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**MEMORANDUM OF THE PRESIDENT
OF
THE INTERNATIONAL DEVELOPMENT ASSOCIATION
AND
THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
AND
THE INTERNATIONAL FINANCE CORPORATION
TO
THE EXECUTIVE DIRECTORS
ON A
COUNTRY ASSISTANCE STRATEGY
FOR
AZERBAIJAN REPUBLIC**

April 29, 2003

**South Caucasus Country Unit
Europe and Central Asia Region**

CURRENCY EQUIVALENTS
(Exchange Rate Effective March 31, 2003)

Currency Unit	=	Azerbaijan Manat (AZM)
US\$	=	4.905.00 AZM
AZM	=	US\$ 0.0002

GOVERNMENT'S FISCAL YEAR

ABBREVIATIONS & ACRONYMS

AAA	Advisory and Analytical Assistance	JSA	Joint Staff Assessment
ACG	Azeri Chirag-Gunashli	LIL	Learning & Innovation Loan
ADB	Asian Development Bank	MDG	Millennium Development Goals
AFC	Agricultural Finance Corporation And Development	MOF	Ministry of Finance
APL	Adaptable Program Loan	MOH	Ministry of Health
AZM	Azerbaijan Manat	MTEF	Medium-Term Expenditure Framework
BEEPS	Business Environment and Enterprise	OSCE	Organization for Security and Cooperation In Europe
BSE	Baku Stock Exchange	PEP	Private Enterprise Partnership
BSL	Banking Systems Law	PER	Public Expenditure Review Performance Survey
BTC	Baku-Tbilisi-Ceyhan	PIP	Public Investment Program
CEM	Country Economic Memorandum	PPL	Public Procurement Law
CFAA	Country Financial Accountability Assessment	PRS	Poverty Reduction Strategy
CIS	Commonwealth of Independent States	PRSC	Poverty Reduction Strategy Credit
CIS	Commonwealth of Independent States	PRSP	Poverty Reduction Strategy Program
CPAR	Country Procurement Assessment Review	PSA	Production Sharing Agreement
CPPR	Country Portfolio Performance Review	PSD	Private Sector Development
ECA	Europe and Central Asia	SAC	Structural Adjustment Credit
EU	European Union	SME	Small and Medium-Scale Enterprise
FIAS	Foreign Investment Advisory Service	SOCAR	State Oil Company of Azerbaijan Republic
FPP	Farm Privatization Project	SOE	State-Owned Enterprise
FSA	Financial Sector Assessment	SOFAR	State Oil Fund of Azerbaijan Republic
FSAP	Financial Sector Assessment Program	SPPRED	State Program on Poverty Reduction and Economic Development
FSTA	Financial Sector Technical Assistance	SSC	State Securities Committee
FY	Fiscal Year	TA	Technical Assistance
GDP	Gross Domestic Product	TACIS	Technical Assistance for
HGA	Host Government Agreements	UNDP	United Nations Development Program
IAS	International Accounting Standards	UNHCR	United Nations High Commissioner for Refugees
IBRD	International Bank for Reconstruction and Development	UNICEF	United Nations Children's Fund
IBTA	Institution Building and Technical Assistance	USAID	United States Agency for International Development
IDA	International Development Association	WBI	World Bank Institute
IDP	Internally Displaced Persons		
IGA	Inter-Governmental Agreement		
IMF	International Monetary Fund		

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AZERBAIJAN REPUBLIC
COUNTRY ASSISTANCE STRATEGY

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EXECUTIVE SUMMARY

i. Azerbaijan is today one of the seven lowest income countries of Europe and Central Asia. It has experienced many of the same challenges as other CIS transition states exacerbated by armed conflict, and a large population of refugees and IDPs. On a more positive note, however, Azerbaijan's future holds tremendous promise because of oil and gas resources which it is currently developing. How the country manages the exploitation of these finite natural resources and the associated revenue boom will determine the success of its medium-term poverty reduction goals, set out in its PRSP.

ii. **Issues for Discussion.** The following issues are suggested for Board discussion:

- Is the strategy appropriately selective and aligned with the PRSP?
- Is policy-based lending through PRSCs warranted to reinforce the policy dialogue?
- Is the blend of IBRD and IDA lending and IFC assistance appropriate?
- Are the risks properly identified and mitigated to the extent possible?

iii. **Macroeconomic and Governance Trends.** After hyperinflation and severe recession, the economy grew at nearly 9% a year during 1997-2002 while annual inflation dropped to 0.1%. Azerbaijan by now has an impressive track record of stabilization with fiscal restraint and prudent monetary policy. External indebtedness is modest and sustainable. If oil and gas developments remain on track GDP growth could reach double digits beyond 2005. However, oil production is expected to peak in 2011 and decline rapidly after 2013, absent other major discoveries. The role of the Oil Fund will be crucial in managing the boom, and securing more equitable growth across current and future generations. Diversified development of the non-oil sector is key for generating jobs and equity. The joint EBRD and Bank survey, BEEPS, showed significant progress on governance and corruption issues during 1999-2002, although much remains to be done to strengthen the business environment.

iv. **Poverty Reduction.** Despite some progress in recent years, about 50% of the population lived in poverty in 2001 and 17% lived in extreme poverty. The incidence of income poverty is greatest among households in provincial towns, although rural areas have more limited access to services and there are significant regional variations in poverty rates. Appropriate management of oil resources offers promising prospects for meeting the Millennium Development Goals.

v. **Azerbaijan's PRSP**, known as the State Program on Poverty Reduction and Economic Development (SPPRED), identifies six strategic pillars: (i) an enabling environment for income-generating opportunities; (ii) macroeconomic stability; (iii) quality of and equity in access to health and education; (iv) infrastructure improvements (including roads, utility services, and irrigation); (v) social protection reforms to serve the vulnerable more effectively; and (vi) better conditions for refugees and IDPs. The SPPRED and the MDGs serve as the organizing framework for the CAS, whose four strategic goals are designed to underpin the six SPPRED pillars. Generally, Azerbaijan is on track to realize most MDGs by 2015, with the caveat that health indicators are difficult to measure due to data uncertainties which need to be addressed.

vi. **The FY03-05 CAS strategy** comprises four interrelated strategic goals, aiming to: (i) manage the oil windfall and maintain macroeconomic stability; (ii) generate jobs and non-oil growth (iii) improve access to services by reversing the decline in social services and infrastructure and (iv) help realize the oil potential to the extent and in the timeframe envisaged by Azerbaijan's poverty reduction program. These would be supported by a carefully balanced combination of policy based assistance (PRSCs) investment projects, institution building and technical assistance, as well as analytical support.

vii. **The FY03-05 CAS Program** includes eight IDA operations totaling up to \$123 million and one IBRD operation of \$40 million in the Base Case. In a High Case scenario, IDA financing would increase to up to \$158 million and a second \$35 million IBRD operation for infrastructure would be added. The CAS triggers are calibrated according to implementation capacity of the Government, with the main difference between the Base and High Cases being the scope of reforms and pace of implementation. In the Base Case scenario, the prerequisites for a PRSC would be in place in early FY05. If the reform progress and the strengthening of governance are faster than envisaged in the base case scenario, Bank assistance could move to the High Case, and include a first PRSC late in FY04 and a second one in FY05. As part of the CAS program, IFC is considering providing up to \$150 million each in A and B loans to finance the BTC pipeline and up to \$100 million for associated oil extraction for the ACG project. Analytical assistance has been strong during the last year, through the PER, Poverty Assessment, CPAR, CFAA, and Integrated Strategy and Action Plan for Trade and Business Development, as well as an IFC supported Investors Conference focused on Azerbaijan's non-oil sector. Planned work for FY03-05 includes updates of the PER, a CEM, an FSAP, and an Energy Sector Report, follow-on work on trade and business environment, agro-processing, and labor markets. Portfolio performance is satisfactory, and is receiving increased attention, including via the decentralization of portfolio management responsibility to the field.

viii. **Risks.** There are three categories of risks to the strategy outlined above. *Political risks* include the unresolved conflict over Nagorno-Karabakh and the possibility that a political transition might lead to instability and/or significant shifts in policy. Ensuring broad-based civic and political ownership of the development strategy, through continuation and expansion of the consultative process of the PRSP will help to mitigate these risks. *Economic risks* are associated with oil and gas developments, including the possibility of a delay in investments, changes in energy prices, and "Dutch disease" effects. The adoption of a prudent fiscal stance and the stabilizing effect of the Oil Fund, as well as the integrated strategy for expanding the non-oil sector, are essential risk mitigation measures. Equally important will be continuous donor engagement through policy-based lending, as well as broad-based civic and political ownership of the reform process. *Implementation and governance capacity* present a final set of risks to the achievement of the CAS objectives. Major attention is paid to these issues as a cross-cutting theme throughout the planned assistance program. Risk mitigation will include significant attention to capacity building in all Bank Group activities, a strong focus on strengthening the management of public expenditures, implementation of action plans resulting from the recent CFAA, CPAR and CPPR, and decentralization of portfolio management and important financial management and procurement functions to the field.

I. INTRODUCTION

1. The last Azerbaijan Country Assistance Strategy (CAS) was discussed by the Board on September 14, 1999 (IDA/R99-157/1[IFC-R99-145/1). The current CAS, covering FY03-05, was prepared jointly by IDA and IFC, taking into account Azerbaijan's new PRSP known as the State Program for Poverty Reduction and Economic Development (SPPRED). It was developed in close consultation with government authorities, other national stakeholders and international development partners. The next few years will be a particularly dynamic period for Azerbaijan, owing primarily to oil and gas sector developments. The CAS seeks to assist the country in managing the opportunities and challenges posed by these developments, as it begins to implement its SPPRED.

II. THE COUNTRY CONTEXT

Initial Conditions and the Challenges Ahead

2. Although Azerbaijan's development prospects seemed bright at the dawn of the 20th century because of its oil and gas resources, subsequent events including two World Wars and its absorption into the Soviet sphere were less favorable. Azerbaijan is today one of the seven lowest income countries of Europe and Central Asia. Over the last decade it has experienced many of the same challenges as other CIS transition economies - severe economic contraction during the early 1990s, a concomitant deterioration in social services and infrastructure and sharp increase in poverty, and a daunting agenda of reforms and institutional challenges needed to redefine the role of the state and create the essential underpinnings of a market economy. In Azerbaijan's case, however, these challenges were exacerbated by armed conflict with Armenia over Nagorno-Karabakh, which led to nearly one million internally displaced people (IDPs) and refugees, loss of control over some 20 percent of the land area, and disruption of key regional trade and transport links. On a more positive note, however, Azerbaijan's future again holds tremendous promise because of new efforts to develop its significant oil and gas resources. How the country manages the exploitation of these finite natural resources and the associated revenue boom will determine the success of its medium-term poverty reduction goals, set out in its PRSP.

3. Although precise measures of income and well-being during the Soviet era are difficult for a variety of statistical reasons, it seems clear that Azerbaijan entered the post-independence transition period considerably poorer than many other former Soviet republics. Azerbaijan's GDP then dropped by 63 percent during 1989-95, compared with an average of 42 percent in the CIS. Thus, even with economic recovery beginning in 1996 and GDP growth averaging more than 8 percent a year over 1997-2002, GDP is still 40 percent less than in 1989 and nearly half the population remains below the national poverty line.

4. The signing of a number of Production Sharing Agreements (PSAs) with oil companies in the mid-1990s and initiation of stabilization and standard reform program marked the beginning of a turnaround in Azerbaijan's development prospects. These have opened the way for investment in two major pipelines which are scheduled for completion by around 2005: the Baku-Tbilisi-Ceyhan (BTC) pipeline will carry oil primarily from the Azeri, Chirag and Gunashli (ACG) oil fields in Azerbaijan to the Turkish port of Ceyhan on the Mediterranean Sea through Georgia, and the Shah-Deniz pipeline will transport gas to Turkey, also through Georgia. Managing the expected substantial, but without major new discoveries, short-lived revenue windfall resulting from these investments, in a way that avoids the risk of severe macroeconomic distortions and encourages diversification and growth of the non-oil sector, poses a complex set of challenges. The FY03-05 CAS will span a critical period, both in preparing for this oil boom and initiating implementation of Azerbaijan's SPPRED. The Bank Group's assistance program, in cooperation with those of other international partners, will focus on helping Azerbaijan meet these challenges.

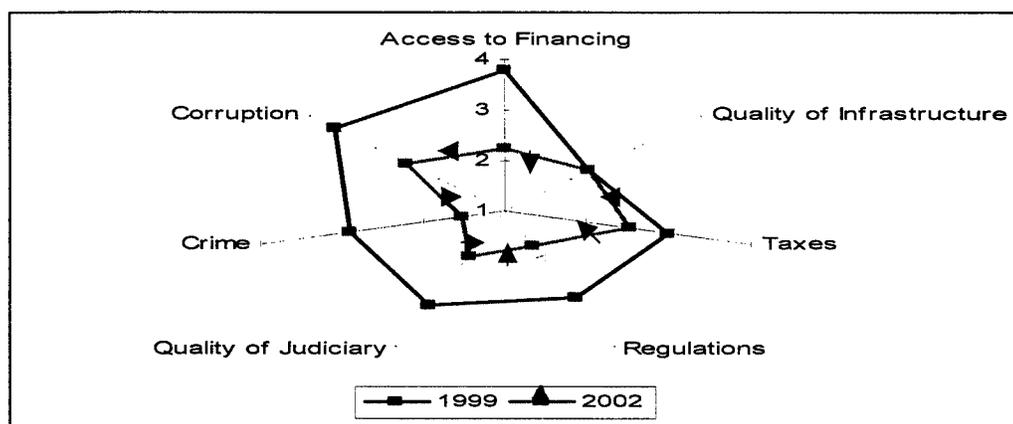
5. As in other CIS countries, the tasks of overcoming the legacy of inefficient production, outdated technology, monopolies, disregard for consumer preferences, environmental neglect and the absence of the institutions of a market economy have proved more difficult in Azerbaijan than initially anticipated. The record of policy and institutional reform has been mixed, but there clearly has been a gain in momentum since 2001. This did not stem from a need to deal with a debt or related financing crisis. Rather, the success of the stabilization program, growing foreign investor interest, and the prospect and risks of large-scale oil revenues seem to have strengthened the authorities' interest in and commitment to reforms. The advent of the SPPRED process provided a timely opportunity for the government and other national stakeholders to initiate a dialogue and planning of a medium-term development strategy which emphasizes tackling poverty and strengthening governance, with technical cooperation from the international community. The most significant reforms have included establishing a State Oil Fund (SOFAR); strengthening of governance in the banking sector; the start of addressing implicit subsidies and the need for greater financial transparency in the utilities sectors; some improvements in the structure of the public sector including consolidation of several activities in the new Ministry of Economic Development; enactment of a modern tax code; and the adoption of more transparent budget execution and accounting, and strengthening of internal and external audit capacity.

Political Economy and Governance

6. The last few years have also seen some slow but significant developments on the domestic political development front in Azerbaijan. A diversified multi-party structure has evolved, which includes opposition parties, an emerging civil society and a growing network of NGOs. Nonetheless, as in many other CIS countries, Azerbaijan's executive is still extremely powerful vis-à-vis other branches of government. The country's admission to the Council of Europe in January 2001 marked an important benchmark in its transition towards pluralistic democracy and has opened the way for monitoring

implementation of democratic commitments undertaken by the country. There has also been an active process of legal reform concerning the Constitutional Court, advocacy, media, civil and criminal procedure, aimed at modernizing Azerbaijani legislation. A national referendum on constitutional changes in August 2002 aimed to bring the country's basic law in line with the European Convention on Human Rights and other commitments related to membership in the Council of Europe. A Presidential election is scheduled for October 2003, and the 79 year-old President Heydar Aliyev has announced his intention to stand for re-election. The international community will provide monitoring, to assess progress compared with the conduct of previous elections and the 2002 national referendum.

Figure 1: Qualitative Assessment of the Business Environment in 1999 and 2002



Source: EBRD and World Bank, Business Environment and Enterprise Performance Survey, 2002. The combined measure of qualitative assessments of the business environment is calculated as an unweighted average across seven dimensions. The values range from 1 to 4, with 1 indicating no obstacles to business growth and operation, and 4 indicating major obstacles. The extremity of each axis represents a score of 4, indicating a less favorable business environment.

7. Regarding other dimensions of governance, recent surveys indicate some progress, particularly concerning corruption and the business environment. The most comprehensive governance/investment climate surveys, including EBRD/IBRD's Business Environment and Enterprise Performance Survey (BEEPS), the Bank Group's Foreign Investment Advisory Service Survey (FIAS), PRS Group's International Country Risk Guide and Heritage Foundation's Economic Freedom Survey have all reported improvements in Azerbaijan's investment climate, particularly in the last three years, albeit from a low base. The 1999 BEEPS ranked Azerbaijan at the bottom of 20 transition economies on measures of state capture and administrative corruption, although the country did considerably better on other criteria, and on the overall Governance Index it ranked 11th among the 20 countries. The 2002 BEEPS shows quite a significant improvement, notably in those areas where Azerbaijan scored poorly in 1999. (See Figure 1.) These trends and those reported in other surveys are encouraging, but should

not be taken as doing much more than providing a promising platform for continuing efforts to improve the governance, anti-corruption, business environment nexus. Given the magnitude of the task there is no room for complacency, and that is the perspective which informs this CAS and the SPPRED.

8. Azerbaijan's location at the crossroads of Europe and Asia offers clear potential for expanded trade and transit opportunities, and cooperation on regional infrastructure and service development, but political conflicts have exacted a high price from all of the countries in the sub-region. Trade and other links between Azerbaijan and Armenia remain suspended pending resolution of the Nagorno Karabakh conflict. Peace mediation efforts are being led by the Minsk Group (including the United States, Russia and France) of the Organization for Security and Cooperation in Europe (OSCE). Periodic dialogue between the Presidents of the two countries has been a positive factor, although this has not yet led to a solution. IDA has indicated its willingness to support an eventual peace accord and, if one should be agreed, a CAS update or new CAS would be prepared.

Poverty Profile and Millennium Development Goals

9. Poverty presents a major challenge, with nearly 50 percent of the Azeri population of 8 million living below the national poverty line in 2001, and 1.3 million of them (17 percent of the total population) living in extreme poverty. The 2001 Household Budget Survey finds that the incidence of income poverty is greatest among urban households, although rural areas are clearly more deficient in terms of access to services and this has led to substantial rural-urban migration. Within the urban category, poverty incidence is highest in provincial towns, but Baku still has the largest absolute number of urban poor. In rural areas there are some significant regional variations in poverty rates. The risk of poverty increases with household size, for both total and extreme poverty. The age of the household head is a poor predictor of the risk of poverty. There is a weak but positive relationship between poverty and educational attainment of the household head. The risk of income poverty is higher for households headed by unemployed workers and pensioners. Men and women are affected in different ways by poverty and more research is required to understand this issue and tailor appropriate solutions. Employment data suggest that females have a higher risk of unemployment and tend to concentrate in the social sectors where wages are below the national average (30 percent in health professions and 70 percent in education). Internally Displaced Persons (IDPs) and refugees are particularly vulnerable, as they lack assets and are dependent on state transfers and donor assistance. However, there is some uncertainty about the extent of income poverty among the IDPs and refugees compared to the general population.

