogue on health issues are raising awareness and momentum for health sector reform. • Health expenditures rose from 5.3 percent to 5.8 percent of public expenditures but with limited rationalization of expenditures, including in right-sizing of the number of hospitals.

<i>2003 CAS objective</i>	<i>CAS performance monitoring indicators</i>	<i>Current status</i>
<i>3c. Support pension, social assistance, and labor reform</i>		
Support new pension legislation ensuring long-term sustainability endorsed by Parliament and implemented by government.	<ul style="list-style-type: none"> • Pensions paid on time and increased annually in real terms at a rate no less than the real increase in non-oil GDP. • By end 2005, all existing pensioners have computerized individual records. 	<ul style="list-style-type: none"> • Effective January 1 2005, the minimum pension amount was increased to AZM 125,000 per month, and is expected to rise to AZM 150,000 in April 2006, which is equivalent to the minimum wage. No arrears observed. • Amendments and changes to the Social Insurance Law will unify the collection of social security contributions for social protection. • Pension Reform Concept approved by President; new pension legislation under preparation • Computerized individual record system for pensioners under implementation.
Support the comprehensive social assistance reform strategy prepared and endorsed by the government.	<ul style="list-style-type: none"> • Social assistance benefits paid on time and increased annually in real terms at a rate no less than the real increase in non-oil GDP. • Social assistance benefits better targeted so that bottom quintile receives 50 percent of benefits. • Social assistance targeting pilot completed and evaluated and a national rollout prepared. 	<ul style="list-style-type: none"> • Social assistance benefits are paid on time and have increased 5 percent annually in real terms. • New targeted social assistance framework approved by Parliament. • The full introduction of a targeted family/poverty benefit scheme is scheduled for mid-2006 and already budgeted for.
Support labor redeployment programs designed and tested in enterprises undergoing restructuring and privatization	<ul style="list-style-type: none"> • Labor force survey introduced and conducted regularly. 	<ul style="list-style-type: none"> • Labor Force Survey conducted in 2003 and led to preparation of National Employment Strategy approved in 2005. Second Labor Force Survey was conducted in June 2006.
<i>3d. Improve the living conditions of internally displaced people</i>		
Redirect benefits to internally displaced people to needs-based approach; improve access of internally displaced people to housing, land, and other agricultural assets.	<ul style="list-style-type: none"> • Per capita income of internally displaced people raised to national average by 2005. • Better and more efficient targeting of internally displaced people in national safety net approach. 	<ul style="list-style-type: none"> • Average per capita income among internally displaced people has slightly exceeded the overall population average. • The full introduction of the targeted family/poverty benefit scheme took place July 1, 2006. • Poverty prevalence among internally displaced people is less than average of population.

<i>2003 CAS objective</i>	<i>CAS performance monitoring indicators</i>	<i>Current status</i>
<i>3e. Reform energy sector</i>		
Phase in elimination of subsidies in the energy and waters sectors, establish user pays principle for public utilities with private sector suppliers, and better target subsidies to mitigate impact of tariff increases on the poor.	<ul style="list-style-type: none"> • Total subsidies in energy and water reduced 35 percent by 2005. • Budgetary institutions become 100 percent current with utility payments by 2003. • Phased increase of utility tariffs. 	<ul style="list-style-type: none"> • Overall level of energy-related subsidies declined from 7.7 percent of non-oil GDP in 2002 to 4.8 percent in 2005 and is projected to further decline to 4.2 percent in 2006. • Percentage of firms seeing electricity as a problem doing business declined from 30 percent in 2002 to 25 percent in 2005 (2005 BEEPS). • Tariff setting institution has been strengthened considerably. • Budgetary organizations current on utility payments. • Phased medium term tariff policy for utilities has been adopted. • Water tariff have been doubled, and gas tariff quadrupled.
<i>3f. Improve the delivery of utility services</i>		
Establish transparent and clearly defined conditions for private sector utility operation, privatize program of downstream utility sector completed, manage contracts for gas distribution signed and legally endorsed, and support on-going emergency investment program in electricity transmission.	<ul style="list-style-type: none"> • Operation and maintenance expenses in utility sector met. • No serious collapse of infrastructure leading to supply interruptions • Transactions for private sector involvement in gas distribution are completed. 	<ul style="list-style-type: none"> • Electricity supply increased 21 percent and gas production 12 percent from 2002 to 2005. • There were no repeats of the 2002 nationwide electricity blackout. However, system reliability remains fragile with frequent localized outages and occasional widespread system failures. Gas tariffs were quadrupled in 2004 and water tariffs doubled in order to move closer to cost-recovery. • Progress with regard to collections in the utility sector has been mixed. While collections in the power sector increased from 54 percent in 2003 to 56.4 percent in 2005, collections in the gas and water sectors fell in response to increased tariff rates. Collections in the gas sector fell from 70 percent to 50 percent and in the water sector from 73 percent to 69 percent. • Management contracts were in effect in the power distribution sector and part of the water sector (in several regions of the country). • Overall, the financial condition of the utility sector, while improving, remains weak and increased metering and improved regulatory framework are needed for electricity, gas and water entities to become commercially sound.

<i>2003 CAS objective</i>	<i>CAS performance monitoring indicators</i>	<i>Current status</i>
Complete emergency investment program in water completed; sign and legally endorse management contract for Baku water supply.	<ul style="list-style-type: none"> • Proportion of people with access to improved water sources increases to 77 percent • Proportion of Baku population that trusts safety of water system increases to 50 percent • Proportion of people with access to improved sanitation increases 2 percent • Decrease of waterborne disease in Baku. 	<ul style="list-style-type: none"> • Around 76 percent of all households have access to an improved drinking water source, including 93 percent in urban areas. • Rehabilitation of the main water treatment plant in Baku nearly complete, improving source quality. • Survey data in Baku show improvement in drinking water safety. • Percent with access to improved sanitation: Urban areas - increased from 96.2 percent in 2002 to 98.4 percent in 2003; Rural areas – increased from 78.3 percent to 84.1 percent in 2003 (HBS data).
<i>3g. Improving the delivery of transport services</i>		
Efficiently manage all classes of roads. Staff and organize MOTC with clear separation of regulatory and commercial functions. Minimize transport costs and delays through measures developed by private/public sector consultative groups.	<ul style="list-style-type: none"> • Restructuring of road administration. • Pavement management system installed. • National road safety program prepared. • Budget for road maintenance increase 10 percent a year. • 60 percent of road budget tendered via competition. • Increase in value of non-oil transit traffic to Central Asia. • Decrease in freight tariffs from Amsterdam to Baku by 8–12 percent, while from Baku to Amsterdam by 5–6 percent. • Decrease in transport time from Amsterdam to Baku by 1 day (after Poland’s accession the European Union). 	<ul style="list-style-type: none"> • Road administration in conjunction with the establishment of the Ministry of Transport. • A functional classification of the road network was completed and a Pavement Management System to analyze and prioritize road projects has been operational since January 2005. • National traffic safety plan prepared in March 2005. • Budget increases for road maintenance have exceeded the 10 percent a year target and there has been increasing competition among suppliers and contractors. • Transported goods along Europe-Caucasus-Asia Transport Corridor in Azerbaijan rose from 32,485 thousand tons in 2001 to 46,700 thousand tons in 2005. • More than 60 percent of road budget are tendered via competition. • Freight tariffs from Amsterdam to Baku decreased 8–12 percent, tariffs from Baku to Amsterdam reduced 5–6 percent. • Transport time from Amsterdam to Baku decreased by one day.
<i>3h. Improve natural resource management</i>		
Improve management of pasture and/or forests in participatory fashion by villages, improve critical ecosystems management, rehabilitate sturgeon fish stock; provide sustainable financing for management of bioresources.	<ul style="list-style-type: none"> • GEF project under implementation. • Sustainable land use plans prepared in project areas. • Sturgeon nursery operational. 	<ul style="list-style-type: none"> • Sturgeon hatchery is operative. Six million sturgeon fingerlings produced in its first year of operation, with an eventual target of 15 million a year. • Rural Environment Project approved, focusing on improving forest and pasture management and on biodiversity conservation. • National Caspian Action Plan developed. • Hazardous Waste Management Strategy adopted in 2004 to mitigate the environmental impacts of oil production. National Monitoring Department established to track pollution emissions and an Agency for