10. With regard to non-income indicators of poverty, Azerbaijan's situation is mixed. Official health statistics compare favorably with those of countries with a similar per capita income, but independent survey data suggests that actual rates of infant and maternal mortality may be considerably higher than officially reported. Azerbaijan is very close to achieving universal primary education, although school enrollment rates decreased slightly during 1995-2000 almost 50 percent of children drop out of school by the age of 16-17, and quality needs to be improved at all levels. While the loss of

employment opportunities is the primary concern of the poor, there is also clear evidence of a continued deterioration in public infrastructure and services (notably gas, water supplies and heating), especially in the rural areas.

11. There are reasonable prospects for meeting most of the Millennium Development Goals (MDGs) in Azerbaijan, although monitoring progress in several areas is complicated by the existence of the aforementioned discrepancies between traditional official data and results of independent surveys, especially in regard to the basic health statistics. In general, the estimates of Multiple Indicator Cluster Survey of 2001 provide quite realistic information to supplement the administrative data for infant mortality, under-5 mortality and maternal mortality. The ongoing household survey also generates useful data for understanding changes in poverty levels. Nonetheless, the government is acutely aware of the need to the strengthen national statistical capacity to monitor the MDGs and, more broadly, the SPPRED. IDA will continue to work with UNICEF and the UNDP, as well as with the national PRSP coordinating unit in the Ministry of Economic Development, the SSC and relevant sector ministries and agencies, to help strengthen the country's data collection and analysis.

Table 1: Millennium Development Goals

<i>Millennium Development Goal</i>	<i>Present Situation</i>	<i>Prospects for Achievement by 2015</i>
Halving income poverty.	About 50 percent of population of Azerbaijan lived in the poverty in 2001. Among these, a group of 1.3 million persons, or 17 percent of the total population, lived in extreme poverty.	With projected high annual GDP growth for 2001-2010, the poverty rate would drop from 50% to 30%, assuming no change in income distribution. Azerbaijan is thus on track for halving income poverty by 2015. With better targeted social programs and stronger job creation, this goal could be met sooner.
Achieving universal primary education.	Enrollment rates in basic education (grades 1-9) are fairly close to 100%, although drop-out rates are higher for the poor than for non-poor. Sector concerns relate more to quality, including the need to build the skills and knowledge necessary to meet the challenges of an increasingly globalized economy.	The country inherited an education system that provides nearly universal basic education. Sector issues relate more to quality, than access.
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.	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.
Reducing under five mortality by two-thirds.	According to official data, infant mortality is relatively low and falling (13 deaths for 1,000 live births in 2000, compared to about 25 in 1990). However, recent surveys estimate that the IMR was as high as 79 per 1,000 live births in 1996, and the under-five mortality rate as high as 105.	Assessing progress is complicated by data uncertainties. To reduce under five mortality by 2/3, a 4.4% annual reduction is needed between 1990-2015. Azerbaijan's progress has been slower at only about 0.9% annually during 1990-2000. Thus

		Azerbaijan is at risk for not meeting this MDG without a concerted effort to strengthen primary health care and make it accessible to the poor.
Reducing maternal mortality by three quarters.	Survey estimates place maternal mortality at 79 deaths per 100,000 births in 1990, while administrative statistics report a figure as low as 9 deaths per 100,000 births in that year. In 2000, the corresponding administrative figure is 37 deaths for 100,000 births.	If survey data is taken as baseline, Azerbaijan could reduce its maternal mortality ratio of 79 per 100,000 live births by 3/4 by the year 2015 with increased public health spending and strengthened PHC and maternal and child health programs, especially in rural areas. Current trends are worrisome as even official data show an increase in MMR.
Reversing the spread of HIV/AIDS.	The prevalence rate of Azerbaijan 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 sero-prevalence surveys and lack of behavioral surveys.	Although the prevalence rate is considered to be low, the trend is increasing and more appropriate survey work is important. There is a clear need for greater attention to HIV/AIDS prevention and care for Azerbaijan to meet this challenge.
Reversing the spread of Tuberculosis	The current Tuberculosis prevalence rate is 50 cases per 100,000 population with a high case fatality rate of 20%. Case detection rate remains at around 30%, much lower than the international standard of 70%, with only a small fraction of cases detected through DOTS.	According to WHO Global Tuberculosis Control Program, Azerbaijan is a DOTS Category 2 country, defined as pilot phase and less than 10% coverage. Political commitment and additional resources are needed to expand coverage from the current 4% to 100% in order to meet the MDG goal of reversing the spread.
Ensuring environmental sustainability (including halving the proportion of people without access to safe water).	According to available estimates, around 76% of all households have access to an improved drinking water source – 93% in urban areas and 58% in rural areas.	Achieving this MDG is feasible if the Government gives sufficient priority to rural water in its public investment program, consistent with the SPPRED.

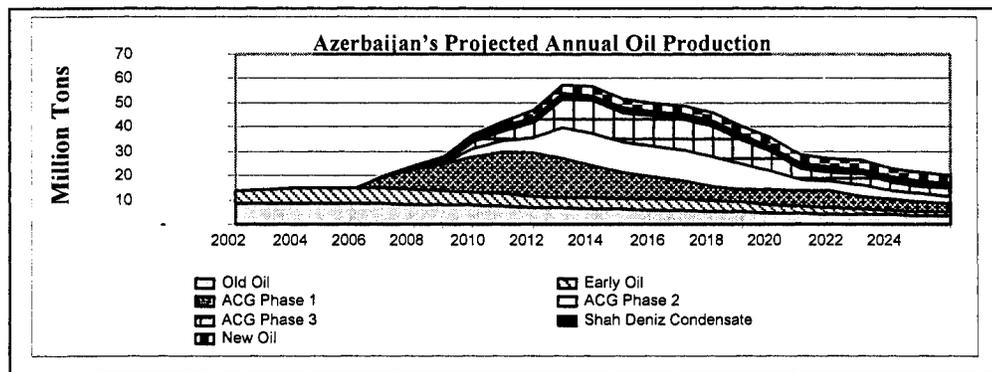
NOTE: Where no 1990 baseline data exist, the value for the closest year for which there is data was used to calculate the MDG target on a pro-rata basis, and the 2015 target was determined in relation to the available base year.

Development of Oil and Gas Reserves

12. Azerbaijan's proven oil reserves are conservatively estimated at 900 million tons. Absent any major new oil discovery, production should peak at about 65 million tons in 2011, followed by a relatively short plateau and thereafter will decline rapidly to less than half its peak level by 2018 and then to about a quarter of the peak level in 2024. This hump-shaped production profile will cause a similar pattern of rising and then decreasing oil revenues. For the remainder of this decade most of the oil revenues will leave the country in the form of profit and capital repatriation or, according to current rules, be

accumulated in the Oil Fund. Therefore, while Government revenues (including Oil Fund inflows) are projected to increase by 180 percent in 2010 relative to 2002, a pragmatic formulation of the medium-term public expenditure envelope follows the trajectory of non-oil GDP.¹ Besides the need to avoid “Dutch disease” and to ensure revenues (through the Oil Fund) for future generations when oil and gas resources will have been depleted, the maximum prudent rate of growth of public expenditures is also constrained by public sector institutional capacity. The base case scenario of IDA’s recent Public Expenditure Review therefore envisages only a gradual increase in public expenditure from 28.4 percent of non-oil GDP in 2001 to 35.6 percent in 2010. The fact that the increase in private consumption per capita is projected to be rather modest for the rest of the decade places an obvious premium on careful prioritization of poverty reduction interventions within the framework of Azerbaijan’s SPPRED.

Figure 2: Azerbaijan Oil Production



13. To manage this hump-shaped oil boom, Azerbaijan has established a State Oil Fund (SOFAR), which provides a financial mechanism for separating commercial decisions on oil extraction from public spending decisions. SOFAR affords the authorities considerable flexibility to “smooth” public expenditures over time in a manner that can maintain monetary stability. It also allows the Government to maintain a degree of continuity in fiscal programs, especially with regard to the implementation of committed investment projects and programs. And it aims at greater transparency in the use of oil revenues. As discussed below, given the hump-shaped profile of oil production, prudent oil windfall management in Azerbaijan requires an accumulation of large savings in the form of financial assets abroad, in order to avoid large and destabilizing oil related inflows which could fuel excessively rapid growth in government expenditures and loss of competitiveness of Azerbaijan’s non-oil sectors.

¹ See Azerbaijan Public Expenditure Review, Chapter IV and Annex IV.

Box 1: Institutional Framework for the State Oil Fund of the Azerbaijan Republic***Supervision and Control***

- The ultimate authority over all aspects of the Oil Fund's activities rests with the President, who is empowered to liquidate and re-establish the Fund, approve the Fund's regulations, identify its management structure, etc.
- The three level management structure consists of the President, Executive Director, and Supervisory Board. Members of the Supervisory Board and the Executive Director are appointed and dismissed by the President.
- The Board consists of key government officials (Prime Minister, ministers), two parliamentary members (nominated by the Speaker), and academia. It is entrusted with the functions of internal supervision to oversee the composition of the Oil Fund's assets and compliance with the expenditure rules.

Investment Strategy and Operational Management of Assets

- The portfolio investment strategy is annually approved by the President based on recommendations of the Executive Director, taking into account recommendations of the Supervisory Board.
- Operational management is delegated to the Executive Director, who chairs the Investment Board (internal structure).
- Professional portfolio managers may be contracted for a certain portion of the Fund's assets.
- Investment portfolio guidelines determine currency composition, the balance between liquid (up to 40 percent of the portfolio) and long-term investments, and fixed and equity income instruments. Preference is given to fixed income instruments, while equity income instruments (corporate securities and shares) are banned unless a highly reputable professional investment manager is hired to handle them.

Transparency, Accountability, and External Oversight

- The President selects a highly reputable international auditor to conduct an annual audit of the Oil Fund's accounts. The results from the annual report on the use of the funds and the external audit report are published in the mass media. Pursuant to the Azeri laws, the Chamber of Auditors may also audit the Fund.
- Quarterly reports produced by the Executive Director shall be submitted to the Supervisory Board and the President.
- The annual report is prepared in coordination with the MOF. After recommendations of the Supervisory Board are incorporated, it shall be submitted to the President. The annual report 2001 is posted on the official website.

Governance of Revenues/Expenditure Rules

- Consolidation with the state budget is ensured through the Budget Systems Law.
- The Parliament approves the consolidated budget expenditures and consolidated deficit.
- All investment expenditures are to be executed through the Treasury.
- Use of the funds is subject to the State Procurement Law, which governs all budgetary expenditures.
- Investments should be in projects of national importance; while criteria for project selection are still to be developed, project investments have to be part of the governmental PIP and MTEF and consistent with the PRSP.

¹ *Annual Report 2001*, State Oil Fund of the Republic of Azerbaijan, and www.oilfund.az.

Recent Macroeconomic Trends and Prospects

14. Table 2 summarizes overall economic performance since independence. Household survey data suggest that the national accounts somewhat underestimated both the level of household consumption and GDP in the mid-1990s, but there is little doubt that both had declined by more than half between 1991-96. Stabilization and other reforms initiated in 1994, coupled with the signing of the oil PSAs, brought about a sharp deceleration of inflation from 1995 and reversed the trend of contracting GDP from 1996 onwards.

15. The oil and gas sectors led growth during 1997-2002 and now comprise one-third of GDP, but more recently the non-oil economy is also showing signs of recovery.

During 1999-2002, non-oil GDP grew more than 8 percent a year, led by construction, which in turn benefited from oil developments. The services sector has also benefited, while agriculture has been boosted by farm privatization and some reversal of the deterioration in irrigation. Recovery in manufacturing, however, remains elusive.

Table 2: Macroeconomic Trends, 1991-2002 (Average Annual Percentage Change)

Key Indicators	1991-1996	1997-2002
GDP	-12.8	9.1
Oil GDP	...	14.5
Non-oil GDP	...	8.3
Agriculture	-9.8	6.4
Manufacturing	-20.2	0.1
Services	-17.2	8.5
Inflation (CPI)	707	0.1
Consolidated Fiscal Deficit (% of GDP)	-5.7	-1.7

16. Azerbaijan has achieved a fairly solid track record of macroeconomic stabilization notwithstanding the oil boom and associated capital inflows. Fiscal and monetary policies, including notably the sterilizing of oil earnings through the new State Oil Fund (SOFAR), have stabilized inflation in the low single digits and avoided exchange rate appreciation. The real effective exchange rate by end-1999 was at the same level as in 1994 when the PSAs were signed, and has since depreciated by some 10 percent.

17. Restrained fiscal policies have been at the heart of the stabilization program. Even excluding the substantial Oil Fund savings deposited abroad, the fiscal deficit was no more than 2.8 percent of GDP by 2001. There has been some progress in raising non-oil revenues, but the brunt of fiscal restraint was borne by expenditure cuts, including social sector spending. While controlling public expenditures in the face of rising oil revenues will be even more critical for future financial stability and avoiding “Dutch disease”, better prioritizing of expenditures within the framework of the SPPRED is clearly an important issue to be addressed.

18. Azerbaijan’s current account deficits have tended to swing sharply due to volatility both in imports related to oil sector investments and oil prices. Specifically, the current account deficit declined from over 13 percent of GDP in 1999 to 3.6 percent in 2000 and 0.9 percent in 2001, before increasing to 12.6 percent in 2002. These deficits were financed by FDI inflows and official borrowing. Cumulative FDI inflows mainly to the energy sector, amounted to \$3.7 billion. Cautious expenditure and borrowing policies have meant that the present levels of external debt are relatively low and considered sustainable, as elaborated below in the discussion of creditworthiness.

19. Looking ahead, current account deficits will rise sharply as a consequence of higher imports for oil-related FDI, but this in turn will lead to large and growing oil

exports. Recent macro projections suggest double-digit oil sector growth rates after 2005, provided oil and gas potential is fully realized. This will depend on four major projects: full development of the Azeri-Chirag-Guneshli oil field; construction of the BTC oil pipeline; development of the Shah Deniz gas field; and a gas pipeline from Baku to Turkey. Implementation of these projects will take at least three years and require investments on the order of \$13 billion, or more than twice 2001 GDP, financed primarily by external sources. With careful macroeconomic management of the oil windfall and assuming a steady implementation of structural reforms, the non-oil sector is projected to grow at about 9.1 percent annually during 2003–05 and then to moderate to about 5 percent annually by the end of this decade, as oil-related FDI dries up.²

Table 3: Key Economic Indicators, 2001-10

Key Indicators	2001	2002	2003-05	2006-10
	(Annual percentage change)			
GDP at constant prices	9.9	10.6	9.5	10.2
Oil GDP at constant prices	7.9	3.9	11.8	25.7
Non-oil GDP at constant prices	10.4	12.3	9.1	5.1
	(Ratios to non-oil GDP, percent)			
Investment	40	61	74.3	50.6
Public sector ¹	5	9	8.0	7.7
Private sector	35	52	66.2	42.9
Oil sector	21	38	50.2	21.7
Non-oil sector	14	14	16.0	21.2
Consolidated government balance	1.3	-0.7	-0.7	17.9
Revenues	30.5	38.6	36.9	53.8
Expenditure	28.9	39.0	37.6	35.9
Current account	-1.2	-17.3	-37.9	31.8
Oil sector	27.6	13.0	-6.9	67.9
Non-oil sector	-28.9	-30.3	-31.0	-36.1
Total DOD	31.6	31.1	27.6	25.2
Memorandum Items				
Oil price US\$ per bbl	24.3	25.0	26.0	21.0
Exchange rate, av. AZM/1 US\$	4,657	4,834	4,893	4,893

¹ Public investment in 2002 and 2003 includes BTC loan of AZM 239 and 594 billion, respectively.

Source: World Bank staff estimates.

Risks and Creditworthiness

20. Azerbaijan's current level of external debt is relatively low at 20.7 percent of GDP and 47.6 percent of exports, and is projected to decline by 2010 to 15 percent of GDP and 24 percent of exports. The debt service ratio (excluding IMF) relative to exports of goods and services was under 4.4 percent in 2002 and is projected to decline throughout the projection period. The Oil Fund's assets are projected to grow from 11 percent of GDP in 2002 to 80 percent in 2010, improving dramatically the country's net asset position. Continuing the track record of cautious expenditure and borrowing

² See Azerbaijan Public Expenditure Review for more details about the non-oil GDP growth projection.

policies, together with long maturities and low interest rates on debt, would help to ensure external debt sustainability.

21. At the same time, the government will need to manage potential risks to creditworthiness which have plagued a number of other oil exporting countries. First, the importance of developing a strong national consensus on the country's long-term development goals and strategy, and of ensuring transparency in decision-making regarding the use of the oil wealth towards those ends, must not be underestimated if the risk of misusing the oil wealth is to be avoided. The SPPRED and SOFAR have critical roles to play in attenuating this risk. The former was developed in a participatory manner, provides a good beginning towards building a long-term political compact on how oil and gas related revenues are to be used not just this year, but for years to come. Maintaining the active participation of stakeholders in SPPRED monitoring and implementation will be critical to avoid distrust about who is benefiting from the oil wealth and a tendency to press for quick and non-sustainable populist solutions to poverty reduction and development of the non-oil sector. SOFAR's governance framework and proper budgeting according to the new Budget Systems Law also provide mechanisms to mitigate this risk.³

22. Second, the risk of increasing corruption will require constant vigilance. As mentioned earlier, Azerbaijan has made some important gains in recent years in terms of political, regulatory and legal reforms, and there are some independent indications of improvements in the business environment. However, these achievements are relatively new and there is still a major agenda to strengthen governance. This will include *inter alia* improving public sector efficiency and transparency, building capacities at the citizen and community level to be able to utilize information and hold the government accountable for achievements in this area, strengthening the still relatively weaker legislative and judicial branches of government, and ensuring orderly electoral processes at the national, parliamentary and local levels.