<i>2003 CAS objective</i>	<i>CAS performance monitoring indicators</i>	<i>Current status</i>
		Management of Toxic Wastes has been created to coordinate waste disposal.
GOAL 4: REALIZE THE OIL AND GAS POTENTIAL		
<p>Complete BTC pipeline, Shah Deniz, South Caucasus Pipeline and other oil and gas developments within established timeframes.</p> <p>SOCAR restructuring</p>	<ul style="list-style-type: none"> • Timely BTC completion in keeping with international environmental standards. • Gas exports to Turkey and development of Shah Deniz oilfields on schedule. • Oil exports through BTC begin by 2005. • High Case trigger only: Begin implementation of agreed action program on financial and corporate restructuring. 	<ul style="list-style-type: none"> • BTC pipeline began operations in June 2006. • Development of gas fields and pipelines on schedule for 2007. • Oil sector projected to grow 60 percent a year between 2005 and 2007. • IFC contribution was catalytic in marshalling financing for the oil field project and subsequent oil pipeline development, and in ensuring maintenance of the highest social, environmental and safety standards. IDA and IMF played a major role in helping Azerbaijan put into place adequate institutions to ensure transparency in revenue tracking and utilization, without which international oil companies would have been hesitant to commit financing. • SOCAR has begun implementation of the agreed action plan by restructuring and consolidating 171 business units into 8 divisions, and several non-core activities have been separated out. The 2004 Accounting Law mandated SOCAR to file according to IFRS by 2008, and implementation is underway.

**Table A3.10 Planned Base Case Lending Program and Actual Deliveries
(millions of dollars)**

Planned in 2003 CAS for FY03-05	\$ planned	Actual Lending for FY03-05	\$ delivered
Baku Water Supply (Supp)	12.9	Delivered 12/10/02	12.9
Education (APL)	18.0	Delivered 5/27/03	18.0
Irrigation	30.0	Delivered 6/17/03	35.0
Private Sector Development	10.0	Fin. Service Deliv. 1/6/05	12.25
Pensions	10.0	Delivered 6/10/04	10.0
Energy Sector (IBRD)	40.0	Delivered 5/17/05	48.0
Environment	8.0	Delivered June 05	8.0
PRSC-I	20.0	Delivered 5/17/05	20.0
Rural Community Infrastructure	15.0	Delivered 6/3/04	15.0
		Internally Displaced People Project (added) FY05	12.0
Total	163.0	Total	183.15

Table A3.11. Planned Nonlending Services and Actual Deliveries

<i>Year/plan</i>	<i>Result</i>
<i>FY03</i>	
Country Financial Accountability Assessment	Delivered
Trade Facilitation Strategy	Delivered
Trade Diagnostic Study	Delivered
Public Expenditure Review	Delivered
Poverty Assessment	Delivered
Electricity and Natural Gas, Oil and Advisory Technical Assistance	Delivered
Municipal Infrastructure Survey	Delivered FY04
Education Sector Note (added)	Delivered
<i>FY04</i>	
Marketing and Agro-Processing Issues Study	Delivered FY05
Energy Sector Study	Delivered FY05
Rural Impact of Utility Price Changes	Delivered
Financial Sector Assessment (FSAP)	Delivered
Business Environment Study	Changed to Annual Benchmark Survey (delivered)
Health Sector Capacity Building Technical Assistance	Delivered
South Caucasus Telecoms/PPIAF Technical Assistance	Delivered
South Caucasus Trade Facilitation Technical Assistance/Policy Notes	Delivered
<i>FY05</i>	
Country Economic Memorandum Update	Postponed to FY08 and substituted with Policy Notes, ongoing
Transcaucasus Tourism Technical Assistance (IDF)	Delivered
Public Expenditure Review Update	Programmatic, ongoing
Higher Education Note	Postponed to FY07
Health Sector Review (added)	Delivered FY06
PSIA Labor Market Study (added)	Delivered
Programmatic Poverty Assessment (added)	Delivered first stage

Annex 4

Likelihood of Meeting Millennium Development Goals

<i>Millennium Development Goal</i>	<i>Current status</i>	<i>Prospects for achieving Goal by 2015</i>
Half income poverty	About 50 percent of the population of Azerbaijan lived in poverty in 2001. In 2005, it is estimated that 24 percent of the population was poor.	Likely. The oil sector boom, combined with broadening of employment-generating economic activities in non-oil sectors together with safety nets policies, would allow Azerbaijan to achieve this target, probably sooner than 2015.
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 and knowledge necessary to meet the challenges of 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.
Reduce under-five mortality by two-thirds	According to official data, under-five mortality rate was 23.1 and infant mortality 12.8 per 1000 live births in 2002). On the other hand, estimates based on surveys indicate that in 1990, the baseline for the MDG goals, the U5MR and IMR were 106 and 84 per 1,000 live births, dropping to 96 and 76, respectively in 2002. However, for the pilot districts covered by the Health Reform Project, UNICEF reports a 13 percent decline from 73.2 per 1,000 births (2002) to 63.7 per 1000 (2004) in infant mortality, which if sustained and generalized to the rest of the country, would put Azerbaijan back on track to meet the goal of 2/3 reduction by 2015.	Unlikely. Assessing progress is complicated by data uncertainties. To reduce under-five mortality by 2/3, a 4.4 percent annual reduction is needed between 1990 and 2015. Azerbaijan's progress has been at only about 0.9 percent annually during 1990–2000. Thus Azerbaijan is at risk of not meeting this MDG without a concerted effort to strengthen primary health care and make it accessible to the poor.
Reduce maternal mortality by three quarters	MIC Survey (UNICEF) estimates place maternal mortality at 79 deaths per 100,000 births in 1990, and 94 in 2000. According to the State Statistical Committee, the MMR was 19.9 deaths per 100,000 births in 2002, a 52 percent reduction compared with 37.6 in 2000.	Unlikely. There has been a disconcerting rise in maternal mortality according to independent surveys, but a reduction in MMR according to official data. In the absence of comprehensive health sector reform to improve access and quality in primary healthcare delivery, it is unlikely that Azerbaijan will meet this goal. For health-related MDGs, problems of data collection and definitions have to be resolved to enable realistic targets and monitoring.

<i>Millennium Development Goal</i>	<i>Current status</i>	<i>Prospects for achieving Goal by 2015</i>
Reverse the spread of HIV/AIDS	The prevalence rate of Azerbaijani citizens infected with HIV is believed to be low by regional standards, although newly reported cases doubled between 1999 and 2000. The actual extent is not known because of limited coverage of seroprevalence surveys and lack of behavioral surveys.	Likely. Although the prevalence rate is considered to be very low, there are an estimated 600,000 IDUs in the country who account for 63 percent of the cases. There is a need for both sero and behavioral surveillance and greater attention to HIV/AIDS prevention and care. As of December 1, 2004 Ministry of Health has launched the HIV/AIDS project funded by the Global Fund to fight AIDS, Tuberculosis and Malaria.
Reverse the spread of tuberculosis	In 2003 tuberculosis prevalence and mortality rates were 50 cases and 12 deaths per 100,000 population, respectively. Case fatality rate stands at a high 14 percent. Case detection rate remains at around 25 percent, much lower than the international standard of 70 percent, with only a small fraction of cases detected through DOTS. The cure rate was 84 percent, close to the target of 85 percent.	Likely. According to WHO Global Tuberculosis Control Program, DOTS population coverage was 48 percent in 2003. Political commitment and additional resources are needed to expand coverage from the current to 100 percent in order to meet the MDG goal of reversing the spread.
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 an improved drinking water source – 93 percent in urban areas and 58 percent in rural areas.	Unlikely. Achieving this MDG is feasible only if the government gives sufficient priority to rural water in its public investment program, consistent with the SPPRED.