23. Finally, heavy dependency of the economy on oil and gas development poses risks to Azerbaijan's external position and non-oil sector development. A successful fiscal strategy would support sustainable development of the non-oil sector, with the medium-term public expenditure envelope following the trajectory of non-oil GDP, thus mitigating the negative impact on competitiveness and consequently, on non-oil sector development.⁴ Accumulating the excess oil revenues in the Oil Fund abroad will provide for fiscal sterilization, thus avoiding excessive real exchange rate appreciation. Provided

³ See Petersen, C., and N. Budina, "Governance Framework of Oil Funds: The Case of Azerbaijan and Kazakhstan," Workshop on Petroleum Revenue Management, Conference Proceedings, World Bank, 2002.

⁴ According to production sharing agreements, profits from oil and sales are divided among the Government (the Oil Fund), the foreign oil companies (for profit and capital repatriation), and SOCAR (the state-owned oil company). The amounts of profit and capital repatriation are determined by the terms and conditions of the Production Sharing Agreements (PSAs). Capital repatriation, as determined by the currently functioning PSAs, is calculated as 50 percent of the profit oil, whereas the rest of the profit oil is divided among the foreign investors, SOCAR (the state oil company), and the Government, as specified in the agreements.

that the trend of re-monetization continues, the inflation rate would remain low and under control, implying that the nominal exchange rate would be relatively constant in the base case projection.

24. Essential mechanisms have been put in place and will need to be strengthened to insulate the economy from temporary oil-price shocks. In the event of a positive price shock, as recently experienced, prudent fiscal policy involves saving the excess oil revenues to preserve economic competitiveness. The implications of a negative price shock would depend on its magnitude and expected duration. According to the sensitivity analysis of the PER, the oil price could drop to US\$15 per bbl without necessitating a major correction in the medium-term fiscal stance, and still have some, albeit less, accumulation in the Oil Fund. Cautious fiscal policy will also be needed to mitigate the impact of oil price changes on the external position. The impact of the oil price changes on the balance of payments is dampened by the fact that a significant amount of the oil revenues do not enter the country as the foreign oil companies repatriate.⁵ Thus, the only significant share of oil revenues accrues to the Government as fiscal revenues (Oil Fund inflows, and oil-related state budget revenues). By sterilizing the excess revenues in the Oil Fund, the Government is further dampening the impact on the BOP. In the event of negative oil price changes within a reasonable range, again, the BOP impact is likely to be dampened, as this would imply lower profit and capital repatriation of foreign oil companies, as well as lower Oil Fund accumulation. Nonetheless, an oil price drop to below US\$ 12 per bbl would put into question the commercial viability of the oil and gas pipeline projects, thereby risking a substantial cut in the FDI and a corresponding impact on the BOP. (For further discussions on risks, see para 83.)

III. THE GOVERNMENT'S PROGRAM : AZERBAIJAN'S POVERTY REDUCTION STRATEGY

25. Azerbaijan's PRSP on which this CAS is based, is known as the SPPRED⁶. The SPPRED was completed in October 2002 and is scheduled to be discussed by the Board at the same time as the CAS. The SPPRED builds on the interim strategy (I-PRSP) presented to the Boards of the IMF and IDA in June 2001, and represents an important milestone in Azerbaijan's ongoing efforts to elaborate a comprehensive, home grown strategy for poverty alleviation and economic growth. It marks the start of a comprehensive dialogue on the overall development strategy between the government and all key stakeholders. As described in Attachment IV, the SPPRED was prepared in a participatory manner with active involvement of civil society and all the main bilateral and multilateral agencies providing assistance to Azerbaijan.

26. The SPPRED identifies six key strategic aims: (i) the facilitation of an enabling environment for growth of income-generating opportunities; (ii) the maintenance of macroeconomic stability; (iii) the improvement in the quality of and equity in access to

⁵Except a much smaller share of profit oil that goes to SOCAR.

⁶ See Report No. 25593-AZ

basic health and education services; (iv) the improvement of infrastructure (including roads, delivery of utility services, communications, irrigation); (v) the reform of the current system of social protection to give more effective protection to the vulnerable; and (vi) the improvement of the living conditions and opportunities for the one million refugees and Internally Displaced Persons (IDPs) of the Nagorno-Karabakh conflict. Details on the policies, objectives and actions envisaged in the SPPRED and on those areas where the Bank Group plans to focus its support are provided in Annex B9.

27. Azerbaijan's SPPRED and a Joint Staff Assessment (JSA) are being distributed separately. As the JSA notes, the SPPRED presents a credible poverty reduction strategy and its broad policy priorities are appropriate and consistent with the multi-dimensional nature of poverty alleviation. The main areas where further progress will be needed during implementation and subsequent updates of the SPPRED include: (i) improved poverty analysis and data collection, particularly on labor market, education and health issues, in order to facilitate targeting and monitoring of progress towards the MDGs; and (ii) further refinement of costing and prioritization of actions consistent with annual budget envelopes, within the MTEF and PIP. A major, long-term effort at government institutional capacity building will be essential to strengthen performance in strategy formulation, implementation, monitoring and evaluation, and resource management. Finally, it will be important to ensure continued and full participation of all stakeholders in further policy development and implementation of the SPPRED.

IV. THE BANK GROUP'S STRATEGY

Bank Group Strategy

28. The Bank Group strategy for FY03-05 has been designed to support the SPPRED. It reflects experience with the ongoing portfolio and an assessment of the areas in which the Bank Group can have most impact, taking into account the activities of Azerbaijan's other external partners. The Bank Group strategy covers all six of the pillars of Azerbaijan's SPPRED, but it is organized into four strategic goals, reflecting in part, the important role played by the IFC's investments in the country's oil sector, which are a pre-condition for the poverty reduction strategy envisaged in the SPPRED. The four strategic goals are:

- **Manage the oil boom** to maintain macroeconomic stability, avoid "Dutch disease" and facilitate non-oil growth, employment and pro-poor expenditures.
- **Generate jobs and non-oil growth** by improving the business environment and access to financial services, building SME support infrastructure, and stimulating agriculture.
- **Improve access to services** by reversing the decline in social services and assistance and in infrastructure.

- **Help realize the oil potential** to the extent and in the time-frame that SPPRED presumes.

The issues in the different sectors and areas that need attention under each of the four strategic goals and the role to be played by the Bank Group are outlined below. Governance issues and capacity building are central elements of the Bank's program, which cut across all four CAS areas and are being pursued in especially close cooperation with other donors.

Strategic Goal # 1: Managing the Oil Boom

29. This strategic goal seeks to create a sound enabling environment for the SPPRED and to support specific components of its first two pillars, by helping to lay the foundations for improved management of Azerbaijan's expected oil and gas revenues. The ongoing SAC II and accompanying IBTA II technical assistance credit are principal instruments for support of this goal, concentrating on: (a) improved, more transparent and integrated public expenditure management, including of extra-budgetary funds into a consolidated budget; (b) initiation of a medium-term expenditure framework (MTEF) and a public investment program (PIP); (c) establishment and functioning of a supreme audit institution; (d) utility reforms, especially the reduction of implicit subsidies and improvement of financial viability in the energy sector; (e) improvements in the business environment; and (f) strengthening the fiduciary framework through adoption of action plans based on the FY02 CPAR and FY03 CFAA.

30. Continuation and deepening of the above reform program will be essential for success in managing the oil boom. Besides sound macroeconomic policies, and efficient and transparent budgeting and fiduciary arrangements, this will require measures to help address the nexus of governance issues and the business environment, the restructuring of the parastatal SOCAR (which occupies a vital place straddling the oil and non-oil economies); financial discipline of public enterprises; and trade, pension and labor market reforms. The IDA would support this agenda through one or two PRSCs (one if Azerbaijan remains in the base case and a second if it moves into to the high case), complemented by intensive AAA. The latter would include an FY04 Energy Sector Report on medium- and long-term sector development issues and use of oil revenues; FY05 PER and CEM updates, and technical advisory support on balanced regional development issues to ensure that the benefits of the oil boom reach beyond the confines of the Absheron peninsula. These are all areas where the Bank Group and IMF will collaborate closely in supplying policy advice and capacity building.

Strategic Goal # 2: Generating Jobs and Sustainable Non-oil Growth

31. This goal corresponds to the second pillar of the SPPRED and would assist the government and key stakeholders in promoting non-oil trade and investment, with a special focus on small and medium-scale farmers and entrepreneurs. The four broad policy components include: (a) improving the trade policy regime and market access by creating a more export-friendly tariff structure, accelerating Azerbaijan's accession to the

WTO, increasing access to regional markets and the European Union; improving access to finance; streamlining administrative procedures; (b) enhancing trade facilitation by streamlining and strengthening customs procedures and improving the quality and capacity of Azerbaijan's transportation infrastructure; (c) modernizing the overall business environment through, *inter alia* improving business registration and licensing; land acquisition and site development; labor market policies; taxation; access to credit; support for SMEs; contract enforcement and dispute settlement; and public sector governance; and (d) developing industry-specific strategies for improving inter-firm cooperation, promoting innovation and quality, encouraging specialization and strengthening supply chains.

32. **Private Sector Development.** In the context of the SPPRED, the Government has prepared a comprehensive SME Action program, which will be supported by IDA and the IFC, working in close cooperation. IDA will provide assistance through an FY04 Private Sector Development Project and Business Environment Survey, focusing on: (a) key issues in the business environment, including programs to significantly improve the effectiveness of the public/private sector interface and Government services; (b) competitiveness in domestic markets and non-oil exports, by building business-related infrastructure to improve SME access to market information and competitiveness related know-how; (c) developing programs to stimulate entrepreneurship and SME development; and (d) improving access to financial services and credit, especially for SMEs and in smaller urban and rural areas.

33. In this context, IFC's strategy emphasizes support for economic diversification of the non-oil sector (see Box 2). To this end, IFC will help catalyze FDI in non-oil sector export activities, help generate foreign exchange earnings and contribute to the modernization of the country's manufacturing base and basic infrastructure. IFC's strategy for the non-oil sectors involves: (a) promotion of competition in the banking sector, establishment of joint ventures in the non-bank financial sector, technical assistance to private local banks for institutional capacity building; (b) improving access to finance through credit lines to local private banks for on-lending to SMEs; (c) efforts to improve the business climate and reduce impediments to foreign investments; (d) support of agri-business and agro-processing; and (e) support for private provision of public services.

Box 2: IFC Program in Azerbaijan

IFC has been active in Azerbaijan since 1995 and to date has approved over US\$130 million in financing for projects for its own account.

In addition to IFC support for the oil sector, during FY03-05, the specific non-oil activities of IFC will be as follows:

- a) **Credit Lines to Local Private Banks:** IFC is currently processing two follow-on credit lines totaling US\$2.4 million to two local private banks.
- b) **Foreign Investors' Conference:** IFC will be organizing a foreign investor's conference in Baku from May 7-9, 2003. This proposed conference is a follow up to a diagnostic study on the environment for FDI led by FIAS. The conference would help focus on the need for greater non-oil investments in Azerbaijan and help catalyze foreign investors' interest through a cooperative effort with the Swiss Secretariat for Economic Affairs (SECO).
- c) **SME Linkage Program:** In connection with the BTC Pipeline investments, IFC is considering ways to have the local businesses (mainly SMEs) benefit from supply chain linkages to the large investment expenditures surrounding the BTC project. IFC will first undertake an SME map detailing the SME business environment and hurdles to growth at both the firm and institutional levels. The map will also identify potential follow-on initiatives via workshops and seminars with the business community. These SMEs may be funded through credit lines to the banks or a specialized SME fund, which could have participation from private investors involved in BTC. SMEs in several oil and gas sub-sectors will receive specific technical assistance to improve their productivity and quality assurance in a programme funded jointly by IFC, BP, Statoil, Unocal, the AIOC Enterprise Center and GTZ (German Development Corporation). In addition, some community development programs are also expected to ensure that a wider segment of the population is able to benefit from the BTC investments and training will be provided to local business development service providers which in turn will assist SMEs.
- d) **Private Enterprise Partnership (PEP) Program:** IFC, through the PEP program is expected to engage in helping on two main fronts: i) Corporate Governance Program for the banks and their clients; and ii) Leasing Sector Development project.
- e) **Baku Stock Exchange (BSE)/State Securities Committee (SSC) Institution Building Technical Assistance:** Capacity building program includes capital markets training to the staff of both institutions and market participants, simulation of IPO case, preparation of IPO guidebook, review of internal rules and regulations, and public awareness seminar.
- f) **Bank Privatization Advisory – United Universal Bank (BUS bank):** is planned to be privatized in 2004. IFC has been requested by Azerbaijan's Central Bank to assist with its privatization. The project development is planned for 2003.
- g) **Other General Manufacturing Opportunities:** IFC has been approached with possibilities for a few other manufacturing projects, to support the non-oil sector of the economy. However, in most cases, the local sponsor's investment needs are too small for direct IFC involvement.

Other areas of interest to IFC include support to transparent privatization of major industrial enterprises; agribusiness and agro-processing, utilities infrastructure, and telecommunications. Environmental upgrading is also a sector where IFC would consider playing a role, should the Bank Groups broader work in the area of preventing environmental degradation result in possible opportunities for private sector involvement.

34. **Financial Sector Development.** The SPPRED includes a comprehensive plan to strengthen the financial sector, which will be supported by IDA and the IFC. The banking system consists of the International Bank of Azerbaijan (IBA), which accounts for 60 to 70% of the market, followed by BUS Bank (established as a remnant of 3 liquidated state owned banks), which has a partial banking license and 10-15 percent of market share. The remaining 40 banks account for about 10% of the banking sector

balance sheet and market penetration. Access to financial services outside of Baku is largely non-existent. The financial sector priorities include: (i) significantly improved access to financial services and credit services for both entrepreneurs and small businesses, especially in rural areas; (ii) increased competition in banking markets; and (iii) further progress regarding safety and stability of the banking system and of non-banking financial markets; and increased integration with regional and international markets. Under the ongoing FY02 Financial Sector Technical Assistance Project (FSTA), the IDA is helping to develop a comprehensive infrastructure for the banking system. This includes a large value and small value/bulk-payment system, a credit risk reference bureau, a settlement and clearing system and building capacity of the postal system to provide access to basic financial services. This will allow banks to become active country-wide and to introduce new banking products at low cost. Under FSTA, the IDA will also assist with the work on privatization of the two major state owned banks and supporting introduction of IAS in the banking system. This work will benefit from a Financial Sector Assessment (FSAP) scheduled to begin in late FY03, at the authorities' request.

35. IFC may consider getting directly involved in the privatization transaction for BUS Bank. IFC has initiated a TA component to improve corporate governance of banks and stimulate the development of smaller private banks. IFC may introduce other training facilities for private banks. The Corporation already provides access to credit to larger private banks and will continue to do so. In addition IFC will consider an alternative SME financing mechanism through the establishment of an investment vehicle or a fund to invest risk capital in Azeri medium-size companies. IFC intends to find other private partners and donors for this initiative. This would introduce new products and new types of non-banking institutions to improve private sector access to finance. Box 2 describes IFC activities in areas other than the development of oil and gas potential.

36. **Trade Facilitation and Barriers to Trade.** In FY03, both a Trade Facilitation Strategy Report and Trade Diagnostic Study were prepared for Azerbaijan; these will be the subject of active dissemination and consensus building in FY04 and the IDA will continue to provide informal trade policy advisory support to the South Caucasus countries throughout the CAS period. Aside from impediments in the overall business environment, a variety of administrative barriers raise effective transport costs and penalize importers and exporters. Would-be exporters suffer from a shortage of information on regional and international markets and market access requirements and the lack of capacity to meet the demand of quality-conscious markets. Inadequate transport infrastructure is another major obstacle. The Ministry of Transport is new; regulatory and commercial functions are not yet properly separated; and there is no framework to develop an integrated transport policy and effective regulation for the sector.

37. Any strategy for generating jobs and economic growth needs a regional dimension, since political tensions have led Azerbaijan and its neighbors to forego many opportunities for trade and cooperation on infra-structure. The BTC pipeline is an example of the benefits that cooperation on energy infra-structure can bring to the

countries of the sub-region. Extending this cooperation on energy to Kazakhstan and other Caspian neighbors offers another potential area for economic growth. Azerbaijan could generate additional employment and economic benefits by serving as a transit corridor for trade to Central Asia. More efforts are needed to ease trade and transport barriers to regional trading partners, especially major potential markets such as Russia, Turkey and Iran. To support this regional outlook, IDA is engaged in non-lending initiatives in trade promotion and trade facilitation, in addition to multi-country initiatives to promote regional cooperation in telecommunications, tourism and environmental protection.

38. Agriculture, Irrigation and Rural Development. Agriculture contributes about 18% of GDP and provides income and employment for 40% of households. Almost all crop production comes from irrigated land. The SPPRED puts the development of agriculture in the context of an integrated rural development policy including linkages to non-farming activities such as agro-processing, industry, handicrafts, retail, distribution, transport, construction and other aspects of rural infrastructure, taking into account environmental concerns.

39. Azerbaijan has been amongst the leaders in the CIS in farm privatization and registration of arable land. The example provided by the IDA financed Farm Privatization Project (FPP) (FY97) spread quickly over most of the country in an excellent example of scaling up. Nonetheless land rights and responsibilities for pasture and forest land remain unclear. Rehabilitation of the large irrigation system, reliable delivery of water to farmers and sustainable land and water management remain major challenges. The FPP also includes a component for irrigation rehabilitation for new private farmers, while the FY00 Irrigation and Drainage Project is beginning rehabilitation of larger-scale systems infrastructure. A third ongoing project supports the first IDA-financed Adaptable Program Loan in Azerbaijan, through an FY99 Agricultural Development and Credit which focuses on research and extension, land registration and credit. Major challenges in the sector include development of sustainable irrigation and applied research and extension systems; evolution towards higher value added crops, livestock and agro-processing; improving rural infrastructure and social services; and sustainable delivery of affordable rural financial services. The proposed strategy builds upon and deepens the significant progress under IDA-supported projects in the sector. An FY03 Irrigation Systems Distribution Project will improve on-farm water delivery and sustainability of irrigation through rehabilitation, and support to water user associations so that farmers take responsibility for operation and maintenance. The second phase of the Agricultural Development and Credit APL will focus on rural finance, a unified cadastre system and further development of agricultural knowledge services and is scheduled to begin in FY06, just after the end of this CAS period. Finally, the FY05 Rural Community Infrastructure Project will support investments in value-added agriculture and agro-processing. Analytical work is planned to identify opportunities and constraints in agro-processing.

40. Environment. As noted in the JSA, the SPPRED emphasizes environmental sustainability. Likewise, the CAS program addresses issues of environmental

sustainability in the gamut of its activities. Paying special attention to the rural energy sector, the Bank has also supported specific interventions bearing on the environment. Azerbaijan has a varied topography and climate and is part of the globally significant Caucasus ecosystem, lying at a biogeographic crossroads. It is bounded on the east by the Caspian Sea, rich in fisheries resources as well as oil and gas. With limited rainfall over much of the country, and dependent on river flows from upstream countries, it is water stressed. Azerbaijan completed a National Environmental Action Plan (NEAP) in 1998 and a Biodiversity Strategy and Action Plan in 2000. In 2001, it established a Ministry of Environment.