Note: Where no 1990 baseline data exist, the value for the closest year for which there is data was used to calculate the MDG target on a pro rata basis and the 2015 target was determined in relation to the available base year.

Annex 5

CPS Consultations with Civil Society and Non-Governmental Organizations

CPS priorities were discussed with a large and diversified set of representatives of the civil society during two rounds of public consultations. Participants were invited to share their views and visions on the perspectives of development processes in the country as well as ask questions if any.

Participants expressed their great interest in the meetings and raised questions and concerns regarding Bank activities in Azerbaijan, as well as provided information on their own activities. Comments and feedback received during the meetings covered both general and specific areas of the Bank's current and potential involvement in this country.

In view of all participants, the World Bank plays an important role in helping the development process move and its presence in Azerbaijan adds credibility to the reforms carried out by the government.

It was also mentioned that at this point, where the country is at a crossroads given the rapidly rising oil revenues, Bank should continue to provide its expertise and technical assistance on the management of revenues and expenditures since cooperation with the Bank is critical to ensure good practices in governance are put in place.

At the same time, the Bank should think of a more effective way to work with NGOs. Participants reiterated the importance of increased involvement of NGOs in design and implementation of Bank-funded projects as well as in assessment of their results.

A general concern is that projects should be well monitored in order to ensure effective and efficient use of funds. A general wish expressed was that the Bank improve the quality and availability of socio-economic data and information on project results and their assessment in the Azerbaijani language.

The representative of the National NGO Coalition dealing with EITI raised the fundamental question of how to engage the civil society as an essential party to policy making.

Representatives of the civil society organizations generally expressed appreciation of their involvement in the preparation of SPPRED but complained about little involvement of NGOs during its implementation. They also feel that the Civil Society Organizations are not adequately involved in the implementation as well as impact monitoring of the Bank-funded projects in Azerbaijan. As meeting participants particularly underlined, it would be a valuable instrument for the development and capacity building of civil society in the country. They were also wondering if there is any independent review of the Bank funded projects in Azerbaijan to ensure the transparency and accountability for the proper usage of the credit funds.

Among the areas, which need attention of the international organizations and should be prioritized for their involvement, several participants particularly indicated the health sector of the country, which was identified as problematic, as health outcomes are raising increased concern. The education sector was also mentioned as not very successful and requiring additional attention. The participants recognized the difficulties of working with the relevant ministries and persuading them to involve NGOs more in their sectors.

Several participants also underlined the importance of municipal development and increasing cooperation between NGOs/municipalities and government structures to fight poverty and ensure economic growth of the country

One of the NGOs working in ecological sector expressed concern with the lands deterioration at the areas where BTC is constructed and requested to forward their concern to the IFC.

Participants suggested that the Bank should put a stronger emphasis on addressing governance issues by encouraging the government to put in place structural reforms such as separation of commercial and regulatory functions of ministries, setting better monitoring mechanisms, and promoting participatory approaches to decision making. The latter would be facilitated by institutionalizing and including adequate budget allocations for the government's support to NGOs.

Domestic trade should be an area of the Bank's attention.

Development of rural infrastructure, especially in remote and mountainous areas is vital for stimulating economic activity of communities. Alternative sources of energy, such as windmills and bio-energy can be a solution when addressing energy efficiency. Access to clean water and irrigation is another area emphasized during the meeting.

Participants suggested that the Bank continues assistance to the financial sector by promoting banking in rural areas, in particular by supporting those banks that have branches in remote areas.

Other areas that were emphasized as deserving the Bank assistance were small and medium-size enterprises. Local entrepreneurs see the Bank's role as a supporter of the institutional development including legal framework, improved corporate governance and promoter of better business and economic education and R&D. The Bank is expected to advocate for a business environment free of harassment, corruption and monopolies.

Notwithstanding the energy resources, Azerbaijan is an agrarian country and therefore, participants said, it is crucial to invest in this sector. The Bank could concentrate on supporting agro-processing and also provide assistance to Azerbaijani entrepreneurs in their efforts to integrate with international markets

With large government spending and the Bank's investments in the non-oil sector, it is vital that the Bank helps improve institutional management and build capacity, two important elements of a successful change. Qualified professionals in the key sectors and good management skills are already in high demand both by the public and the private sector.

Several participants mentioned the importance of a comprehensive approach to the development of particular sectors and the Bank's investment operations.

The last but not the least comment was that all operations should be gender sensitive and target women as important beneficiaries of Bank-funded projects.

Annex 6

Collaboration with Development Partners

The Bank is collaborating closely with other development partners, particularly in structural reform areas. On the overall reform program there has been close coordination between the Bank's support through the SAC-II and PRSC and the IMF-supported Poverty Reduction and Growth Facility (PRGF). The fourth review of the PRGF was completed satisfactorily in December 2004 and the program has come to conclusion in 2005. The ADB, the European Union, and the IsDB for capacity building provided critical support. The EU TACIS also helped on modernizing the taxation system. The Bank worked as one team with USAID on Treasury Systems, PIP and utility regulatory reform and teamed up with US Treasury on budgetary reform. The Bank worked closely with EBRD and USTDA on SOCAR restructuring. The Bank has also joined with ADB, Switzerland, and UNDP to support the formulation and implementation of the SPPRED. The latter has been particularly helpful in integrating the monitoring of the MDGs into the recent SPPRED progress report. An intensive three-way dialogue between the Bank, IMF and the government, and close cooperation supported achievements in the macro/financial management/governance environment with other donors, especially the European Union and USAID. Highlights of this collaboration over the CAS period include the following:

- *Macroeconomic management and public expenditure.* The Bank will continue to work closely together with the IMF. On Treasury modernization, the Bank is financing computerization together with USAID. The Bank is also coordinating with USAID on its Public Investment Policy and Efficiency (PIPE) project, which is supporting improvements of capital budget formulation, investment project preparation, and long-term budget planning at the Ministry of Economic Development and selected line ministries. The U.S. Treasury is supporting a long-term engagement with the Ministry of Finance on improving the budget preparation process and moving toward program budgeting.
- *Financial sector.* IDA and the IMF collaborated closely on the preparation of the 2005 Financial Sector Assessment Report; this collaboration will continue with implementation support of the FSAP recommendations. USAID is providing support for banking supervision. KfW is playing an important role in supporting the Credit Guarantee Fund and Deposit Insurance. It is expected that the European Union will support the strengthening of anti-money laundering legislation and institution building.
- *Accounting.* The Bank and IFC have cooperated closely with the ADB and the European Union in the context of the recent Accounting and Auditing ROSC, which is being finalized. The European Union, the Bank (including the IFC), the IsDB, and USAID are working very closely in supporting accounting reforms and the implementation of the new accounting law. The Bank used Consultant Trust Funds made available by Canada and Switzerland to extend assistance to policymakers, regulators, and private sector stakeholders in enhancing financial reporting and internal control systems in Azerbaijan.

- *Anticorruption.* The Bank will work closely with the European Commission on corruption as its ENP Action Plan crystallizes. It is expected that the European Commission will include specific actions to strengthen enforcement and assess the impact and progress of the Anticorruption Law in force since January 2005 and the state program on fighting corruption, which is closely related to the policy framework supported by the CPS. The European Union is expected to play a leading role in simplifying and streamlining customs and tax legislation and procedures in line with EU and international standards.
- *Judicial reform.* Several donors are working with the Ministry of Justice and the courts in the areas of law drafting, procedural reforms, and training of judges. The Council of Europe and European Union are working on law drafting, the selection and hiring of 100 additional judges, and development of supervision systems. USAID and GTZ are working on training. The American Bar Association Central European and Eurasian Law Institute (ABA CEELI) is working on legal education and information, judicial training on ethics and commercial law, and alternative dispute resolution (ADR). Preliminary consultations indicate that donors are not fully satisfied with the institutional capabilities or infrastructure of judicial institutions to actually implement many of the law and human rights reforms that have been initiated and approved in recent years with their assistance. IDA will collaborate closely with donors (including the Netherlands, the International Committee of the Red Cross, OSCE, the Eurasia Foundation, and Soros Foundation) on the implementation of judicial reform and training activities.
- *Agriculture.* IDA is coordinating its agricultural program with USAID, the ADB, the International Fund for Agricultural Development (IFAD), and GTZ, which are providing credit to agricultural producers, supporting small and medium-size enterprises, and working to increase the competitiveness of rural enterprises. USAID is supporting three programs that provide support to small and medium-size enterprises and farmers to improve linkages to markets. It is launching a program to strengthen microfinance institutions in rural areas. The ADB is planning a new project to support micro-finance institutions (MFIs) in nonurban areas through the provision of a credit line. IDA is working with the European Union Food Security program and TACIS on coordinating activities in the agricultural sector. The development of rural areas and collaboration, especially in the areas of food safety, have been discussed. IDA is coordinating activities related to real estate and cadastre development with the ADB, KfW, and SDC. The second phase of the ADCP will coordinate closely with all stakeholders on their areas of involvement.
- *Health.* IDA is coordinating with UNDP and UNICEF on establishing family clinics and district health programs. GTZ is enhancing the national health monitoring system. USAID/Caucasus-Azerbaijan has started a new \$5 million project that focuses on redefining and restructuring primary health care with improved financing and resource allocations in order to improve service quality. Other USAID-funded programs include the Child Survival Program (Mercy Corps) and the Reproductive Health and Family Planning (ACQUIRE). USDA is supporting primary health care (via ADRA) and a

HIV /AID program (via IRD). UNICEF is planning to continue its activities in safe motherhood, neonatal care, nutrition, and HIV/AIDS prevention and care. It is also supporting overall health sector reform within the SPPRSD framework. A United Aid for Azerbaijan project is supporting early intervention services, and the United Nations Population Fund (UNFPA) is implementing a reproductive health program. The Global Fund to Fight AIDS, Malaria and Tuberculosis has granted the Ministry of Health \$6 million for a HIV/AIDS project, and further funding is being considered for malaria and tuberculosis. GOPA/KfW has been involved in implementing DOTS for tuberculosis treatment in Azerbaijan. Further tuberculosis screening and follow-up is needed to strengthen integrated primary health care services and epidemiology and sanitary control. The World Health Organization will be providing technical assistance to the Ministry of Health on primary health care, health policies and strategies, health financing, tobacco, HIV/AIDS, tuberculosis programs, and immunization.

- *Education.* The ADB has launched an early childhood development project. The Soros Foundation is complementing the IDA program in providing support for early childhood development. The Open Society Institute and BTC/SCP are implementing a rural inclusive education program to integrate children with special needs into mainstream kindergarten and primary classes. The Japanese government has provided a grant for building and rehabilitating primary schools. JBIC is preparing a project on secondary vocational education development. The Saudi Fund has financed the construction of five secondary schools in Baku. USAID is considering a grant project in secondary and tertiary education. UNICEF, USAID and SDC are involved in the sector through civic education, voter education, and youth projects.
- *Social protection.* In close coordination with IDA, UNDP will maintain its support to the Social Protection Fund for establishing the system of individual accounts until the end of 2006. The EU TACIS and Food Security programs are planning to continue their support to the ministry of labor and social protection in implementing targeted social assistance. These projects are still being developed.
- *Internally displaced people.* IDA and the ADB are working together to help improve the economic opportunities of internally displaced people and integrate them into society. Their efforts partially complement the more immediate humanitarian support provided by UNHCR (shelter) and the World Food Program (food security).
- *Infrastructure.* Several donors are currently supporting different parts of the North-South and East-West road corridor modernization including ADB, EBRD, IDB, Kuwait Fund, OPEC Fund, and the Saudi Fund. In view of its substantial involvement in the sector, the Bank will provide overall leadership and coordination in the transport area as recently agreed with ADB. EBRD and ADB technical assistance is coordinated with and continues the Bank's technical assistance program started with the Azerbaijan Highway Project. The Bank's support for the water sector is complemented by support provided by ADB and KfW on water supply in secondary towns and rural areas. ADB is working on an integrated and comprehensive urban planning approach in three provincial cities. With regard to the energy sector the Bank is working closely with

EBRD on SOCAR restructuring and major upstream and pipeline investments. The Bank is taking the lead on donor coordination in this sector.

Annex 7

Country Financing Parameters for Azerbaijan

Table A5.1. Country Financing Parameters for Azerbaijan

<i>Item</i>	<i>Parameters</i>	<i>Explanation/Result</i>
<p><i>Cost-sharing</i> Limit on the proportion of individual project costs that the Bank may finance</p>	Up to 100 percent	It is expected that 100 percent Bank financing would be applied selectively. This would most likely be needed for community-driven development projects and for IDF grants.
<p><i>Recurrent cost financing</i> Any limits that would apply to the overall amount of recurrent expenditures that the Bank may finance.</p>	No country-level limit on recurrent cost financing	Recurrent cost financing is expected to remain limited. The Bank will continue to monitor the aggregate fiscal position and prospects, and its implications for recurrent cost financing. In determining Bank financing of recurrent costs in individual projects, the Bank will take into account sustainability issues at the sector and project levels, including implied future budgetary outlays.
<p><i>Local cost financing</i> Are the requirements for Bank financing: financing requirements for the country's development program would exceed the public sector's own resources (for example, from taxation and other revenues) and expected domestic borrowing; and the financing of foreign expenditures alone would not enable the Bank to assist in the financing of individual projects.</p>	Yes	The criteria for Bank financing of local costs are met. The Bank may finance local costs in the proportions needed in individual projects.
<p><i>Taxes and duties</i> Are there any taxes and duties that the Bank would not finance?</p>	None	There are no taxes and duties that are judged to be unreasonable. At the project-level, the Bank would consider whether taxes and duties constitute an excessively high share of projects costs.