41. The IDA is assisting capacity-building in the new Ministry of Environment and financing an FY98 Urgent Environment Investment Project which supports sturgeon recovery, cleanup of polluted industrial sites and onshore oil fields and the strengthening of environmental management capacity. It is also supporting an important environmental component in the FY01 Irrigation and Drainage Project. The regulatory framework for environmental management and assessment is in place but compliance needs strengthening. Increasing rural poverty has also placed pressure on natural resources. Through the GEF-financed Caspian Sea Environment Program, Azerbaijan is working with the other littoral states on improved management of fisheries resources, management of coastal zones, coastal and marine biodiversity and invasive species, and oil spill prevention.

42. Going forward, IDA's strategy comprises a free-standing operation and the following: (a) at the macro-level, to continue to support the energy reforms and improved governance that contribute to improved environmental management; (b) to strengthen the capacity of the Ministry; (c) to ensure adherence to adequate environmental standards for the energy pipelines; (d) to improve management of irrigation and drainage water and local water user associations; (e) with GEF support, to pilot participatory approaches to sustainable forest, pasture and protected area management and promote sub-regional cooperation in the globally significant ecosystems of the Caucasus mountains; and (f) to support sustainable delivery of basic heating and water supply services to households at affordable prices. The Government is also developing a comprehensive program on Conservation of Bio-diversity of the Caspian coastal zone. Feasibility studies have been initiated to identify issues which should be addressed in a future project on improvement of access by sturgeon to spawning grounds in the Kura River, establishment of a protected area in the Kura River Delta, and improvement of the livelihood of fishing communities of the Delta.

Strategic Goal #3: Improving Social Services and Infrastructure

43. This strategic goal pertains to the last four pillars of the SPPRED program. It tackles both the final outcomes (improved infrastructure; access to health, education and opportunities for IDPs) and the governance and institutional strengthening required to make them happen. Issues of implicit subsidies, financial condition, restructuring and privatization of utilities all have an important bearing on inadequate maintenance and investment in infrastructure. It is proposed to address these both through adjustment

lending and sector investment projects. The restructuring of SOCAR occupies pride of place. Such energy sector reforms also contribute to improved governance. An operation to rehabilitate the electricity transmission system and to improve fuel efficiency is planned. This would be the first IBRD financed project in Azerbaijan. The energy sector reforms under SAC II provide the pre-conditions of the success of this proposed project. The collapse of institutions responsible for local level delivery and O&M for infrastructure such as state farms requires, *inter alia*, the strengthening of community involvement and support for nascent local governments. This will be one of the objectives of the proposed FY05 Rural Community Infrastructure Project, complemented by AAA support on municipal development issues. In education, the issues are not so much of access as of poor quality. As such, teacher training, curriculum reform and improved teaching and learning materials will be central components of an FY03 Education APL to support a comprehensive ten-year education reform program. Finally, IDA has played a leading role in analytical work on pension reforms and this will be followed by an FY04 project to support pension reform. Analytical work on social safety nets and labor markets is also planned. Some specific issues and elements of the Bank's strategy in the many sectors involved in the provision of infrastructure and social services are discussed below.

44. **Energy.** The policy agenda in the SPPRED is based on the Government's detailed program for strengthening financial discipline in the energy sector supported by SAC II. IDA has had two investment operations in the sector – Petroleum TA (now closed) and Gas Rehabilitation (due to close in June). The main policy dialogue, however, has evolved through the ongoing SAC II and within the context of IFC's plans to finance ACG Phase 1 and BTC. Aside from the over-arching issue of oil revenue management, the energy sector is crucial for the other strategic goals of the CAS both as an input for non-oil growth and jobs and as a consumption item for poor households. The sector issues include implicit subsidies (estimated at 11% of GDP in 2001) resulting from a combination of non payments, tariffs which do not reflect full economic costs, tariff cross-subsidies and excessive operating losses. These are now being addressed with initial focus in the non-payments issue. Under SAC II, measures are being taken to improve the financial viability of these (and the water) utilities.

45. While notable progress is being made with energy sector reforms under SAC II, some additional important measures are under consideration by the Government, including a restructuring of SOCAR, further reduction of implicit subsidies beyond the SAC II program and concomitant social assistance reform, which would be supported through the proposed PRSC(s). There are significant environmental issues in the energy sector with its outdated technologies, malfunctioning equipment, limited pollution control mechanisms, inadequate waste management and poor quality raw materials. Moreover, environmental degradation has been growing as many households have attempted to cope with reduced gas supplies by switching to fuel, wood or oil. In contrast to the considerable emphasis on attracting investment to the upstream oil and gas sector, the Government's vigorous attention to the domestic energy sector is more recent and the actions, commitments and stated policies include: (a) the transfer of the power distribution business to the private sector; (b) actions to reduce energy sector non

payments; (c) proposals to increase tariffs (along with a safety net for the poor); (d) the stated intent to transfer Azerigaz and power generation into private hands; and (e) a commitment to restructure SOCAR.

46. **Transport.** The SPPRED actions involving the transport sector include: (i) restructuring and modernization of sector institutions, including the newly-established Ministry of Transport; (ii) rehabilitation of the East West Highway; (iii) improvement of rural roads, including their management and financing; and (iv) facilitating trade. IDA's on-going road project focuses on the rehabilitation of crucial sections of the East-west Highway. It also includes five small pilot subprojects for rural roads. A recent Bank study on trade and transport facilitation in the South Caucasus (TTFSC) highlighted both the current impediments and the future potential for economic growth and increased revenues. A strategy and action plan has been developed and a public-private committee to support trade and transport facilitation has been established.

47. **Water.** Eighty seven percent of the residents of Baku perceive piped water to be unsafe. On average, water is available in Greater Baku about 22 days per month for four hours per day. These water shortages tend to affect lower income households more adversely as they spend a higher proportion of income on coping strategies. The sector's technical problems are tied to the financial ones of the utilities. The Government has begun institutional reforms in the water supply and sanitation sector, including creation of an independent joint stock company for Greater Baku and decentralization of responsibility for municipal water and wastewater services to local governments. The reform strategy aims to eliminate implicit subsidies over five years and strengthen financial discipline. A major element in the Government's and IDA's strategy will be continuation of these reforms supported by SAC-II and IBTA-II.

48. **Education.** The SPPRED emphasizes the importance of improving the quality of education, and equity in access to it. It supports the long term education reform program, launched in 1999 with IDA's support. The ongoing Education Reform LIL has piloted some elements of a new school curriculum; the training of teachers in modern teaching and learning; and new equipment for selected institutions. Azerbaijan still maintains an extensive network of education institutions across the country, but the quality of physical infrastructure, teaching and learning environment has deteriorated sharply along with teachers' salaries and the availability of learning materials. At the upper secondary and higher education levels, there are sharp drops in student enrollments, particularly for the poor. To address these issues, and based on the lessons learned from the ongoing LIL, a comprehensive education reform project is currently being prepared. This new FY03 Education Project which is being presented to the Board together with the current CAS, will be the first phase of an APL. Analytical work is also planned on labor market and higher education issues.

49. **Health.** An ongoing FY01 LIL in the health sector (in partnership with UNICEF) aims at building capacity of the Ministry to carry out health care reforms and pilot them in selected districts. The deterioration in health care of recent years has been associated with a sharp fall in the real salaries of medical staff, reported rise in informal payments

and governance problems. While data are unreliable, there are indications that decreased access to health care, especially for the poor, has led to a worsening of some key health indicators. Simply increasing spending on health will not ensure improved outcomes because of the urgent need for a fundamental realignment of the approach toward the delivery of health services. The SPPRED recommends a move towards an outpatient-oriented approach with emphasis on primary health care. IDA's strategy in the future will depend partly on the results of the Health LIL, which will help to ascertain the Ministry's ability to reform health care by making it pro-poor and oriented to primary care. Meanwhile, the Bank is supporting the sector through informal AAA work aimed at disseminating knowledge on health issues and their management in other countries. If there is evidence of serious political commitment to improving governance and outcomes in the health sector, the Bank will explore additional ways to support the sector.

50. **Social Protection.** The SPPRED rightly envisages a comprehensive reform of the social safety net system, including better targeting of social protection expenditures, and reform of pensions. IDA has assisted in analytical work and legislation on pension reforms. This is to be followed up with a Pensions & Social Assistance Project which would assist the Government to clarify the respective roles for social insurance and social assistance, introduce measures to make the pension system sustainable and more equitable, and rationalize social programs focusing on providing more meaningful assistance to the most vulnerable groups. In addition to the planned project, IDA's strategy in social protection consists of: (a) working with the EU team to monitor the ongoing pilot project on means-testing; (b) reviewing with the government the possible mechanisms for targeting, and especially proxy means-testing work; (c) supervising the social protection and labor market components in the IBTA I and IBTA II projects; (d) assisting the work on designing a social safety net to protect the poor from the effects of energy sector and associated utility reforms; (e) continuing to work on the data from the household survey, including the analysis of the Year 2002 results, and supporting the continued strengthening of the State Statistical Agency; (f) monitoring the implementation of the relevant social protection actions in the SAC II; and (g) undertaking a labor market study.

Strategic Goal # 4: Realizing Oil and Gas Potential

51. Underlying the macroeconomic framework and the financing of the SPPRED is the assumption that increased oil and gas exports and revenues are realized as currently scheduled. Without these revenues, the prospects for poverty reduction in Azerbaijan would be far less promising. In this context, the fourth strategic goal provides the underpinnings for the other three, and the Bank Group plays a key role, both in facilitating and financing the oil and gas development, and in ensuring that the projects' social, environmental and macroeconomic impacts are appropriately monitored and mitigated.

52. The development and exploitation of the Shah Deniz gas field for export to Turkey is to be assisted by EBRD. IFC together with EBRD, is considering supporting the investments needed for the ACG Phase I and BTC pipeline project, which will be the

primary conduit for oil produced from ACG. IFC expects to provide up to \$250 million to finance both ACG phase I and BTC projects. The due diligence process for both projects is at an advanced stage and a significant amount of work has been done and will continue on the environmental and social aspects of the projects, including consultations with affected local communities and local and international NGO's. The project is expected to be considered by the Board in FY04.

53. In the meantime, the complex production schedule and financing plan of BTC as well as of the gas pipeline may require Azerbaijan to meet substantial cash calls, as happened once for BTC in the latter part of 2002. The Bank worked closely with the IMF to help the Government to find alternatives to meet the cash call without jeopardizing the principles of the Oil Fund. In the likely event of future cash calls, the Bank will again work closely with the IMF to provide advice to the Government on how best to meet them.

54. The IFC will fulfill several key roles through its proposed investment. IFC's role is to: (a) assist in mitigating political risk perceived by international investors in a cross-border project and help ensure stability of the Project's arrangement and operation; (b) provide long-term financing (both directly and by mobilizing commercial bank funding through its B loans) that is especially needed by the smaller borrowing companies; (c) provide a framework for the development and operation of the project in an environmentally and socially sustainable manner; (d) help ensure broader development impacts by IFC's SME and community development programs (currently being developed to complement the Sponsors's SME and community development programs); (e) assist in the transparent and effective management of the Oil Fund in Azerbaijan in coordination with the rest of the World Bank Group; and (f) act as a neutral third party in projects, which are based upon the PSA granted by Azerbaijan, and a number of Host Government Agreements (HGAs) and an Inter-Governmental Agreement (IGA) for oil transport involving cooperation between three Governments, several state companies, as well as a diverse group of the international oil companies.

Assistance Program and Triggers

55. **Strategic Choices.** Several key strategic choices underpin the CAS. *First*, is the question of how the Bank Group should support the management of the oil boom. The planned strategy aims to do so by a combination of policy-based lending and AAA, in close collaboration with the IMF. Azerbaijan is in a special turnaround situation, because it is undergoing heavy structural adjustment whilst beginning to realize a temporary resource boom. Policy-based lending in the form of one or more PRSCs remains an appropriate instrument because it brings different components in the government together around a time-bound, actionable reform strategy in support of the PRSP. The political economy impact would be substantial, even though the adjustment amounts are modest. The Government's desire for policy-based lending, also reflects the views of those leading the reform efforts that this would be very helpful in bolstering reforms. It also represents a desire to avoid easy and frequent recourse to the Oil Fund, by instilling

discipline and strengthening systems of public expenditure management and prioritization before the Oil Fund is resorted to simply as a growing source of finance.

56. *Second*, with the progress made on macroeconomic stabilization and structural reform in recent years, Azerbaijan's creditworthiness has improved. Further improvements in creditworthiness are expected if the triggers for the base and high case lending programs are met. The lending program proposed for this CAS period is therefore based on a blend of IDA and IBRD resources.

57. Third, is the question of how to exercise selectivity in the face of the extensive policy agenda in the PRSP/SPPRED. This involves choices on where the Bank Group can make maximum impact, and it necessarily involves difficult trade-offs. The Bank's dialogue and working relationship with the relevant agencies is an important factor in these decisions. This, for example, underlies the decision to support education and pension reform, but to defer more significant support for the health sector where experience under an ongoing LIL is more recent and limited, and not yet as encouraging.

58. Another consideration in exercising selectivity concerns what other donors are planning to do and ongoing activities. For example, given the support to be provided to main roads by the Asian and Islamic Development Banks, and the very recent IDA highway project for which implementation is just starting, further lending is not envisaged during the FY03-05 CAS period, although IDA would support rural community infrastructure. With regard to IDPs/refugees, IDA's assistance will be provided through accelerated implementation of the ongoing project and better targeting of social assistance and selective support under sector investment projects. If there is a breakthrough in the resolution of the Nagorno Karabakh conflict, the possible need for new lending would be revisited.

59. The FY03-05 time frame is expected to be one of rapidly changing circumstances in Azerbaijan during which the precise time-path, financing and impact of oil and gas sector developments should become clear. FY05 is likely to be a watershed year. Pipelines should be coming on line; oil revenues should begin to rise; a regional political settlement may be closer at hand. By FY06, there will be a need to reassess the Bank's assistance strategy and instruments, including the mix and balance of IBRD and IDA. These developments will make it desirable to prepare a new assistance strategy for FY06 and beyond. Broadly, the Bank would expect to continue supporting efforts to successfully manage the anticipated bigger oil boom; to improve governance and to diversify the economic base; as well as lend for the subsequent phases of the APLs in agriculture and education; and possible new projects in health, social protection and delivery of infrastructure services to less well-off households, and protection of biodiversity resources of the Caspian Coastal Region.

60. The FY03-05 Lending and AAA Program comprises eight IDA operations totaling \$123 million over FY03-05 and one IBRD operation of \$40 million in the Base Case. In a High Case scenario, IDA financing would increase to \$158 million for nine operations, including a second PRSC. A second IBRD operation for infrastructure is also

envisaged in the High Case. A Low Case scenario is unlikely, but should it materialize, there would be no IBRD lending and IDA allocation would drop to \$95 million. Recently completed ESW and other analytical and advisory activities that have been recently completed, as well as those planned in FY03-05, are shown in Annex (B4), whilst Table 5 below pertains to the subset of core diagnostic work.

Table 4: Proposed Lending Program
(US\$ million)

BASE CASE		HIGH CASE	
FY 03		FY03	
Baku Water Supply	12 IDA	Baku Water Supply	12 IDA
Education APL	18 IDA	Education APL	18 IDA
Irrigation 2	30 IDA	Irrigation 2	30 IDA
Subtotal:	60 IDA	Subtotal	60 IDA
FY 04		FY04	
PSD/SME	10 IDA	PSD/SME	15 IDA
Social Protection/Pensions	10 IDA	Social protection/Pensions	15 IDA
Energy Sector	40 IBRD	Energy Sector	40 IBRD
		PRSC1/IBTA3	20 IDA
Subtotal:	20 IDA/40 IBRD	Subtotal:	50 IDA/40 IBRD
FY 05		FY05	
Rural Investment	15 IDA	Rural Investment	20 IDA
Environment	8 IDA	Environment	8 IDA
PRSC 1+IBTA 3	20 IDA	PRSC II+IBTA 4	20 IDA
		Infrastructure Development	35 IBRD
Subtotal:	43 IDA	Subtotal:	48 IDA/35 IBRD
TOTAL: 123 IDA/40 IBRD		TOTAL: 158 IDA/75 IBRD	

Table 5: Status of Core Diagnostic Work

<i>Core Diagnostic Report</i>	<i>Last Completed</i>	<i>Next Scheduled</i>
Country Economic Memorandum (CEM)	FY00	FY05
Public Expenditure Review	FY03	FY05
Poverty Assessment	FY03	
Country Financial Accountability Assessment (CFAA)	FY03	
Country Procurement Assessment Report (CPAR)	FY02	

61. There is broad agreement between the Bank Group and the Government about the SPPRED and medium term development strategy, as well as the reforms needed to achieve the country's strategic goals. The questions concern mainly institutional capacity and pace at which the Government will be prepared to take on complex and politically demanding reforms, and the Base and High Case triggers have been designed to reflect these issues.

62. The Base Case triggers focus on (a) the macroeconomic framework, (b) governance and the business environment, (c) progress in implementation of the

SPPRED, and (d) the quality of portfolio implementation. With regard to macroeconomic performance, as indicated earlier, Azerbaijan has developed a strong track record of stabilization and prudent macro-management during the past several years, but the prospective oil boom poses a set of risks which need to be carefully avoided. In assessing the quality of macroeconomic management, the Bank Group will maintain a close dialogue with the IMF and will place particular importance on the proper integration of Oil Fund and any other extra-budgetary revenues into the country's consolidated fiscal expenditure envelope and to maintaining an overall fiscal stance geared towards sustainable development of the non-oil sector. The Bank would also expect to see inflation remain in the single digits (barring major unanticipated shocks) and to observe continued reduction of implicit subsidies to energy and water utilities in compliance with SAC II monitoring indicators. Other Base Case triggers are summarized in Box 3. Assuming satisfactory compliance with these triggers, a first PRSC in support of Azerbaijan's SPPRED could be presented to the Board in FY05.