Annex 8

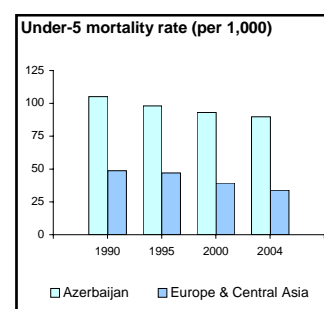
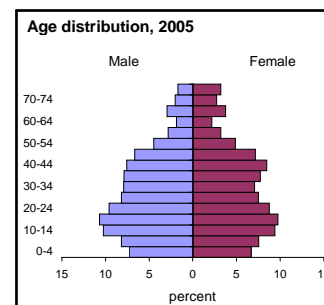
Standard CPS Tables

Table A2:	Azerbaijan at a Glance
Table B2:	Selected Portfolio Indicators
Table B3:	IBRD/IDA Program Summary
Table B3:	IFC and MIGA program Summary
Table B4:	Summary of Non-Lending Services
Table B5:	Social Development Indicators
Table B6:	Key Economic Indicators
Table B7:	Key Exposure Indicators
Table B8:	Operations Portfolio
Table B8b	IFC's Held & Disbursed Portfolio

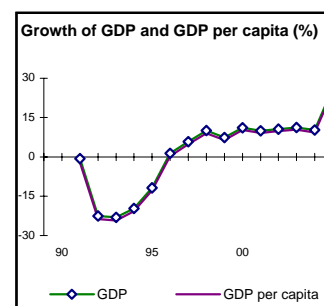
Azerbaijan at a glance

10/2/06

Key Development Indicators (2005)	Azerbaijan	Europe & Central Asia	Lower middle income
	Population, mid-year (millions)	8.4	473	2,475
Surface area (thousand sq. km)	87	24,238	39,946
Population growth (%)	1.1	0.1	1.0
Urban population (% of total population)	52	64	50
GNI (Atlas method, US\$ billions)	10.4	1,945	4,746
GNI per capita (Atlas method, US\$)	1,240	4,113	1,918
GNI per capita (PPP, international \$)	4,890	9,142	6,313
GDP growth (%)	26.2	6.0	6.9
GDP per capita growth (%)	25.0	5.9	5.9
(most recent estimate, 2000–2005)			
Poverty headcount ratio at \$1 a day (PPP, %)	4	2	..
Poverty headcount ratio at \$2 a day (PPP, %)	33	16	..
Life expectancy at birth (years)	72	69	70
Infant mortality (per 1,000 live births)	75	28	33
Child malnutrition (% of children under 5)	7	5	12
Adult literacy, male (% of ages 15 and older)	99	99	93
Adult literacy, female (% of ages 15 and older)	98	96	85
Gross primary enrollment, male (% of age group)	98	105	115
Gross primary enrollment, female (% of age group)	96	102	113
Access to an improved water source (% of population)	77	92	82
Access to improved sanitation facilities (% of population)	54	85	57



Net Aid Flows	1980	1990	2000	2005 ^a
<i>(US\$ millions)</i>				
Net ODA and official aid	..	0	139	176
<i>Top 3 donors (in 2004):</i>				
United States	19	48
Germany	..	1	9	17
Japan	..	0	36	10
Aid (% of GNI)	..	2.1	2.8	2.2
Aid per capita (US\$)	..	0	17	21
Long-Term Economic Trends				
Consumer prices (annual % change)	..	912.3	1.8	9.7
GDP implicit deflator (annual % change)	..	83.5	12.5	10.3
Exchange rate (annual average, local per US\$)	..	0.0003	0.895	0.931
Terms of trade index (2000 = 100)	100	145
Population, mid-year (millions)	6.2	7.2	8.0	8.4
GDP (US\$ millions)	..	8,858	5,273	12,561
<i>(% of GDP)</i>				
Agriculture	..	29.0	17.1	10.0
Industry	..	32.9	45.3	62.3
Manufacturing	..	19.3	5.6	7.8
Services	..	38.1	37.5	27.7
Household final consumption expenditure	..	51.2	63.5	47.6
General gov't final consumption expenditure	..	17.6	15.2	10.9
Gross capital formation	..	26.5	20.7	37.8
Exports of goods and services	..	43.9	39.0	57.4
Imports of goods and services	..	39.2	38.4	53.8
Gross national savings	..	4.9	17.1	32.6



1980–90 1990–2000 2000–05
(average annual growth %)

Note: Figures in italics are for years other than those specified. 2005 data are preliminary estimates. .. indicates data are not available.
a. Aid data are for 2004.

Development Economics, Development Data Group (DECDG).

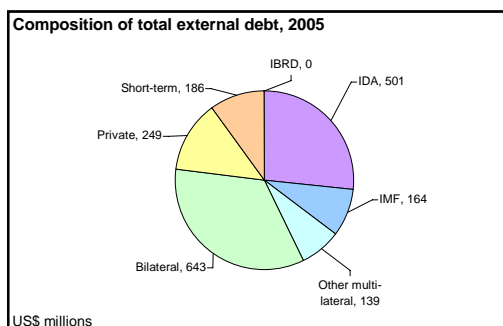
Azerbaijan at a glance (cont.)

Azerbaijan

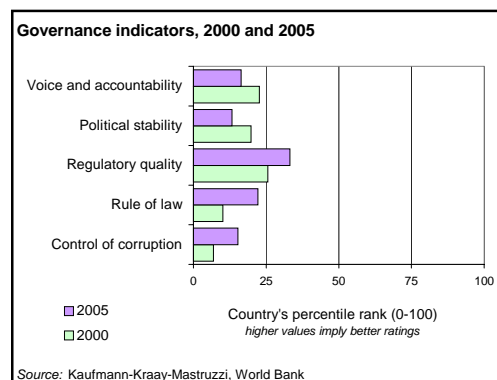
Balance of Payments and Trade	2000	2005
<i>(US\$ millions)</i>		
Total merchandise exports (fob)	1,799	7,649
Total merchandise imports (cif)	1,539	4,350
Net trade in goods and services	36	1,329
Workers' remittances and compensation of employees (receipts)	57	363
Current account balance as a % of GDP	-187	167
	-3.6	1.3
Reserves, including gold	680	1,178
Consolidated Government Finance		
<i>(% of GDP)</i>		
Revenue	21.2	26.5
Tax revenue	14.5	16.0
Expense	21.8	23.8
Cash surplus/deficit	-0.6	2.7
Highest marginal tax rate (%)		
Individual	35	35
Corporate	27	22

External Debt and Resource Flows

<i>(US\$ millions)</i>		
Total debt outstanding and disbursed	1,352	1,881
Total debt service	130	235
HIPC and MDRI debt relief (expected; flow)	–	–
Total debt (% of GDP)	25.6	15.0
Total debt service (% of exports)	6.0	3.0
Foreign direct investment (net inflows)	149	459
Portfolio equity (net inflows)	0	31



Private Sector Development	2000	2005
Time required to start a business (days)	–	115
Cost to start a business (% of GNI per capita)	–	12.5
Time required to register property (days)	–	61
Ranked as a major constraint to business (% of managers surveyed who agreed)		
Tax administration	..	24.9
Tax rates	..	22.9
Stock market capitalization (% of GDP)	0.1	..
Bank branches (per 100,000 people)	..	4.1



Technology and Infrastructure	2000	2004
Paved roads (% of total)	92.3	47.0
Fixed line and mobile phone subscribers (per 1,000 people)	152	333
High technology exports (% of manufactured exports)	4.5	2.1

Environment

Agricultural land (% of land area)	55	57
Forest area (% of land area, 2000 and 2005)	11.3	11.3
Nationally protected areas (% of land area)	..	6.4
Freshwater resources per capita (cu. meters)	..	977
Freshwater withdrawal (% of internal resources)	..	212.6
CO2 emissions per capita (mt)	3.7	3.4
GDP per unit of energy use (2000 PPP \$ per kg of oil equivalent)	1.8	2.3
Energy use per capita (kg of oil equivalent)	1,430	1,493

World Bank Group portfolio	2000	2005
<i>(US\$ millions)</i>		
IBRD		
Total debt outstanding and disbursed	0	0
Disbursements	0	0
Principal repayments	0	0
Interest payments	0	0
IDA		
Total debt outstanding and disbursed	216	501
Disbursements	27	48
Total debt service	2	6
IFC (fiscal year)		
Total disbursed and outstanding portfolio of which IFC own account	163	61
Disbursements for IFC own account	46	26
Portfolio sales, prepayments and repayments for IFC own account	6	58
MIGA		
Gross exposure	65	1
New guarantees	30	0

Note: Figures in italics are for years other than those specified. 2005 data are preliminary estimates.
.. indicates data are not available. – indicates observation is not applicable.

10/23/06

Development Economics, Development Data Group (DECDG).

Azerbaijan at a glance (cont.)

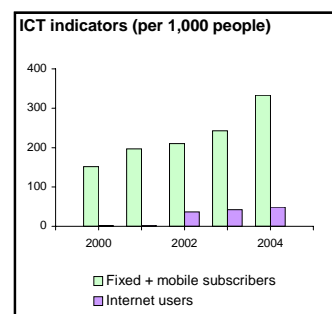
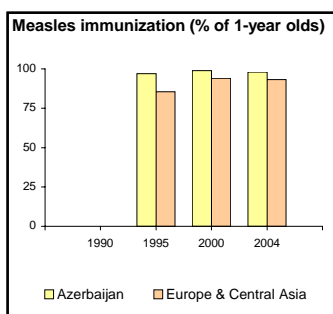
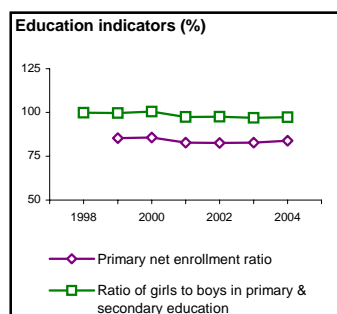
Millennium Development Goals

Azerbaijan

With selected targets to achieve between 1990 and 2015

(estimate closest to date shown, +/- 2 years)

	Azerbaijan			
	1990	1995	2000	2004
Goal 1: halve the rates for \$1 a day poverty and malnutrition				
Poverty headcount ratio at \$1 a day (PPP, % of population)	..	10.9	3.7	..
Poverty headcount ratio at national poverty line (% of population)	..	68.1	49.0	27.5
Share of income or consumption to the poorest quintile (%)	..	..	12.2	..
Prevalence of malnutrition (% of children under 5)	..	10	17	..
Goal 2: ensure that children are able to complete primary schooling				
Primary school enrollment (net, %)	89	..	86	84
Primary completion rate (% of relevant age group)	..	81	89	96
Secondary school enrollment (gross, %)	88	..	75	83
Youth literacy rate (% of people ages 15-24)	..	..	..	100
Goal 3: eliminate gender disparity in education and empower women				
Ratio of girls to boys in primary and secondary education (%)	100	..	100	97
Women employed in the nonagricultural sector (% of nonagricultural employment)	34	39	44	49
Proportion of seats held by women in national parliament (%)	..	12	12	11
Goal 4: reduce under-5 mortality by two-thirds				
Under-5 mortality rate (per 1,000)	105	98	93	90
Infant mortality rate (per 1,000 live births)	84	80	77	75
Measles immunization (proportion of one-year olds immunized, %)	66	97	99	98
Goal 5: reduce maternal mortality by three-fourths				
Maternal mortality ratio (modeled estimate, per 100,000 live births)	..	..	94	..
Births attended by skilled health staff (% of total)	..	..	84	..
Goal 6: halt and begin to reverse the spread of HIV/AIDS and other major diseases				
Prevalence of HIV (% of population ages 15-49)	..	..	..	0.1
Contraceptive prevalence (% of women ages 15-49)	..	..	55	..
Incidence of tuberculosis (per 100,000 people)	35	..	..	75
Tuberculosis cases detected under DOTS (%)	..	5	6	47
Goal 7: halve the proportion of people without sustainable access to basic needs				
Access to an improved water source (% of population)	68	..	..	77
Access to improved sanitation facilities (% of population)	..	..	..	54
Forest area (% of total land area)	..	..	11.3	11.3
Nationally protected areas (% of total land area)	..	..	..	6.4
CO2 emissions (metric tons per capita)	7.5	4.2	3.7	3.4
GDP per unit of energy use (constant 2000 PPP \$ per kg of oil equivalent)	..	1.1	1.8	2.3
Goal 8: develop a global partnership for development				
Fixed line and mobile phone subscribers (per 1,000 people)	87	84	152	333
Internet users (per 1,000 people)	0	0	1	49
Personal computers (per 1,000 people)	..	..	..	18
Youth unemployment (% of total labor force ages 15-24)	..	..	..	..



Note: Figures in italics are for years other than those specified. .. indicates data are not available.

10/2/06

Development Economics, Development Data Group (DECDG).

CAS Annex B2 - Azerbaijan
Selected Indicators* of Bank Portfolio Performance and Management
 As Of Date 10/23/2006

Indicator	2004	2005	2006	2007
Portfolio Assessment				
Number of Projects Under Implementation ^a	14	18	18	16
Average Implementation Period (years) ^b	3.5	3.2	2.7	2.8
Percent of Problem Projects by Number ^{a, c}	14.3	5.6	0.0	0.0
Percent of Problem Projects by Amount ^{a, c}	30.5	3.5	0.0	0.0
Percent of Projects at Risk by Number ^{a, d}	14.3	5.6	0.0	0.0
Percent of Projects at Risk by Amount ^{a, d}	30.5	3.5	0.0	0.0
Disbursement Ratio (%) ^e	18.0	26.6	16.2	2.8
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	11	8
Proj Eval by OED by Amt (US\$ millions)	340.8	192.3
% of OED Projects Rated U or HU by Number	45.5	37.5
% of OED Projects Rated U or HU by Amt	37.2	20.7

- 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 Azerbaijan

As Of Date 07/11/2006

Proposed IBRD/IDA Base-Case Lending Program ^a

<i>Fiscal year</i>	<i>Proj ID</i>	<i>US\$(M)</i>	<i>Strategic Rewards (H/M/L)</i>	<i>Implementation Risks (H/M/L)</i>
2007	Corporate & Public Sector Accounting	20	H	H
	National Land Title & Registry	30	M	M
	Railways TTF	80	M	M
	National Water Supply and Sanitation	220	H	H
	Gas Flaring	Carbon Financing	M	L
	Result	350		
2008	Financial Sector Modernization	10	M	M
	Transit Corridor and Traffic Management II	200	M	M
	Education APL II	40	H	M
	Social Protection II	10	H	M
	Absheron Env. Cleanup	50	H	M
	Result	310		
2009 - 10	e-Government & Pub. Sect. Reforms	30	H	H
	Irrigation & Drainage II	75	M	M
	Transit Corridor and Traffic Management III	200	M	M
	WSS and Urban Rehabilitation	200	H	H
	Other Infrastructure TBD	50	M	M
	Higher Education	45	H	M
	Other Global Partnerships	Carbon Financing	L	L
	Result	600		
Overall Result		1,260		

CAS Annex B3 (IFC & MIGA) for Azerbaijan					
Azerbaijan - IFC and MIGA Program, FY 2002-2006					
	2002	2003	2004	2005	2006
IFC Commitments (US\$m)	0.00	4.15	61.40	0.4	10.3
Sector (%)					
Finance & Insurance		100		100	100
Oil, Gas and Mining			100		
Total	0	100	100	100	100
Investment instrument (%)					
Loans		58	100		78
Equity		42		100	22
Total	0	100	100	100	100
MIGA guarantees (US\$m)	38.06	3.23	3.56		