63. If the Government is able to accelerate significantly the pace of structural reforms in the utilities sector and adopt a comprehensive trade and business development agenda in FY04, the Bank would envisage moving to a High Case lending scenario with a first PRSC in that year and a second in FY05, as well as some additional IBRD lending for infrastructure development in FY05. The most significant High Case trigger would involve the restructuring of the State Oil Company of Azerbaijan (SOCAR), which is by far the biggest and most important company in the country. SOCAR's headquarters, business unit offices and main operational facilities are dispersed throughout the country and until recently consisted of 171 business units grouped by type of operations in 16 departments, within a multi-layered organizational structure, with approximately 80,000 employees. SOCAR is at the center of the development of Azerbaijan's oil and gas reserves, with 21 Production Sharing Agreements involving more than 30 international oil and gas companies and stakes in the BTC oil and Shah-Deniz pipeline projects. With the present organizational structure it has been difficult to obtain the financial transparency required by modern international standards, or to assess SOCAR's proper tax liabilities. In late January 2003, the Government indicated that it may wish to work with the Bank on a program to privatize SOCAR's non-core assets, and implement an organizational and financial restructuring based on International Accounting Standards. The Bank and EBRD have agreed to provide technical assistance to prepare a restructuring plan; this is expected to start shortly and to take about nine months, after which full implementation would take another 12-24 months. The High Case trigger would be satisfied when a detailed design is adopted at the end of the preparatory phase, any legal preconditions for implementation are addressed, and the actual implementation phase begins.

64. Other High Case triggers would include reduction of implicit subsidies to electricity, gas and water beyond the 30 percent reduction target in the SAC II program, satisfactory progress in privatization of downstream gas and water distribution, and adoption of an integrated trade and business development agenda. SAC II is supporting the adoption of strategies and time-bound agendas for 2003-08 for wide-ranging utility restructuring, including separation of regulatory and operational functions, the drafting of

a modern regulatory framework, private sector participation in distribution, and improved tariff policies. Government receipt of bids for private participation in gas and water distribution would indicate important progress towards implementing the strategies and action agendas, and would thus be a trigger for the High Case. The third main trigger with regard to trade and business development would entail the adoption of a program along the lines proposed in the Bank's forthcoming FY03 Action Plan for Trade and Business Development, as a significant step towards achievement of the CAS second strategic goal of Generating Jobs and Sustainable Non-Oil Growth. This should incline concrete steps aimed at improving the trade policy regime, enhancing trade facilitation, modernizing the macro-business environment and improving competitiveness at the enterprise level.

Table 6: CAS Triggers FY03-05

Outcomes	Monitoring indicators
A. Base Case	
Satisfactory macroeconomic framework	<ul style="list-style-type: none"> Continuance of sound fiscal and monetary performance, including annual inflation in single digits and reduction in implicit subsidies to utilities in conformity with SAC II monitoring indicators.
Good governance and conducive business environment	<ul style="list-style-type: none"> Implementation of an improved Budget Systems Law (BSL) and Treasury systems reforms, as evidenced by 2004 budget being prepared and adopted in accordance with BSL. Adoption of action program based on the CPAR and CFAA, including timeframe for implementation. Chamber of Accounts becomes operational. Improving business environment as indicated by periodic business surveys. Satisfactory audits of SOFAR carried out by reputable international firms and published annually
Satisfactory progress on SPPRED implementation	<ul style="list-style-type: none"> Key SPPRED poverty and welfare indicators well defined and monitored with annual progress reports Annual MTEF and PIP aligned with SPPRED objectives with respect to public service delivery, especially health, education, essential infrastructure development and targeted assistance to the poor.
Satisfactory Portfolio Implementation	<ul style="list-style-type: none"> No more than 2 projects rated Unsatisfactory and maintenance of a satisfactory portfolio disbursement rate.
B. Low Case	
Failure to meet base case triggers, barring external shocks	Same as Base Case
C. Additional Triggers for the High case	
Accelerated progress in implementation of structural reforms, including governance	<ul style="list-style-type: none"> Begin implementation of agreed action program on financial and corporate restructuring of the State Oil Company of Azerbaijan (SOCAR) Program of reduction of implicit subsidies to utilities continues beyond SAC II. Strengthening of transparency through regular publication of quarterly financial and budget execution statements of SOFAR. Adoption of new integrated trade and business development agenda. Privatization program of downstream utility sector on track.
Progress in Social Protection	<ul style="list-style-type: none"> Real annual increase in pensions and social benefits no less than real increase in non-oil GDP.

V. IMPLEMENTING THE CAS

Lessons of The Last CAS

65. Many, but not all, of the development outcomes of the last CAS were achieved. The macroeconomic policy agenda and facilitation of private sector investment in the energy sector were highly successful. Public sector reform outcomes were more mixed. Of the four pillars of the public sector strategy, progress on internal and external audit systems has been substantial, although the tempo was slow, especially during the early years of the CAS. Achievements in public expenditure management have gone further than anticipated. On the other hand, there has been only limited progress in administrative and legal reform. It is fair to say that reform measures proposed in some of these areas were very ambitious, and their political reverberations were underrated by Bank teams, who viewed them in a more technical light.

66. It is noteworthy that the reform tempo picked up significantly during the second half of the CAS period, even though there was no significant shift in the makeup of the Government. This underlines the importance of being realistic about what can be achieved, and allowing time during project preparation and design to ensure broad consensus and understanding of the reforms at all levels of government, administration and civil society. An OED review of SAC 1, for instance, characterized its sustainability as “fragile” due to weak government ownership. This lesson has been incorporated in the design of the current CAS, where a broad country ownership on overall policy direction has been achieved through the SPPRED, and the pace of reforms, set by the government, will be the main determinant of the Base Case/High Case scenarios.

67. Both in the utility sector and the social sector, initial reform progress was slower than anticipated, but the pace of reform has picked up noticeably in the last two years. Here, another key constraint has been the shortage of institutional capacity, particularly in the areas of policy formulation, data collection and analysis. While some poverty reduction took place during the last CAS period, there was an inadequate data base to measure and analyze it. This critical weakness was addressed in part during the formulation of the PRSP/SPPRED, which was closely integrated with the preparation and dissemination of a full-scale poverty assessment on a collaborative basis. This will continue to be a major area of focus during the current CAS. (See also Box 3 on Lessons Learned from the Azerbaijan Client Survey.)

Box 3: Lessons Learned From The Azerbaijan Client Survey

The 2003 Client Survey in Azerbaijan points out a number of areas of strength for the Bank, as well as areas that require more attention and exploration. Overall, respondents gave a positive assessment of the Bank's effectiveness. Among different stakeholders, however, ratings varied, with **government officials and other donors the most favorable, and private sector respondents the least favorable**. NGO respondents were in the middle, and reported the lowest level of familiarity with Bank programs, among stakeholder groups. Respondents saw the Bank as **most effective** in helping to bring about economic growth; ensuring that attention is paid to the environment; helping to strengthen the financial system; and helping to reduce poverty. They saw the Bank as **less successful** in strengthening the judicial system; helping to strengthen the regulatory framework; increasing integration of information technology; and helping to strengthen the health sector. Respondents reported a **high level of satisfaction with their personal dealings with Bank staff**, giving the staff high marks for straightforwardness, consistency, accessibility and treating clients and stakeholders with respect. **But the Bank scored lower on flexibility**, both in terms of adjusting to changing project circumstances and in adjusting to changing country circumstances. Similarly, respondents reported a high level of satisfaction with the Bank's technical competence and ability to produce "useful" knowledge, but less with the Bank's ability to adapt its knowledge to Azerbaijan's needs. The survey revealed several points that need to be further explored by the Country Team. One area of concern is the fact that the Bank received higher marks for effectively monitoring and evaluating its projects and programs, than for safeguarding against corruption in projects. It is also noteworthy that the Bank was seen as an effective catalyst for discussion on issues related to poverty, but respondents were less convinced that the Bank's work reflects its own mission of poverty alleviation.

Outcomes, Monitoring and Institutional Capacity Building

68. Issues of institutional capacity and ensuring the sustainability of reforms will remain in the forefront during the CAS period. It is worth noting that IDA projects in Azerbaijan, while receiving generally satisfactory ratings from QAG and OED, have not scored as well on sustainability and institutional development as on other indicators. For this reason, the current CAS puts particular emphasis on ensuring sustainability through building capacity. Drawing on the lessons of the last CAS, the achievement of development outcomes will be monitored through a series of benchmarks that relate both to Azerbaijan's progress in meeting SPPRED objectives and to a core subset of monitoring indicators that depend more specifically on the input from Bank projects, supported by ESW. (Table 7) The country program matrix (Annex B9) provides a more detailed and comprehensive list of expected outputs.

69. Under the framework of the SPPRED, the Bank will work closely with the Government, civil society and other donors to support plans for monitoring and evaluation, based on sample surveys as well as statistical reporting systems. Ongoing work under the public expenditure management reform will contribute to improve the timeliness and quality of expenditure data. Other key areas of focus will include the health sector, where currently, data unreliability makes it impossible to adequately monitor Azerbaijan's progress in achieving the MDGs. IDA will also help in strengthening data collection and analysis on the economic status of displaced populations (both IDPs and refugees) and women, in order to make it possible to formulate targeted policies for poverty reduction.

Table 7: Core CAS Monitoring Benchmarks

SPPRED OBJECTIVE	CAS MONITORING INDICATOR	CAS INSTRUMENTS
STRATEGIC CAS GOAL: GENERATING JOBS AND SUSTAINABLE NON-OIL SECTOR GROWTH		
Facilitate an enabling environment for growth of an income generating activities.	<ul style="list-style-type: none"> Volume of credit to the private sector increased by 25%. Tenfold increase in access points to financial services outside Baku (from 40 to 400) SME sector employment rises by 10%. 	FSTA (FY02) <i>FSAP</i> PSD Project (FY04) PRSC (05) <i>Action Plan for Trade Diagnostic Study Agro-processing. & Marketing Study</i> IFC support for non-oil SMEs and the financial sector
STRATEGIC CAS GOAL: MANAGING THE OIL BOOM		
Maintenance of macro-economic stability.	<ul style="list-style-type: none"> Average annual inflation rate in single digits. All state extra budgetary resources integrated into state budget. Budgets after 2003 prepared, published, and executed according to new budget law. Internationally acceptable audits of State Oil Fund of Azerbaijan carried out and published annually. 	SAC II (FY02) PER Update IBTA II (FY02) <i>CEM Update</i> PRSC (FY05)
STRATEGIC CAS GOAL: IMPROVING SOCIAL SERVICES AND INFRASTRUCTURE		
Improvement in the quality of and equity in access to, basic health and education services.	<ul style="list-style-type: none"> General education enrollment ratio increased from 94% in 2001 to 98% in 2005, with 90% of children in grades 1-5 having free access to textbooks. Increase of 40% in the number of patients seen at reformed primary health care facilities. 	Education Sector Development APL (FY03) Health Sector LIL (FY02)
Improvement of infrastructure, (including roads, delivery of utility services, communications, irrigation.)	<ul style="list-style-type: none"> Decrease in energy supply disruptions resulting from collapse of critical infrastructure. Total subsidies in the energy and water sectors are reduced by 35% by 2005 as compared with 2002. Share of Baku population trusting safety of water supply increases from 13% to 50%. 	Energy Sector Project (FY04) SAC II PRSC <i>Energy Sector Study</i> Irrigation Distribution System Project (FY03) Baku Water Supply Supplement (FY03) <i>Municipal Infrastructure Survey</i>
Reform of the existing system of social protection to give more effective protection to the vulnerable.	<ul style="list-style-type: none"> Real annual increase in pensions and social benefits no less than real increase in non-oil GDP. Majority of existing pensioners have computerized individual records by end 2005. Implementation of well-targeted social safety net mechanism to compensate for cost-recovery of utility and other services. 	Pension & Social Assistance Project (FY04) <i>PER, PER Update</i>
Improvement of the living conditions and opportunities of the refugees and IDP population.	<ul style="list-style-type: none"> Increase in IDP per capita income to equal the national average by end 2005. 	Pilot Reconstruction Project/SFDI (FY99) <i>Poverty Assessment</i>

Portfolio and Fiduciary Issues

70. Assessments of the Azerbaijan portfolio by the Bank's Quality Assessment Group (QAG) and Operations Evaluation Department (OED) have mostly been satisfactory. Four projects were reviewed for Quality at Entry (Highways, SAC I, Pilot Reconstruction and Agriculture Credit and Development), two for Quality of Supervision (Petroleum TA and Urgent Environment) and one piece of ESW was reviewed (CPAR). All were rated satisfactory. Of the three completed or closed projects reviewed by OED, the Rehabilitation Credit was rated "Satisfactory"; Petroleum TA "Moderately Satisfactory" and SAC 1 "Moderately Unsatisfactory."

71. At the end of FY02, the IDA portfolio comprised 15 operations with net commitments of US\$368.3 million and an average age of 3.2 years, and all PSR summary ratings were satisfactory although some projects carry several risk flags, and the pace of disbursement is below the ECA regional average and needs to improve. The gap appears mainly related to slow start-up of new projects, with time required to build capacity of the newly established Project Implementation Units and effectiveness delays.

72. The Bank is taking several steps to strengthen portfolio implementation. First, a CPAR was carried out in late FY02 and a CFAA in FY03. Both have resulted in action plans which the government has broadly agreed to implement. Within the Bank, responsibility for Portfolio Management has been decentralized to the Country Manager, supported by the appointment in FY03 of an internationally recruited staff member in Baku to handle financial management issues and of a procurement specialist in the Georgia Country Office who will also cover a part of the Azerbaijan portfolio.

CAS Consultations

73. Consultations on the draft FY 2003-05 CAS were held with representatives of the Government and civil society in Azerbaijan from March 7-12, 2003. Meetings were held with the Prime Minister and Council of Ministers; Parliamentarians headed by the Deputy Speaker; the PRSP team; NGOs; representatives of private sector; and the donor community.

- **The Government** emphasized the importance of continued cooperation with the Bank Group in making further progress on structural reforms. While in full agreement with the CAS program, the Government would like to see the IDPs given support through confessional assistance programs.
- **Members of the Parliament** would like closer contacts with the Bank, and suggested that rural development be given high priority. Several members of Parliament and of the Government expressed their concern that Azerbaijan's IDA allocation continues to be low when compared on a per capita basis with other countries from the Caucasus.

- **The private sector representatives** found the CAS emphasis on non-oil growth very welcome and would like to see state intervention in the private sector reduced both in the area of regulation and control of state enterprises. They would also like to see greater support to financial sector development, and expressed their concerns about: inadequate dialogue with the Government; lack of information on rules and regulations; the heavy weight of an unaccounted shadow economy; and a slow justice system.
- **The national and international NGOs** and other representatives of the civil society emphasized the importance of focusing on anti-corruption; improved monitoring in implementation of Bank financed projects to ensure their effectiveness; and regional development with a particular focus on decentralization as a way to reduce the imbalances.
- **Donors** expressed their confidence and support for the overall program. However, there was a lively debate with some donors expressing concerns on the exclusion of new lending for health, an SPPRED priority, while some others supported that decision.
- **The SPPRED team** questioned whether the SPPRED goals would be achieved under the base case scenario. The team expressed hopes that the CAS program could be revisited based on swift implementation of the SPPRED.

Partners

74. The process of PRSP/SPPRED formulation in Azerbaijan has facilitated closer cooperation and coordination of efforts within the government, among donors and with the NGO community and the private sector. The CAS foresees building upon this collaboration with other partners. UNDP has taken the lead in the overall coordination of the PRSP process from the donor side, and along with GTZ has helped fund the PRSP Secretariat, established in the Ministry of Economic Development. ADB has provided assistance to the Secretariat and five of the sector working groups, as well as funding for a workshop. EU and USAID supported the participation of civil society through surveys, participatory appraisals at the village level, and town hall meetings. Continued close cooperation will be essential during the CAS period, since major donors are all working to align their assistance programs with the priorities expressed in Azerbaijan's SPPRED.

75. **IMF** and the Bank have worked closely together in supporting Azerbaijan's reform program, in line with their respective mandates, particularly with respect to the management of public finances, including the Oil Fund, utility and energy reforms, the financial sector, and the cross-cutting issue of governance. This close collaboration will continue in future efforts to support Azerbaijan's reforms and transition. (See Attachment 1 for details.)

76. **UNDP** is committed to helping convert 'black gold into human gold' by supporting the implementation of the SPPRED with a special emphasis on its priority of

promoting employment in the non-oil sector. UNDP has also initiated the MDG reporting process by strengthening the Government's new Poverty Monitoring Unit in the SPPRED Secretariat. Other major initiatives in Ump's principal thematic areas include public administration reform through support to e-governance and the National ICT Strategy, promotion of human rights by building the capacity of the new Office of the Ombudsman and environmental protection in the region through the Caspian Environment Program.

77. **UNICEF** is also a very active and close partner in the social sectors. The health project, in particular, is very much a joint activity of the Bank and UNICEF, which is intimately involved in its implementation. UNICEF has also worked with the Bank in the context of the Poverty Assessment and currently has a staff member seconded to the Bank's Country Office.

78. The **EBRD** is another close partner and a major donor in Azerbaijan. The EBRD's focus has been on improving the country's infrastructure through investments in the power and transport sectors, and energy sector reform. This has included assistance in developing Azerbaijan's oil potential including through proposed participation in the financing of both the oil and gas pipelines. In the case of the BTC oil pipeline, the EBRD and IFC are working closely together. The EBRD has also been involved in bank privatization and in the context of PSD, in promotion of SMEs, and improvements in the business climate. The Bank Group has worked closely with the EBRD on these issues, as well as on governance arrangements for the Oil Fund, where the EBRD, IMF and Bank have all provided complementary TA.

79. The **EU** is committed to supporting the SPPRED in areas matching its country priorities, including support for regional integration and cooperation (through the TRACECA program), food security and sustainable rural development, and public sector capacity building. The indicative budget for TACIS/EU assistance for 2004-2006 is 30 million Euros. Specific areas of focus include institutional support for the new Ministries of Environment and Economic Development, and Customs, and development of vocational training and higher education reform.

80. **The Asian Development Bank (ADB)** is a comparatively new partner for Azerbaijan and has not yet begun lending operations. However, the ADB has been active in assisting the SPPRED process and in providing TA and preparing projects. Areas of focus for the ADB will be IDPs, rural development, water supply, sanitation and roads. The Islamic Development Bank (**IDB**) is finalizing the formulation of its three year program for 2003-2005. So far it has provided concessional lending for public infrastructure (irrigation, roads, power generation) and grants to support refugees and IDPs. **The Black Sea Trade and Development Bank (BSTDB)** aims at development of the non-oil sector. So far it has provided trade finance to IBA and invested equity in the new Microfinance Bank of Azerbaijan.

81. **Japan** is a major bilateral donor whose assistance to Azerbaijan totals \$US 500 million in concessional loans extended mainly to the energy sector and in grants to various sectors including food security, health rehabilitation, sports and culture, and in

technical assistance including studies/education programs. More recently, **USAID** has been able to widen its assistance as the result of the waiver of section 907 of the foreign assistance act which had prevented lending to the government in the absence of a peace deal with Armenia. In close coordination with the Bank, the US is currently providing assistance to the Ministry of Finance on further development of the Treasury system and on the Budget Systems Law implementation, as foreseen in SAC II, and to the Ministry of Tax on tax policy. The US is also providing TA for the oil and petrochemical sectors and on WTO accession. USAID's current strategic plan focuses on development of private enterprise, support for democratic processes and humanitarian assistance.

82. In the area of democracy and governance, USAID is helping to strengthen the electoral system, develop independent media, and establish the rule of law. The **UK** is also providing assistance in these areas. So are the **OSCE** and the **Council of Europe**, which is particularly active in the area of judicial reforms as is **Germany** (GTZ and KFW). GTZ's bilateral cooperation program for the years 2002-2004 focuses on development of the private sector through business training, facilitation of investments and business matching, legal advice to entrepreneurs and journalists, logistical support to the PRSP process, and economic rehabilitation of some state owned enterprises. In February-March 2003, GTZ will initiate a project to deal, on a pilot basis, with the issues of mitigating the social impact of enterprise restructuring. **Switzerland** has been especially active in supporting the preparation of SPPRED through grant financed activities that include the forthcoming Investor's Conference that the IFC is also involved in assisting. **France** is providing support for social assistance and services and **Italy** has done so for SPPRED work on the environment.

Risks

83. There are four category of risks to the strategy outlined above:

- **Risks in the external environment** include the sharpening of regional instability, resulting from conflicts in neighboring countries (including Iraq). For Azerbaijan, the most important source of regional instability is the unsolved conflict over Nagorno-Karabakh. Resumption of hostilities would have major economic and human costs, while a peaceful resolution would improve the likely payoff from the CAS/SPPRED strategy significantly. The international community is active in trying to resolve the dispute through the OSCE's Minsk Group. IDA has indicated its willingness to assist a peace deal with help for reconstruction and more intensive support for refugees/IDPs. In that event, a CAS update will be prepared.
- **Internal political risks** include the possibility that a political transition in Azerbaijan leads to instability and/or significant shifts in policy. To mitigate against this risk it is important to continue and expand the consultative elements established during SPPRED preparation, to ensure broad-based civic and political ownership of the development strategy.

- **An economic risk** to the CAS strategy would be a decision not to go forward with ACG I, BTC pipeline and/or the Shah Deniz gas development due to unexpected problems, such as a significant drop in energy prices, or difficulties in securing financing. This would have a major impact and a serious delay would necessitate a recasting of the SPPRED strategy. The volatility of energy prices represents another risk. These risks are partially mitigated by the Government's adoption of a prudent fiscal stance, and its strategy of expanding the non-oil sector. The first of these risks is also mitigated by proposed IFC involvement in the financing package for BTC. A third risk is a slowing down or reversal of economic reforms that results in mismanagement of the oil boom and serious "Dutch disease". This is mitigated by the proposed policy-based lending as well as the more broad-based civic and political ownership of the reform process that also serves to mitigate the political risk noted above.

- **Implementation and governance capacity** is another set of risks. Hence, major attention is paid to governance and capacity building issues as a cross-cutting theme throughout the proposed strategy, notably in the ongoing SAC II and the proposed PRSC. Areas of emphasis for capacity building will include transparency in the management of public expenditures and other governance issues as captured by BEEPS. Risk mitigation at the project level will be strengthened by measures pertaining to portfolio implementation, including the action plans stemming from the CFAA, CPAR and CPPR and decentralization of important financial management and procurement functions. The technical assistance being provided by the Bank, especially under IBTA II, and by other external partners will also help to overcome implementation constraints.

VI. CONCLUDING REMARKS

84. Although still a low-income country, Azerbaijan has strong potential to grow rapidly in the years ahead because of the oil and gas resources which it is currently developing. These resources are considerable, but finite, peaking in about a decade and then declining steadily. The most difficult challenge Azerbaijan faces, which is well understood by the Government, is to avoid the path followed by many natural resource rich countries, wherein their citizens derive little benefit from the influx of oil revenues. This will require designing and implementing a policy agenda that leads to poverty reduction and improves incomes as well as equity for current and future generations, while maintaining macroeconomic and financial stability. Strong institutions are essential to tackle this challenge, yet Azerbaijan has had little more than a decade in which to build the government institutions and the civil society networks to support them. For this reason, the Bank Group's assistance is essential in providing cross-country experience, helping to build the institutional capacity and sustain the policy reforms

necessary for Azerbaijan to succeed. A great deal of work was accomplished in the previous CAS period in terms of building up the public expenditure framework, including establishment of the State Oil Fund. Still, much remains to be done to strengthen these institutions and their oversight, and encourage development of the non-oil sector. The CAS period represents a window of opportunity for vigorous engagement with Azerbaijan, to prepare for the influx of oil revenues, which is expected to begin in 2005. For Azerbaijan to achieve the ambitious goals of poverty reduction envisaged under the SPPRED, it is essential that this opportunity not be lost, particularly since under current scenarios the anticipated oil boom will be short-lived.

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Washington D.C.
May 27, 2003

Attachment I - Azerbaijan: IMF-World Bank Relations

Partnership in Azerbaijan's Development Strategy

The Government's poverty reduction strategy, embodied in its first full State Program for Poverty Reduction and Economic Growth (SPPRED) is expected to be endorsed by the IDA and IMF Boards in May 2003. The strategy comprises six key strategic aims identified as follows: (i) the facilitation of an enabling environment; (ii) the maintenance of macroeconomic stability; (iii) the improvement in the quality of and equity in access to basic health and education services; (iv) the improvement of infrastructure (including roads, delivery of utility services, communications, irrigation); (v) the reform of the current system of social protection to give a more targeted, but effective protection to the vulnerable; and (vi) the improvement of the living conditions and opportunities for the one million refugees and Internally Displaced People (IDP) of the Nagorno-Karabakh conflict. While the PRSP's overall direction is considered appropriate, weaknesses were identified related to costing, prioritizing, and sequencing measures as well as their monitoring and evaluation.

Macroeconomic management aims at maintaining a stable economic environment through appropriate fiscal, monetary, exchange rate, and sustainable debt policies. In support of these policies, the authorities are tightening payment discipline, especially in the energy sector, hardening budget constraints for state-owned enterprises, and pursuing enterprise and banking privatization and restructuring. Consistent macroeconomic management of recent years has supported the economic recovery since 1995. Nonetheless, maintaining strong growth will depend importantly on accelerating structural reforms to enhance private sector development and to encourage foreign and domestic investment, particularly in the non-oil sectors of the economy.

The IMF has taken the lead in assisting Azerbaijan in enhancing macroeconomic stability and related structural reform measures. In this regard, the Fund has encouraged the authorities to continue with fiscal consolidation and to maintain a prudent monetary policy stance. The Government has also been encouraged to enhance governance and strengthen financial discipline in the energy sector, and to improve the legal and regulatory environment for private sector development. The Fund has supported Azerbaijan's economic reform program since 1995. The authorities were successful in achieving macroeconomic stabilization under the economic reform program supported by the early IDA and IMF structural adjustment arrangements, which formed the foundation for an ongoing Fund-supported program under the Poverty Reduction and Growth Facility (PRGF), approved by the Executive Board in July 2001, with the first review endorsed by the Board on February 20th, 2002 and the second review scheduled for May 14 2003.

The World Bank has taken the lead in the policy dialogue on structural reforms, including poverty reduction measures, public expenditures, agricultural policies, private sector development, institution building and governance. A range of instruments is used to conduct the dialogue. SAC II is supporting a wide-ranging structural reform agenda and its accompanying institution building and technical assistance credit (IBTA II) is assisting institutional capacity building, especially of government budget preparation and execution, privatization and utility reforms. This broad-based policy reform approach is combined with sector investments in agriculture, roads, water, refugees/IDPs, environment, education, health and domestic gas. Recent analytical and advisory assistance has included a poverty assessment, a PER, a CPAR (procurement assessment), a CFAA (financial accountability), pension reforms paper and ongoing exercises on trade facilitation and mitigation of the social costs of utility price increases.

The next section describes the Bank program and the division of responsibility between the two institutions. In a number of areas – social sectors and safety nets, environment, governance, infrastructure, and agriculture – the Bank takes the lead in the dialogue and there is no cross conditionality with the IMF-supported program. The Bank is also leading the dialogue in private sector development and public enterprise reform and Bank analysis serves as an input into the Fund program. In other areas – energy, financial sector, public expenditure management, public sector, trade and investment policy – both institutions work together and share cross conditionality. Finally, in areas like monetary policy, tax policy and customs, the IMF takes the lead with limited Bank involvement. (see Table 1).

Table 1. Bank-Fund Collaboration on Azerbaijan

<i>Area</i>	<i>Specialized Advice from Fund</i>	<i>Specialized Advice from Bank</i>	<i>Key Instruments</i>
Macroeconomic Framework/Management	Monetary policy, exchange rate, fiscal and trade policies, economic statistics	Medium- to long-term public expenditure management of oil windfall, trade reform.	<i>IMF:</i> PRGF performance criteria and benchmarks on monetary and fiscal targets. <i>Bank:</i> SAC II and IBTA II support of reforms in budget preparation and execution, PER, integrated trade development framework.

<p>Budget</p>	<p>Consolidated medium-term budget framework, including the Oil Fund's operations, budget systems law, treasury modernization, tax policy and administration, customs, debt management, extra budgetary funds</p>	<p>Budget systems law, consolidated medium-term budget framework, integration of the Oil Fund's governance framework, PIP capacity building.</p>	<p><i>IMF:</i> PRGF performance criteria on overall consolidated fiscal deficit, excluding Oil Fund revenues and overall consolidated non-oil deficit including quasi-fiscal activities; performance criteria related to rules and legislation related to ensuring coherent fiscal policy.</p> <p><i>Bank:</i> SAC II conditionality on governance of the Oil Fund, budget systems law, MTEF and PIP, and IBTA-II supported activities for capacity building.</p>
<p>Public Sector Reform</p>	<p>Support to State Customs Committee, Ministry of Taxes, Ministry of Finance</p>	<p>Support to Ministry of Environment, Ministry of Economic Development and consolidation of Agencies and Departments, State Procurement Agency, Chamber of Accounts</p>	<p><i>IMF:</i> PRGF performance criteria and benchmarks related to ongoing administrative reforms in customs, taxes and finance.</p> <p><i>Bank:</i> technical assistance supported by IBTA-II.</p>
<p>Energy Sector Reform</p>	<p>Strengthening financial discipline in energy sector by unification of domestic and international prices for natural gas and oil products, allocation of subsidies to Azerenergy and Azerigas, and offsetting tax credits to SOCAR, full payment by budgetary organizations for their utility consumption</p>	<p>Strengthening financial discipline in energy sector by elimination of implicit subsidies and improved collections and tariff policies, privatization of distribution companies, introduction of regulatory framework and agency, and specialized advice on oil and gas sector development.</p>	<p><i>IMF:</i> PRGF performance criteria and benchmarks related to domestic energy prices, as well as the incorporation of previously quasi-fiscal subsidies into the state budget</p> <p><i>Bank:</i> SAC II conditionality on utility reforms, especially aimed at improving financial viability. PPIAF/ESMAP TA on sector restructuring and regulations. IBTA-I and -II supported assistance for privatization and in analyzing the environmental and social</p>

			impact of such reforms and designing measures to protect the poor.
Financial Sector Reform	Strengthening the competitiveness and health of the banking system, privatization of state-owned banks, revision and introduction of a new legal framework for the banking sector (banking law, bankruptcy law, central bank law), development of manat financial markets, including the market for T-bills, safeguards assessment of a financial sector, FSAP	Restructuring and privatization of large State banks, strengthening of ANB's supervisory capacity, introduction of electronic payment systems, credit rating agencies and registries, SME credit.	<i>IMF</i> : PRGF performance criteria and benchmarks on bank privatization, banking system law and central bank law. <i>Bank</i> : SAC II conditions on the financial sector and the financial sector TA credit.
Social/Poverty		Public expenditure reforms, strengthening of monitoring and evaluation systems, reform strategies for education, health, social assistance and protection as well as pension reform and direct assistance to IDPs.	<i>Bank</i> : Conditionality in SAC II. Poverty Assessment and TA for Household and other surveys, assistance with design of pension reforms and better targeting of social expenditures. Project to assist IDPs and refugees. Education and Health LILs aimed at improving service delivery to the poor.
Private Sector Development	Trade and investment policy	Integrated framework for trade and business development, improving and monitoring of the business and investment environment, streamlining procedures for entry and exit, enhancing high-level public/private sector dialogue, trade and transport facilitation, SME support, and	<i>IMF</i> : PRGF <i>Bank</i> : enhanced public-private partnership supported via SAC II and IBTA II; analytical assistance on the nexus of business environment and governance in cooperation with FIAS; integrated trade and business development framework report. trade and transport facilitation report; SAC II and IBTA II supported TA on privatization and labor redeployment.

		privatization of SOEs.	redeployment.
Other sectors		Strengthening rural and agricultural infrastructure, transport policy and infrastructure, environmental clean-up and preservation.	<i>Bank:</i> investment projects in environment, agriculture and highways.

IMF-World Bank Collaboration in Specific Areas

Areas in which the World Bank leads and there is no direct IMF involvement

These areas are the social sectors, agriculture, infrastructure and environment. In the social sphere, the Bank has been involved in both improving the data and analyzing poverty as well as in helping design pension reforms, and measures to mitigate the social impact of utility reforms aimed at raising collections and tariffs. In education a LIL is to be followed by an APL to improve quality. There is also an ongoing LIL in the health sector (in partnership with UNICEF) which aims at building capacity of the Ministry to carry out health care reforms and pilot them in selected districts.

In infrastructure, Bank lending to date has comprised projects for Gas Rehabilitation, water supply and highways. An environment project is being followed by assistance to build the capacity of the new Ministry of Environment and mainstreaming environmental concerns across-the board, especially in the energy sector. In Agriculture the Bank has provided credits for farm privatization, irrigation rehabilitation and credit, extension and other agricultural services.

Areas in which the World Bank leads and its analysis serves as input into the IMF program

The Bank leads the dialogue on structural reforms through the SAC II, approved by the Bank's Board in FY02. Bank leads in the areas of:

Privatization and Private Sector Development. The Bank is taking the lead in the formulation of an integrated strategy and action plan for trade and private sector development.⁷ An important element of the strategy is in providing a framework to better integrate the efforts of key stakeholders—i.e., the Government, multilateral and bilateral donors, the private sector, and others—in promoting non-oil trade and investment. The four broad policy components include: (i) Improving the Trade Policy Regime and Market Access - creating a more export-friendly tariff structure, accelerating Azerbaijan's accession to the WTO, increasing access to regional

⁷ See: *Azerbaijan: Building Competitiveness for Increased Non-Oil Trade and Investment—An Integrated Strategy and Action Plan*, World Bank, forthcoming.

markets and the European Union; improving access to finance; streamlining administrative procedures; (ii) Enhancing Trade Facilitation - streamlining and strengthening customs procedures and improving the quality and capacity of Azerbaijan's transportation infrastructure; (iii) Improving the Macro Business Environment - the macro business environment cover a wide range of issues impacting on private sector development, including improving business registration and licensing; land acquisition and site development; labor market policies; taxation; access to credit; support for SMEs; contract enforcement and dispute settlement; and public sector governance; and (iv) Developing Competitive Industry Clusters - industry-specific strategies for improving inter-firm cooperation, promoting innovation and quality, encouraging specialization and strengthening supply chains.

The Foreign Investment Advisory Service (FIAS) has recently conducted a diagnostic study of the investment environment to determine the most important impediments to private sector investments, and this was followed up by the CIS Business Environment Enterprise Performance Survey 2002 (BEEPS) conducted by the Bank and EBRD together.

IFC's strategy emphasizes support to the non-oil sector to help economic diversification (see box). To this end, IFC will help catalyze FDI in non-oil sector projects which focus on exports, help generate foreign exchange earnings and contribute to the modernization of the country's manufacturing base and basic infrastructure. IFC's strategy for the non-oil sectors involves: (i) promotion of competition in the banking sector, establishment of joint ventures in the non-bank financial sector, technical assistance to private local banks for institutional capacity building; (ii) improving access to finance through credit lines to local private banks for on-lending to SMEs; (iii) efforts to improve the business climate and reduce impediments to foreign investments; (iv) support of agri-business and agro-processing; and (v) support for private provision of public services.

As for **privatization**, the Bank provides support for hiring of financial technical and legal advisors, advises on the transaction processes, and ensures that proper social and environmental mitigation is taken into account. The Bank is also supporting the development of a strategy for further industrial privatization as well as for labor redeployment. Together with the EBRD, the Bank is also involved in the **financial and corporate restructuring of SOCAR**.

Regulatory Reforms, including approval of draft regulations for electricity, gas, and water sectors, separation of regulatory and commercial functions in utilities, transport and communications sectors, establishing an independent regulator agency assigned with regulatory functions. In particular, all regulatory functions currently exercised by Azal, Azeri Rail and Caspian Shipping Company will be transferred to the Ministry of Transport, the commercial and regulatory functions of the Ministry of Communications will be separated, and remaining regulatory functions of SOCAR will be transferred to the appropriate government institution.

While the Bank has taken the lead in privatization and in structural reforms in the private sector as described above, the IMF has also a strong interest in these areas since many of these reforms are critical to achieving macroeconomic stabilization and enhancing growth prospects. Accordingly, there is a high degree of consultation and coordination between the two institutions on these matters.

Areas of shared responsibility

The Bank and the Fund are working jointly in the following three main areas, supported by the Bank's SAC 2, several investment and technical assistance operations and the Fund's PRGF:

Public Expenditure Management. This area includes public expenditure management reforms aimed at introduction of a medium-term expenditure framework and public investment program, consolidation of all extrabudgetary resources including the Oil Fund with the state budget, modernization of the Treasury, strengthening the Chamber of Accounts and supporting tax and customs administration. Both institutions are involved in supporting treasury modernization, while the Fund is providing technical assistance in support of tax and customs operations. The Fund and the Bank work very closely together on the formulation and implementation of the Budget Systems Law and recent amendments to the Law were submitted to Parliament as a prior action for the PRGF and second tranche release of SAC II. The governance framework for the Oil Fund is another area, in which there is very close cooperation, as well as the elimination of all quasi-fiscal subsidies.

Financial sector reforms. This area includes strengthening the competitiveness and health of the banking system, privatization of state-owned banks, revision and introduction of a new legal framework for the banking sector (banking law, bankruptcy law, central bank law), development of manat financial markets, including the market for T-bills and implementing IMF's safeguards assessment's recommendations. Both institutions are planning to conduct a joint FSAP during 2003. In terms of banking supervision, the IMF is monitoring the closure and merger of banks that do not satisfy prudential requirements.