CAS Annex B4 - Summary of Nonlending Services

As Of Date 7/11/2006

<i>Product</i>	<i>Completion FY</i>	<i>Cost (US\$000)</i>	<i>Audience^a</i>	<i>Objective^b</i>
Recent completions				
Business Env. Survey (BEEPS)	FY05	23.8		
Energy Sector Review	FY05	78.9		
Health Sector Review	FY05	199.3		
PSIA on the Impact of Utility Sector Reform	FY05	114.8		
PSIA on Labor Markets	FY05	108.5		
Education Spending on the Poor	FY06	53.1		
Corporate and Accounting ROSCs	FY06	85.8		
Statistical Capacity Bldg	FY06	18.4		
Prog. PER	FY06	95.1		
Agro-processing Study	FY06	144.6		
Prog. Poverty Assessment	FY06	126.8		
Underway				
PER Core with PEFA Assessment	FY07	150		
Business Env. TA	FY07	50		
Structural Reform TA	FY07	250		
Water Sector Review	FY07	20		
Prog. Poverty Assessment	Program.	125 p.a.		
Planned				
Prog. PER with PIFC Assessment	FY08	150		
CEM	FY08	250		
Structural Reform TA	FY08	250		
BEEPS	FY08	-		
Transport Sector Review (with ADB)	FY08	-		
Prog. Poverty Assessment	Program.	125 p.a.		
Education Review	FY08	200		
Environmental Review	FY08	125		
Prog. PER with CFAA/CPAR updates	FY09	100		
Private and Financial Sector TA (inc. FSAP in 08)	Program.	50 p.a.		
Regional Development Strategy	FY09	100		
Social Sector Review	FY09	125		
Natural Disaster Management	FY09	250		

a. Government, donor, Bank, public dissemination

b. Knowledge generation, public debate, problem-solving.

c. May be integrated into a Public Financial Management Report

d. The timing and financing of this activity are still to be determined

e. May be integrated into the Programmatic Public Expenditure Review

CPS Annex B5
Azerbaijan Social Indicators

	Latest single year			Same region/income group	
	1980-85	1990-95	1999-05	Europe & Central Asia	Lower-middle-income
POPULATION					
Total population, mid-year (<i>millions</i>)	6.7	7.7	8.4	472.9	2,474.7
Growth rate (<i>% annual average for period</i>)	1.6	1.4	0.8	0.0	1.0
Urban population (<i>% of population</i>)	53.5	52.4	51.5	63.7	49.5
Total fertility rate (<i>births per woman</i>)	2.9	2.3	2.0	1.6	2.2
POVERTY					
<i>(% of population)</i>					
National headcount index	..	68.1	27.5	..	..
Urban headcount index	..	..	26.3	..	..
Rural headcount index	..	..	29.0	..	..
INCOME					
GNI per capita (<i>US\$</i>)	..	400	1,240	4,113	1,918
Consumer price index (<i>2000=100</i>)	..	87	125	130	130
Food price index (<i>2000=100</i>)	..	..	..	..	..
INCOME/CONSUMPTION DISTRIBUTION					
Gini index	..	36.0	..	..	..
Lowest quintile (<i>% of income or consumption</i>)	..	..	..	..	..
Highest quintile (<i>% of income or consumption</i>)	..	..	..	..	..
SOCIAL INDICATORS					
Public expenditure					
Health (<i>% of GDP</i>)	..	2.1	1.0	..	..
Education (<i>% of GDP</i>)	..	4.5	3.1	4.4	4.3
Net primary school enrollment rate					
<i>(% of age group)</i>					
Total	..	89	84	90	..
Male	..	89	85	91	..
Female	..	89	83	90	..
Access to an improved water source					
<i>(% of population)</i>					
Total	..	68	77	92	82
Urban	..	82	95	99	94
Rural	..	51	59	80	71
Immunization rate					
<i>(% of children ages 12-23 months)</i>					
Measles	..	97	98	93	85
DPT	..	96	96	93	88
Child malnutrition (<i>% under 5 years</i>)	..	..	7	5	12
Life expectancy at birth					
<i>(years)</i>					
Total	69	69	72	69	70
Male	66	65	70	64	68
Female	73	73	75	73	73
Mortality					
Infant (<i>per 1,000 live births</i>)	89	80	75	28	33
Under 5 (<i>per 1,000</i>)	114	98	90	34	42
Adult (15-59)					
Male (<i>per 1,000 population</i>)	262	216	230	316	184
Female (<i>per 1,000 population</i>)	127	96	107	134	117
Maternal (<i>per 100,000 live births</i>)	..	..	94	58	163
Births attended by skilled health staff (%)	..	..	84	94	86

CAS Annex B5. This table was produced from the CMU LDB system.

10/02/06

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.

CPS Annex B6
Azerbaijan - Key Economic Indicators

Indicator	Actual			Estimate			Projected		
	2002	2003	2004	2005	2006	2007	2008	2009	2010
National accounts (as % of GDP)									
Gross domestic product ^a	100	100	100	100	100	100	100	100	100
Agriculture	15	13	12	10	9	8	9	9	10
Industry	50	53	55	62	67	67	66	63	60
Services	35	34	33	28	24	24	26	28	30
Total Consumption	73	70	66	45	36	36	36	38	41
Gross domestic fixed investment	34	53	58	44	40	37	36	36	37
Government investment	5	4	4	4	10	12	15	14	13
Private investment	29	49	54	40	30	24	22	22	24
Exports (GNFS) ^b	43	42	49	66	76	77	74	70	63
Imports (GNFS)	50	66	73	56	52	50	46	44	41
Gross domestic savings	27	30	34	55	64	64	64	62	59
Gross national savings ^c	22	25	28	46	54	58	61	60	59
<i>Memorandum items</i>									
Gross domestic product (US\$ million at current prices)	6,236	7,276	8,682	12,561	19,139	25,628	32,855	38,728	42,754
GNI per capita (US\$, Atlas method)	720	820	950	1,240	1,650	2,400	3,330	3,940	4,450
Real annual growth rates (% , calculated from 2005 prices)									
Gross Domestic Product at market prices	10.6	11.2	10.2	26.4	24.6	27.1	19.9	11.6	5.7
Real annual per capita growth rates (% , calculated from 2005 prices)									
Gross Domestic Product at market prices	9.8	10.4	9.3	25.1	23.6	26.1	19.0	10.7	4.8
Balance of Payments (US\$ millions)									
Exports (GNFS) ^b	2,667	3,057	4,235	8,332	14,584	19,652	24,283	27,063	26,790
Merchandise FOB	2,305	2,625	3,743	7,649	13,733	18,595	23,100	25,749	25,343
Imports (GNFS) ^b	3,121	4,770	6,312	7,003	9,954	12,727	15,133	16,897	17,604
Merchandise FOB	1,823	2,723	3,582	4,350	6,993	9,190	11,283	12,545	12,814
Resource balance	-454	-1,713	-2,077	1,329	4,630	6,926	9,150	10,166	9,186
Net current transfers	70	134	189	484	1,088	1,866	1,993	2,494	2,612
Current account balance	-768	-2,021	-2,589	167	2,749	5,452	8,217	9,464	9,109
Net private foreign direct investment	1,067	2,352	2,351	459	-1,539	-4,120	-1,456	-667	81
Long-term loans (net)	167	115	17	218	163	311	339	337	418
Official	175	149	62	70	114	193	254	303	337
Private	-8	-34	-45	148	49	118	85	34	80
Other capital (net, incl. errors & omissions)	-230	-199	665	-208	457	1,409	2,110	2,012	1,714
Change in reserves ^d	-236	-247	-444	-636	-1,830	-3,051	-9,210	-11,146	-11,322
<i>Memorandum items</i>									
Resource balance (% of GDP)	-7.3	-23.5	-23.9	10.6	24.2	27.0	27.9	26.2	21.5
Real annual growth rates									
Merchandise exports (FOB)	8.7	-4.2	12.9	46.6	47.8	45.8	32.0	19.6	5.1
Merchandise imports (CIF)	23.2	34.3	22.4	21.4	55.8	26.6	22.3	10.5	1.5

(Continued)

Azerbaijan - Key Economic Indicators
(Continued)