Utilities Reform, including measures to reduce implicit subsidies in the electricity, gas, and water sectors, to ensure full payment by budgetary institutions their utility bills, to improve overall utility collections, revision of electricity and gas tariffs to cover the true costs of providing these services. The Fund takes the lead in seeking to ensure that budget organizations and state-owned enterprises pay their utility bills in full, while the Bank is taking the lead in utility and state-owned enterprise reform, tariff revision and collections from households, regulatory reform and privatization.

Areas in which the IMF leads and its analysis serves as input into the World Bank program

The Fund leads the dialogue on fiscal matters, setting the overall ceiling on the consolidated budget. In addition to the achievement of overall fiscal targets the Fund-supported PRGF includes performance criteria and structural benchmarks requiring: (i) adoption of improved regulations, in consultation with Fund staff, on the issuance of VAT refunds; (ii) establishment of a revenue forecasting commission, and (iii) adoption of the new Banking System Law.

In the budgetary area the Fund is taking the lead on reforms of budgetary revenues and expenditures to (i) complete the process of subjecting all taxpayers to the tax legislation; (ii) improve procedures for revenue forecasting; (iii) improve tax and customs administration; (iv) eliminate the earmarking of revenues for some extra-budgetary operations of budget organizations. In these areas, as well as monetary policy, the Bank takes into account the policy recommendations of the IMF and ensures that its own policy advice is consistent.

The Bank plays a central role in advising on development of a Medium Term Expenditure Framework and Public Investment Program.

Attachment II - MIGA and FIAS in Azerbaijan

MIGA has facilitated estimated foreign direct investment of US\$59.5 million into Azerbaijan to date. MIGA's outstanding portfolio in Azerbaijan consists of two contract of guarantee, one in the financial sector and one in agribusiness, representing a total gross exposure of US\$3.2 million.

In FY 2000 MIGA undertook a review of the investment promotion structures then in place in Azerbaijan, delivering a report to the government that stressed the need to focus on improvements to the investment environment, and on facilitation of non-oil industry investment. The government responded indicating interest in proceeding with implementation of the report's recommendations. MIGA referred them to FIAS, which conducted a Study of the Environment for Foreign Direct Investment in cooperation with the World Bank and the IFC. The study examined the policy, legal and regulatory, administrative (red-tape), and institutional environments for FDI. The findings were presented to the Government in December 2002 in a public private sector workshop.

Since the workshop, the Government has drafted a new Foreign Investment Law taking FIAS recommendations into consideration and has requested FIAS to provide a detailed analysis of the Draft. The Government has also taken a series of steps to improve the business environment, which will be presented to the business community at an investor conference that is being co-sponsored by the IFC in May 2003.

If the Government of Azerbaijan would like to develop a reform program to improve the investment climate based on findings of the FIAS Diagnostics study, MIGA and FIAS would consider working with them in areas in their competence in cooperation with the World Bank.

Attachment III - Core Labor Standards in Azerbaijan

- **Forced Labor.** The Constitution allows forced labor only under a state of emergency or martial law or as the result of a court decision affecting a condemned person. Two departments in the General Prosecutor's office (the Department of Implementation of the Labor Code and the Department for Enforcement of the Law on Minors) were responsible for enforcing the prohibition on forced or bonded labor.
- Azerbaijan is both a country of origin and a transit point for trafficking in persons. The Government is formulating a National Plan of Action, which will, inter alia, include amend national legislation to include specific anti-trafficking provisions.
- **Effective Abolition of Child Labor.** The minimum age for employment is 16 years. The law allows children aged 14 and 15 to work with the consent of their parents and limits the workweek of children between the ages of 14 and 16 to 24 hours per week. The Ministry of Labor and Social Security has primary enforcement responsibility for child labor laws. With high adult unemployment, there were few complaints of abuses of child labor laws.
- **Elimination of Discrimination in Employment.** Foreign workers are protected under the law and enjoy the same rights as citizens. The Constitution provides for equal rights without respect to gender, race, nationality or national origin, social status, membership in political parties, trade unions or other public organizations. However, how effectively these provisions are implemented is not clear.
- **Freedom of Association and the Right to Collective Bargaining.** The Constitution provides for freedom of association, including the right to form labor unions; however, there were some limits on this right in practice. The overwhelming majority of labor unions still operate as they did under the Soviet system and remain tightly linked to the government. There were reports of anti-union discrimination by foreign companies operating in Baku; however there were no reports of government anti-union discrimination. Unions were free to form federations and to affiliate with international bodies.
- The Constitution provides for the right to strike, and there were no legal restrictions on this right. The law prohibits retribution against strikers. A number of peaceful strikes to demand salary increases or payment of unpaid wages have been reported in the media.

Attachment IV - SPPRED : The Participatory Process

- The PRSP launch mission, in July 2001, consulted widely the members of the Government, local and international NGOs and members of civil society on the full range of poverty issues and completed its work with a major workshop bringing together the Government, donors and local and international NGOs. The workshop marked the opening of a genuine dialogue between government officials and civil society on issues related to poverty reduction. The international community pledged to assist this effort, both financially and technically
- Next steps included the establishment of a Secretariat at the Ministry of Economic Development, and of 15 Sector Working Groups whose findings would be major inputs for the preparation of the full PRSP (which subsequently came to be known as SPPRED). Each group was composed of members of Government, NGOs, civil society and international experts.
- Participatory appraisals, financed by UNDP and the EU, took place at the village level, first on a pilot basis and then on a larger scale, in order to bring government officials into direct contact with civil society in five regions of the country (Guba, Nakhchivan, Massally, Ganja and Sheki). Interviews and regional consultations and workshops covered 63 villages and towns engaging some 2,000 participants. The appraisals brought into focus the phenomenon of “new poverty” resulting from the transition process.
- USAID encouraged the process by funding a series of Town Halls Meetings aimed at continuing the dialogue between Azeri citizens and the Government. Through the town hall meetings and participant group trainings, many “good practices” suggested by the Bank and other IFIs were consolidated to encourage active participation. The meetings were attended by MPs, government representatives, NGOs and activists of the respective regions. Coordination between the EU, USAID and the Bank was excellent.
- Encouraged by the government’s readiness to cooperate, the National NGO Forum took the initiative to help establish a working relationship with the government, intending to further develop it during PRSP implementation. It replicates the sectoral working groups within the NGO forum, allowing them to develop alternative approaches and proposals and submit them to the Secretariat. In addition, at least one NGO was nominated by the Forum to participate in each of the 15 official working groups. The Bank is encouraging the Forum to continue to reach out to other NGOs who are not members, especially those outside of Baku, in order to expand participation and representation.
- Sector Policy Notes (SPNs) drafted by the working groups reflected findings of the consultation processes and inputs from some of the NGOs. The writing of the

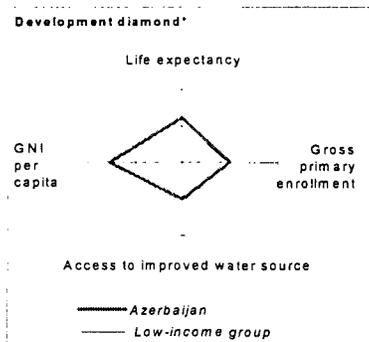
full report began in February 2002 and was revised after successive consultation with members of the Government, civil society and members of the international community.

- The final draft was presented at a widely publicized and televised Conference chaired by President Aliyev in October. It was officially adopted by the Government in February 2003.

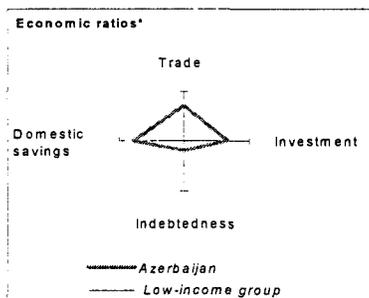
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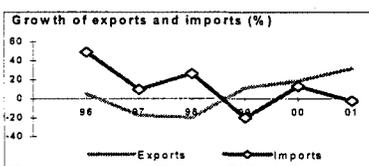
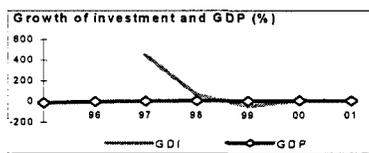
	Azerbaijan	Europe & Central Asia	Low-income
POVERTY and SOCIAL			
2001			
Population, mid-year (millions)	8.1	475	2,511
GNI per capita (Atlas method, US\$)	660	1,960	430
GNI (Atlas method, US\$ billions)	5.7	930	1,069
Average annual growth, 1995-01			
Population (%)	0.9	0.1	1.9
Labor force (%)	1.8	0.6	2.3
Most recent estimate (latest year available, 1995-01)			
Poverty (% of population below national poverty line)	50	..	..
Urban population (% of total population)	58	63	31
Life expectancy at birth (years)	72	69	59
Infant mortality (per 1,000 live births)	13	20	76
Child malnutrition (% of children under 5)	17	..	..
Access to an improved water source (% of population)	76	90	76
Illiteracy (% of population age 15+)	..	3	37
Gross primary enrollment (% of school-age population)	95	102	96
Male	..	103	103
Female	..	101	88



	1981	1991	2000	2001	
KEY ECONOMIC RATIOS and LONG-TERM TRENDS					
GDP (US\$ billions)					
GDP	5.3	5.7	
Gross domestic investment/GDP	..	3.1	17.4	27.1	
Exports of goods and services/GDP	..	45.7	39.0	40.9	
Gross domestic savings/GDP	18.1	30.7	
Gross national savings/GDP	13.9	26.2	
Current account balance/GDP	-3.6	-0.9	
Interest payments/GDP	0.5	0.5	
Total debt/GDP	22.2	22.2	
Total debt service/exports	2.3	3.5	
Present value of debt/GDP	18.8	..	
Present value of debt/exports	44.4	..	
(average annual growth)					
GDP	..	-0.3	11.1	9.9	9.8
GDP per capita	..	-1.3	10.2	9.0	8.9
Exports of goods and services	..	0.1	18.5	31.8	18.1



	1981	1991	2000	2001
STRUCTURE of the ECONOMY				
(% of GDP)				
Agriculture	..	31.0	15.9	14.8
Industry	..	29.6	42.5	41.6
Manufacturing	..	16.7	5.8	5.3
Services	..	33.8	35.4	33.8
Private consumption	..	73.0	68.2	58.2
General government consumption	..	19.4	13.7	11.1
Imports of goods and services	..	41.2	38.4	37.3
(average annual growth)				
Agriculture	..	-0.4	12.1	11.1
Industry	..	-3.8	6.2	7.4
Manufacturing	..	-10.1	15.3	-3.7
Services	..	10.7	10.3	8.9
Private consumption	..	9.1	15.7	-5.3
General government consumption	..	17.8	6.0	-18.7
Gross domestic investment	..	27.5	11.2	9.9
Imports of goods and services	..	10.2	13.2	-2.4



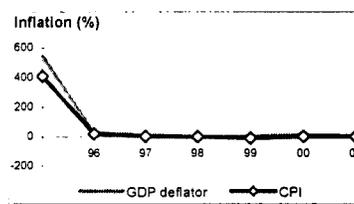
Note: 2001 data are preliminary estimates.

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

Azerbaijan

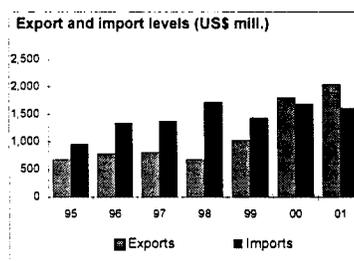
PRICES and GOVERNMENT FINANCE

	1981	1991	2000	2001
Domestic prices				
(% change)				
Consumer prices	1.8	1.5
Implicit GDP deflator	12.5	2.5
Government finance				
(% of GDP, includes current grants)				
Current revenue	21.2	21.5
Current budget balance	2.4	4.5
Overall surplus/deficit	-0.6	0.9



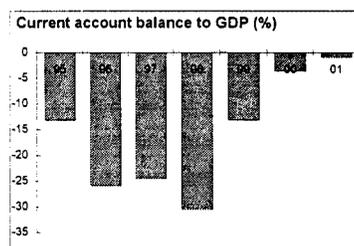
TRADE

	1981	1991	2000	2001
(US\$ millions)				
Total exports (fob)	1,799	2,046
Commodity 1
Commodity 2
Manufactures	243	190
Total imports (cif)	..	336	1,683	1,612
Food
Fuel and energy
Capital goods	200	167
Export price index (1995=100)	288	249
Import price index (1995=100)	69	68
Terms of trade (1995=100)	417	366



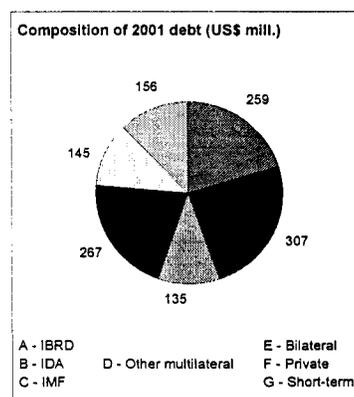
BALANCE of PAYMENTS

	1981	1991	2000	2001
(US\$ millions)				
Exports of goods and services	2,059	2,336
Imports of goods and services	2,024	2,130
Resource balance	35	206
Net income	-295	-332
Net current transfers	73	77
Current account balance	-187	-50
Financing items (net)	-282	-322
Changes in net reserves	-59	-74
Memo:				
Reserves including gold (US\$ millions)	679.6	725.0
Conversion rate (DEC, local/US\$)	4,474.2	4,767.5



EXTERNAL DEBT and RESOURCE FLOWS

	1981	1991	2000	2001
(US\$ millions)				
Total debt outstanding and disbursed	1,170	1,269
IBRD	0	0
IDA	216	259
Total debt service	114	118
IBRD	0	0
IDA	2	2
Composition of net resource flows				
Official grants	50	..
Official creditors	146	88
Private creditors	68	-11
Foreign direct investment	149	229
Portfolio equity	0	..
World Bank program				
Commitments
Disbursements	27	43
Principal repayments	0	0
Net flows	27	43
Interest payments	2	2
Net transfers	26	41



CAS Annex B2 - Azerbaijan
Selected Indicators* of Bank Portfolio Performance and Management
As Of 04/25/03

Indicator	2000	2001	2002	2003
Portfolio Assessment				
Number of Projects Under Implementation ^a	11	13	15	15
Average Implementation Period (years) ^b	2.7	2.7	3.2	4.0
Percent of Problem Projects by Number ^{a, c}	9.1	7.7	13.3	6.7
Percent of Problem Projects by Amount ^{a, c}	6.9	1.7	2.7	5.2
Percent of Projects at Risk by Number ^{a, d}	18.2	7.7	33.3	33.3
Percent of Projects at Risk by Amount ^{a, d}	14.7	1.7	26.2	37.9
Disbursement Ratio (%) ^e	16.3	16.9	13.3	11.8
Portfolio Management				
CPPR during the year (yes/no)	No	No	Yes	Yes
Supervision Resources (total US\$000)	1,060	953	1,203	946
Average Supervision (US\$000/project)	96	73	80	63

Memorandum Item	Since FY 80	Last Five FYs
Proj Eval by OED by Number	3	2
Proj Eval by OED by Amt (US\$ millions)	148.5	87.1
% of OED Projects Rated U or HU by Number	33.3	50.0
% of OED Projects Rated U or HU by Amt	52.2	89.0

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

CAS Annex B3 - IBRD/IDA Program Summary Azerbaijan

Proposed IBRD/IDA Base-Case Lending Program^a

<i>Fiscal year</i>	<i>Proj ID</i>	<i>US\$(M)</i>	<i>Strategic Rewards b (H/M/L)</i>	<i>Implementation b Risks (H/M/L)</i>
2003	BAKU WS (SUPPLMT)	12.9	M	M
	ED SECT DEV. APL	18.0	H	M
	IRRIG DIST SYS & MGMT IMPROVEME	30.0	M	L
	Result	60.9		
2004	PRIVATE SECTOR DEVELOPMENT	10.0	H	M
	PENSIONS	10.0	H	H
	ENERGY SECTOR (IBRD)	40.0	H	M
	Result	60.0		
2005	ENVIRONMENT	8.0	M	H
	PRSC 1/IBTA 3	20.0	H	M
	RURAL COMM. INFRASTRUCTURE	15.0	M	M
	Result	43.0		
2006*	AGRICULTURE APL	30.0	H	M
	TRADE FACILITATION	5.0	H	H
	Result	35.0		
Overall Result 2003-2005		163.9		

* 2006 inclined for illustrative purpose only

CAS Annex B3 (IFC & MIGA) for Azerbaijan				
Azerbaijan - IFC and MIGA Program, FY 2000-2003				
	2000	2001	2002	2003
IFC approvals (US\$m)	0.00	0.06	1.75	
Sector (%)				
FINANCE & INSURANCE		100	100	
Total	0	100	100	0
Investment instrument(%)				
Loans				
Equity		100	100	
Quasi-Equity				
Other				
Total	0	0	0	0
MIGA guarantees (US\$m)	65.4	40.6	38.0	33.2

CAS Annex B4 - Summary of Nonlending Services - Azerbaijan
As Of 04/25/03

<i>Product</i>	<i>Completion FY</i>	<i>Cost (US\$000)</i>	<i>Audience^a</i>	<i>Objective^b</i>
FY02				
Country Procurement Assessment Report	FY02	100	G, B	KG, PS
FY03				
Country Financial Accountability Assessment	FY03	23	G, B	KG, PS
Trade Facilitation Strategy	FY03	40	G, D, B, P	PD, PS
Trade Diagnostic Study	FY03	139	G, D, B, P	PD, PS
Public Expenditure Review	FY03	93	G, B, P	KG, PD, PS
Poverty Assessment	FY03	355	G, B	KG
Electricity & Natural Gas, Oil & Advisory TA	FY03	21	G, B	KG
Municipal Infrastructure Survey	FY03	52	G,D,B	KG, PS
FY04				
Marketing and Agro-processing Issues Study	FY04	80	GD,B	KG, PS
Energy Sector Study	FY04	100	G, B	KG, PS
Rural Impact of Utility Price Changes	FY04	50	G,D, B	KG, PS
Financial Sector Assessment (FSAP)	FY04	0	G, D, B	KG
Business Environment Study	FY04	203	P	KG, PD
Health Sector Capacity Building	FY04	30	G, P	KG, PS
S. Caucasus Telecoms/PPIAF (Regional)	FY04	11	G, B, P	KG, PS
S. Caucasus Trade Facilitation	FY04	17	G, D, B, P	PD, PS
FY05				
Country Economic Memorandum Update	FY05	140	G, D, B, P	KG
Transcaucasus Tourism TA (IDF)	FY05	44	G,D,B,P	PD, KG
Public Expenditure Review Update	FY05	100	G, B, P	KG, PD, PS
Higher Education Note	FY05	72	G, B	KG, PS

a. Government (G), donor (D), Bank (B), public dissemination (P).

b. Knowledge generation (KG), public debate (PD), problem-solving (PS).