Indicator	Actual			Estimate			Projected		
	2002	2003	2004	2005	2006	2007	2008	2009	2010
Public finance (as % of GDP at market prices)^e									
Current revenues	27.3	26.8	26.8	26.5	40.8	45.3	63.9	64.7	61.4
Current expenditures	21.2	21.5	21.7	19.1	22.6	23.9	24.0	22.9	22.9
Current account surplus (+) or deficit (-)	6.1	5.2	5.1	7.4	18.2	21.3	39.9	41.8	38.6
Capital expenditure	5.6	6.0	4.1	4.7	10.7	12.8	15.4	14.9	13.9
Overall budget balance	0.5	-0.8	1.0	2.7	7.5	8.5	24.5	27.0	24.7
Monetary indicators									
M2/GDP	13.0	14.3	17.6	15.4	21.1	26.3	27.8	31.3	35.7
Growth of M2 (%)	14.4	29.8	47.5	22.1	93.6	59.0	28.6	26.0	22.4
Private sector credit growth / total credit growth (%)	77.4	120.3	136.8	108.8	114.2	106.9	103.8	101.8	100.3
Price indices (2005 = 100)									
Merchandise export price index	47.8	56.8	71.8	100.0	121.5	112.9	106.2	99.0	92.7
Merchandise import price index	83.7	93.1	100.0	100.0	103.2	107.1	107.6	108.2	108.8
Merchandise terms of trade index	57.1	61.0	71.8	100.0	117.7	105.4	98.8	91.5	85.2
Real exchange rate (US\$/LCU) ^f	88.4	86.3	87.4	100.0	117.4	139.4	170.9	202.1	227.8
Consumer price index (% change)	2.8	2.2	6.7	9.7	13.0	17.0	17.0	13.0	10.0
GDP deflator (% change)	3.1	6.0	8.3	10.1	14.0	0.0	1.5	0.3	1.3

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 and changes in Oil Fund assets. "-" denotes an increase in reserves/Oil Fund assets.

e. Consolidated government, including Oil Fund.

f. "LCU" denotes "local currency units." An increase in US\$/LCU denotes appreciation.

CPS Annex B7
Azerbaijan - Key Exposure Indicators

Indicator	Actual				Estimate			Projected		
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Total debt outstanding and disbursed (TDO) (US\$m) ^a	1,299	1,499	1,746	1,982	1,881	2,009	2,284	2,604	2,924	3,328
Net disbursements (US\$m) ^a	-4	102	101	154	98	127	276	320	320	404
Total debt service (TDS; US\$m) ^a	132	171	216	240	235	140	195	211	243	262
Debt and debt service indicators (%)										
TDO/XGS ^b	51.7	52.3	53.5	44.1	21.1	12.9	10.8	10.0	9.9	11.2
TDO/GDP	22.8	24.0	24.0	22.8	15.0	10.5	8.9	7.9	7.5	7.8
TDS/XGS	5.3	5.9	6.6	5.3	2.6	0.9	0.9	0.8	0.8	0.9
Concessional/TDO	35.4	46.1	53.8	57.7	60.3	..	..	..	..	..
IBRD exposure indicators (%)										
IBRD DS/public DS	0.0	0.0	0.0	0.0	0.0	0.6	2.9	7.0	11.2	18.1
Preferred creditor DS/public DS (%) ^c	59.7	54.8	64.5	62.3	62.1	53.6	52.3	49.0	50.4	58.3
IBRD DS/XGS	0.00	0.00	0.00	0.00	0.00	0.00	0.02	0.04	0.07	0.11
IBRD TDO (US\$m) ^d	0	0	0	0	0	39	126	257	442	659
Of which present value of guarantees (US\$m)	0	0	0	0	0	0	0	0	0	0
Share of IBRD portfolio (%)	0	0	0	0	0	0	0	0	0	1
IDA TDO (US\$m) ^d	235	314	422	493	501	557	613	683	754	804
IFC (US\$m)										
Loans	101	73	43	64	53	40	..	..	..	..
Equity and quasi-equity ^e	3	3	3	3	3	4	..	..	..	..
MIGA										
MIGA guarantees (US\$m)	0	0	0	0	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.

B8 – Bank Portfolio

CAS Annex B8 - Azerbaijan

Operations Portfolio (IBRD/IDA and Grants)

As Of Date 10/23/2006

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Closed Projects 15

IBRD/IDA *

Total Disbursed (Active)	98.54
of which has been repaid	0.00
Total Disbursed (Closed)	436.64
of which has been repaid	3.89
Total Disbursed (Active + Closed)	535.18
of which has been repaid	3.89
Total Undisbursed (Active)	478.83
Total Undisbursed (Closed)	1.12
Total Undisbursed (Active + Closed)	479.96

Active Projects

Project ID	Project Name	<u>Last PSR</u>		Fiscal Year	<u>Original Amount in US\$ Millions</u>			Cancel.	Undisb.	<u>Difference Between Expected and Actual Disbursements[#]</u>		
		<u>Supervision Rating</u>	<u>Development Objectives</u>		<u>Implementation Progress</u>	IBRD	IDA			GRANT	Orig.	Frm Rev'd
		S	S		S							
P090887	ADCP-II	S	S	2006		29.2		29.77634	0.5986687			
P066100	AVIAN FLU (formerly IBTA ;MS		MS	2002		9.45		5.798345	1.0995392	0.352502		
P058969	CULT HERITAGE PRSV	S	MS	1999		7.5		1.15716	0.7906696	0.848857		
P070989	ED SECT DEV (APL #1)	MS	MS	2003		18		11.79557	7.8255115			
P081616	FIN SERV DEVT	S	S	2005		12.25		12.02468	1.044056			
P040716	HIGHWAY	S	S	2001		40		13.43396	7.2165239	-2.358133		
P094220	Health Sector Reform Proje#		#	2006		50		50.66384	0.1943635			
P094488	Highway 2	S	S	2006	200			199.5	3.6666667			
P089751	IDP ECON DEVT SUPPOR	S	S	2005		11.5		9.734903	3.5136212	3.213711		
P008286	IRRIG DIST SYS & MGMT I	S	S	2003		35		35.50905	8.6989496			
P008284	IRRIG/DRAINAGE REHAB	S	S	2000		47		11.8883	3.5072262	-1.174162		
P099201	JUDICIAL MOD	S	S	2006		21.6		21.73839				
P049892	PENSION & SOC ASST	S	S	2004		10		7.880014	5.4536767	-0.203337		
P083341	POWER TRANSMISSION	S	MS	2005	48			47.66717	5.6671659			
P066199	RURAL ENVIRONMENT	MS	MS	2005		8		7.937838	0.9481482			
P077031	RURAL ENVIRONMENT (GMS	MS	MS	2005			5	5	0.6733333			
P076234	RURAL INVSM T (AZRIP)	MS	MS	2004		15		12.3264	1.8374608			
Overall Result					248	314.5	5	483.832	52.735581	0.679437		

Statement of IFC's
Held and Disbursed Portfolio
As of 06/18/2006
(In US Dollars Millions)

FY Approval	Company	Held				Disbursed			
		Loan	Equity	Quasi	Partic	Loan	Equity	Quasi	Partic
1998/2003/2006	Azerigazbank	0.9	2.30	0	0	0.9	0	0	0
1999	Baku Hotel	1.46	0	0	0	1.46	0	0	0
2002/2006	MFB Azerbaijan	3.0	1.6	0	0	3.0	1.6	0	0
1998/2003	Rabitabank	0.9	0	0	0	0.9	0	0	0
2005	Unibank	5.0	0	0	0	2.39	0	0	0
2004	BTC	31.0	0	0	31.0	31.0	0	0	31.0
Total Portfolio:		42.26	3.9	0	31.0	39.65	1.6	0	31.0

Approvals Pending Commitment

		Loan	Equity	Quasi	Partic
2001	Azer JV Increase	0	0.06	0	0
2005	AG Leasing	3	0	0	0
Total Pending Commitment:		3	0.06	0	0

MAP SECTION