Azerbaijan Social Indicators

	Latest single year				Same region/income group	
	1970-75	1980-85	1994-00	2001	Europe & Central Asia	Low- income
POPULATION						
Total population, mid-year (millions)	5.7	6.7	8.0		474.3	2,459.8
Growth rate (% annual average for period)	1.9	1.6	1.0		0.2	2.0
Urban population (% of population)	51.5	53.6	57.3		65.4	31.9
Total fertility rate (births per woman)	3.9	2.9	2.0		1.6	3.6
POVERTY (% of population)						
National headcount index	..	..	68.1	49.6	..	..
Urban headcount index	..	..	..	55.8	..	..
Rural headcount index	..	..	..	42.5	..	..
INCOME						
GNI per capita (US\$)	..	..	600		2,010	410
Consumer price index (1995=100)	..	..	115		187	140
Food price index (1995=100)	..	0	105		..	..
INCOME/CONSUMPTION DISTRIBUTION						
Share of income or consumption						
Gini index	..	..	36.0	0.365	..	..
Lowest quintile (% of income or consumption)	..	..	6.9	7.5	..	..
Highest quintile (% of income or consumption)	..	..	43.3	44.1	..	..
SOCIAL INDICATORS						
Public expenditure						
Health (% of GDP)	..	..	1.0		4.1	1.2
Education (% of GDP)	..	..	3.4		4.4	3.4
Social security and welfare (% of GDP)	..	..	7.5		8.8	..

Azerbaijan Social Indicators
(Continued)

Net primary school enrollment rate					
<i>(% of age group)</i>					
Total			96	..	..
Male			95	..	..
Female			97	..	..
Access to an improved water source					
<i>(% of population)</i>					
Total	..	..	..	90	76
Urban	..	..	..	..	88
Rural	..	..	..	..	70
Immunization rate					
<i>(% under 12 months)</i>					
Measles			99	93	57
DPT			99	93	57
Child malnutrition (% under 5 years)			17	..	..
Life expectancy at birth					
<i>(years)</i>					
Total	68	69	72	69	59
Male	65	66	68	64	58
Female	72	73	75	74	60
Mortality					
Infant (per 1,000 live births)	37	29	13	20	76
Under 5 (per 1,000 live births)	..	..	21	25	115
Adult (15-59)					
Male (per 1,000 population)	247	262	207	298	294
Female (per 1,000 population)	117	127	103	127	261
Maternal (per 100,000 live births)			37	..	..
Births attended by skilled health staff (%)			99	..	..

Note: 0 or 0.0 means zero or less than half the unit shown. Net enrollment ratios exceeding 100 indicate discrepancies between the estimates of school-age population and reported enrollment data.

Azerbaijan - Key Economic Indicators

Indicator	Actual			Estimate			Projected				
	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
National accounts (as % of GDP)											
Gross domestic product ^a	100	100	100	100	100	100	100	100	100	100	100
Agriculture	..	20	18	18	16	15	14	17	17	16	14
Industry	..	37	35	39	43	42	41	40	39	42	48
Services	..	36	43	39	35	34	32	34	36	34	30
Total Consumption	..	90	98	87	82	69	66	67	74	68	59
Gross domestic fixed investment	..	37	36	29	19	27	42	56	57	48	42
Government investment	..	1	2	1	1	2	4	5	4	3	3
Private investment	..	36	34	28	18	25	38	52	53	45	38
Exports (GNFS) ^b	..	29	23	28	39	41	44	45	38	40	46
Imports (GNFS)	..	53	55	42	38	37	51	68	69	56	46
Gross domestic savings	..	10	2	13	18	31	34	33	26	32	41
Gross national savings ^c	..	11	3	13	14	26	29	27	22	27	34
<i>Memorandum items</i>											
Gross domestic product (US\$ million at current prices)	..	3962	4446	4581	5273	5708	6124	6882	7345	8121	9445
GNI per capita (US\$, Atlas method)	..	410	510	570	616	660	699	772	832	905	1005
Real annual growth rates (% calculated from 1998 prices)											
Gross domestic product at market prices	..	5.8	10.0	7.4	11.1	9.9	10.6	9.2	8.8	10.5	13.9
Real annual per capita growth rates (% calculated from 1998 prices)											
Gross domestic product at market prices	..	4.8	9.0	6.5	10.2	9.0	9.7	8.4	7.9	9.7	13.0
Total consumption	..	-3.5	18.7	14.3	13.6	-7.6	1.3	10.6	13.7	-1.9	-4.1
Private consumption	..	-6.2	16.7	12.7	14.8	-6.1	-0.8	10.9	16.3	-2.6	-5.0
Balance of Payments (US\$ millions)											
Exports (GNFS) ^b	..	1150	1010	1283	2059	2336	2667	3072	2820	3271	4336
Merchandise FOB	..	808	678	1027	1799	2046	2305	2685	2398	2813	3837
Imports (GNFS) ^b	..	2101	2417	1917	2024	2130	3121	4701	5040	4579	4385
Merchandise FOB	..	1375	1716	1433	1539	1465	1823	3100	3416	3053	2980
Resource balance	..	-951	-1407	-634	35	206	-454	-1630	-2219	-1308	-49
Net current transfers	..	46	69	81	73	77	70	77	84	90	105
Current account balance	..	-971	-1356	-601	-187	-50	-769	-2046	-2544	-1727	-724

Azerbaijan - Key Economic Indicators (Continued)

Indicator	Actual			Estimate			Projected				
	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Net private foreign direct investment	..	1093	1024	550	149	299	1048	2074	2306	1591	965
Long-term loans (net)	..	11	49	207	341	121	32	82	438	384	295
Official	..	26	73	139	239	140	167	126	123	131	131
Private	..	-14	-24	68	102	-19	-135	-44	315	253	164
Other capital (net, incl. errors & om)	..	9	224	-4	-243	-295	-276	-55	-126	-177	-484
Change in reserves ^d	..	-143	59	-152	-59	-74	-35	-55	-74	-71	-52
<i>Memorandum items</i>											
Resource balance (% of GDP)	..	-24.0	-31.7	-13.8	0.7	3.6	-7.4	-23.7	-30.2	-16.1	-0.5
Real annual growth rates (YR98 prices)											
Merchandise exports (FOB)	..	-17.5	-19.9	11.7	18.5	31.8	15.2	-1.2	9.9	34.8	45.9
Primary (Oil & gas)	..	-15.7	-18.0	11.5	36.8	43.6	7.7	2.8	5.7	35.6	63.4
Manufactures (Others)	..	-25.7	-29.4	12.5	42.0	-25.5	27.0	8.5	6.7	4.7	1.6
Merchandise imports (FOB)	..	9.7	26.3	-19.8	13.2	-2.4	20.7	64.3	10.2	-10.5	-2.5
<i>Public finance (as % of GDP at market prices)^e</i>											
Current revenues	..	19.1	19.6	18.5	21.2	21.5	28.0	28.0	27.7	27.6	25.3
Current expenditures	..	18.9	21.9	19.9	18.8	17.0	22.8	23.5	22.7	22.2	19.8
Current account surplus (+) or deficit (-)	..	0.2	-2.3	-1.4	2.4	4.5	5.2	4.5	5.0	5.4	5.5
Capital expenditure	..	1.9	1.6	3.9	3.0	3.5	5.7	6.4	5.1	4.8	4.7
Foreign financing	..	2.0	2.6	7.0	3.5	2.5	3.1	2.3	2.2	2.0	3.6
<i>Monetary indicators</i>											
M2/GDP	..	13.1	11.0	10.9	11.0	12.8	12.8	13.6	14.4	14.4	14.1
Growth of M2 (%)	..	33.6	-8.6	8.7	1.9	7.7	14.8	15.1	13.8	16.4	15.3
<i>Price indices (YR98=100)</i>											
Merchandise export price index	..	45.7	47.8	64.7	100.0	86.3	84.4	99.6	80.9	70.4	65.8
Merchandise import price index	..	99.3	98.5	102.1	100.0	98.1	101.2	104.7	104.7	104.5	104.7
Merchandise terms of trade index	..	46.0	48.5	63.4	100.0	87.9	83.5	95.1	77.3	67.4	62.9
Real exchange rate (US\$/LCU) ^f											
Consumer price index (% change)	..	3.7	-0.8	-8.5	2.2	1.3	3.3	2.5	2.5	2.5	2.5
GDP deflator (% change)	..	9.2	-1.0	2.2	12.5	2.5	0.7	4.1	-1.9	0.0	2.1

a. at factor cost or purchasers prices depending on original national accounts presentation

b. "GNFS" denotes "goods and nonfactor services."

c. Includes net unrequited transfers excluding official capital grants.

d. Includes use of IMF resources.

e. Consolidated central government.

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

Azerbaijan - Key Exposure Indicators

Indicator	Actual			Estimate			Projected			
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Total debt outstanding and disbursed (TDO) (US\$m) ^a	507	708	1038	1170	1269	1384	1452	1541	1641	1737
Net disbursements (US\$m) ^a	138	181	320	238.7	139.6	167.2	126.0	123.5	131.1	130.7
Total debt service (TDS) (US\$m) ^a	78	24	86	114	118	173	141	121	103	110
Debt and debt service indicators (%)										
TDO/XGS ^b	43.5	67.4	78.9	50.4	50.1	47.6	45.1	51.5	47.1	37.8
TDO/GDP	12.8	15.9	22.7	19.7	20.5	20.7	20.1	19.8	19.0	17.4
TDS/XGS	6.7	2.3	6.5	4.2	4.9	4.4	5.6	5.0	3.7	2.4
Concessional/TDO	23.0	23.1	29.1	33.7	35.9	..	..	..	..	..
IBRD exposure indicators (%)										
IBRD DS/public DS	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Preferred creditor DS/public DS (%) ^c	87.5	53.1	48.5	49.5	64.1	63.3	68.0	78.8	82.4	81.9
IBRD DS/XGS	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
IBRD TDO (US\$m) ^d	0	0	0	0	0	0	0	0	0	0
Of which present value of guarantees (US\$m)										
Share of IBRD portfolio (%)	0	0	0	0	0	0	0	0	0	0
IDA TDO (US\$m) ^d	116	141	199	216	259	303	332	353	363	365
IFC (US\$m)										
Loans										
Equity and quasi-equity /c										
MIGA										
MIGA guarantees (US\$m)	16.5	19.2	19.2	65.4	40.6	38.0	33.2	..	..	..

- 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.

CAS Annex B8 - Azerbaijan
Operations Portfolio (IBRD/IDA and Grants)
As Of 04/07/03

Closed Projects 3

IBRD/IDA *	
Total Disbursed (Active)	168.76
of which has been repaid	0.00
Total Disbursed (Closed)	148.52
of which has been repaid	0.00
Total Disbursed (Active + Closed)	317,281,663.82
of which has been repaid	0.00
Total Undisbursed (Active)	201.71
Total Undisbursed (Closed)	0.00
Total Undisbursed (Active + Close)	201,708,670.63

Active Projects

Project ID	Project Name	Development Objectives	Supervision Rating		Fiscal Year	IBRD	Original Amount in US\$ Millions			Cancell.	Undish.
			Implementation	Progress			IDA	GRANT	IBRD		
P035813	AGRIC DEVT & CREDIT	S	S	S	1999		30				18,11339
P008288	BAKU WS	S	S	S	1995		73.92				13,7398
P058969	CULT HERITAGE PRSV	S	S	S	1999		7.5				5,278098
P057959	EDUC REF	S	S	S	1999		5				1,493791
P040544	FARM PRIV	S	S	S	1997		14.7				0,376143
P070973	FIN.SCT.TA	HS	HS	S	2001		5.4				4,312543
P008287	GAS REHAB	U	S	S	1997		20.2			0.2705042	6,632004
P069293	HEALTH REF LIL	S	S	S	2001		5				3,678839
P040716	HIGHWAY	S	S	S	2001		40				42,45771
P008283	IBTA	S	S	S	1996		18				0,21621435
P066100	IBTA.2	S	S	S	2002		9.45				1,959959
P008284	IRRIG/DRAINAGE REHAB	S	S	S	2000		42				10,21829
P035770	PILOT RECON	S	S	S	1999		30				32,84155
P055131	SAC.2	S	S	S	2002		60				32,07299
P055155	URG ENV INVST	S	S	S	1998		20				12,07999
Overall result							381.17			0.48671855	201,7089

Statement of IFC's
Held and Disbursed Portfolio
As Of 04/25/03
(In US Dollars Millions)

FY Approval Company	Held				Disbursed			
	Loan	Equity	Quasi	Partic	Loan	Equity	Quasi	Partic
1999 Amoco Caspian	25.4	0	0	1.66	25.4	0	0	1.66
1998 Azerb. JV Bank	0	1	0	0	0	1	0	0
1997/98 Baku Coca Cola	3.5	0	0	0	3.5	0	0	0
1999 Baku Hotel	13.13	0	0	0	13.13	0	0	0
1999 Early Oil Fin	11.95	0	0	0.78	11.95	0	0	0.78
1999 Lukoil Overseas	14.93	0	0	0.97	14.93	0	0	0.97
1999 Turkish Petrol	10.08	0	0	0.66	10.08	0	0	0.66
1999 Unocal Chirag	15.01	0	0	0.98	15.01	0	0	0.98
Total Portfolio:	94	1	0	5.05	94	1	0	5.05

Approvals Pending Commitment

	Loan	Equity	Quasi	Partic
2002 MicrofinBank Aze	0	1.750	0	0
2001 Azer JV Increase	0	0.60	0	0
Total Pending Commitment:	0	1.810	0	0

CAS OBJECTIVE I: MANAGING THE OIL BOOM					
Government Strategy/SPPRED	Focus of Bank Actions	Expected Results FY 03-05	Bank Group Program	Partners	WB Performance Indicators
<i>I.a. Development of Institutional Capacity to Manage Revenues</i>					
<p>Improve capacity for budget preparation and execution of strategic priority setting with a Medium Term Expenditure Framework (MTEF).</p> <p>Institutional strengthening of public sector implementation capacity.</p> <p>Continue reforms in the financial and fiscal sectors.</p>	<p>Develop integrated and consolidated budget preparation system with horizontal and vertical accountability of Government and Parliament and modern computerized single account Treasury system.</p> <p>Develop better bottom-up approach to the Medium Term Expenditure Framework and appraisal capacity for preparation of consistent Public Investment Program.</p>	<p>Improved budget systems enable the government to articulate and follow through on medium term expenditure strategies focused on economic growth and poverty reduction.</p>	<p>SAC 2 IBTA 2 PRSC I-II (FY05) PER CFAA PER Update</p>	<p>IMF USAID US Treasury EBRD TACIS ADB GTZ</p>	<p>Budgets after 2003 prepared, published, and executed according to new budget law.</p> <p>All state extra budgetary resources integrated into state budget.</p> <p>Public Investment Appraisal Division at Ministry of Economic Development established and staffed.</p>
<p>Transparent operation of the State Oil Fund of Azerbaijan (SOFAR).</p>	<p>Ensure that Oil Fund Expenditures are integrated in overall budgetary framework.</p>	<p>Execution of Oil Fund results in transparent and accountable management of oil revenues in accordance with SOFAR regulations.</p>	<p>SAC 2 PER PER Update</p>	<p>IMF EBRD</p>	<p>Regular publication of quarterly financial and budget execution statements of SOFAR.</p> <p>Internationally acceptable audits of SOFAR carried out and published annually.</p>
<p>Strengthening the state procurement procedures.</p> <p>Strengthening the auditing system on budget resources.</p> <p>Continue reforms in accounting and the regulation of private sector development.</p>	<p>Establishment of comprehensive public procurement system that is transparent, suitable for a market economy and introduces competition into the system.</p> <p>Strengthening of Supreme Audit Institution and Chamber of Accounts.</p>	<p>Development and implementation of Public Procurement Implementation Plan and Public Financial Accountability Action Plan leads to improved accountability and transparency of public financial management.</p>	<p>CPAR CFAA IBTA 2 SAC 2 PRSC I-II (FY-05)</p>	<p>USAID TACIS</p>	<p>Regular audit reports of the Chamber of Accounts indicate compliance with the Budget Systems Law, the Procurement Law, the MTEF and the PIP.</p> <p>Regular procurement audit reports.</p>

<i>I. b Maintenance of Macroeconomic Stability and Promotion of Broad-based Growth</i>					
Maintain low level of inflation/and financial discipline.	Careful management of oil and gas investment boom and preparation for later resource boom.	Avoidance of Dutch Disease. Exchange rate stability maintained through successful sterilization of forex earnings by Oil Fund and prudent macroeconomic policies.	CEM	IMF	Average annual inflation rate in single digits.
Avoid Dutch Disease.	Trade & private sector development: 1). Customs, tariff and tax simplifications; 2). WTO harmonization; 3). Regional trade integration; 4). Trade and Transport Facilitation; 5). Investment and business climate improvements; 6). Privatization; 7). Competitiveness enhancement; 8). Export development.	No major reversal in macroeconomic framework.	FIAS Business Environment Study Trade Diagnostic Study	EU/TACIS TRACECA	Fiscal stimulus to non-oil sector.
Develop the non-oil sector and trade in non-oil goods and services.		Adherence to fiscal and monetary targets as endorsed by IFIs. Non-oil sector growth, investment and job creation, and increased trade.	Trade Facilitation Dialogue PRSC I-II (FY05)		Foreign debt not to exceed 40% of GDP by 2005. Growth in non-oil sector of 5%-7% pa. Balanced private sector growth leading to a reduction in the poverty rate of 5%.

<i>I. c Improved Poverty Monitoring and Targeting of resources for poverty alleviation</i>					
Close monitoring of poverty and living standards.	Build up capacity in the State Statistical Committee to ensure the further development of the new Household Budget Survey.	Improved policy design based on greater input of locally produced research on poverty and household welfare.	IBTA 2	UNDP	Updated poverty assessment.
Continuation of the Household Budget Survey, with staff compensated appropriately and with strong quality control.	Build up capacity in the Government in the analysis and use of HBS data.	Improved monitoring and analysis of poverty outcomes.	SAC 2	ADB	Regular consultations on poverty data and analysis.
Regular analysis of survey data collected.	Produce an updated poverty profile for the country	Improved statistics and statistical capacity in government	PRSC 1-2 (FY05)	UNICEF	Increased confidence in the accuracy and reliability of the official statistics, including being able to monitor progress towards MDGs for health.
Establishment of Poverty Monitoring Unit.	Work with State Statistical Committee to ensure that IDPs are incorporated in HBS in a manner which allows comparative assessment of their vulnerability.	Improved data and analysis for targeting of vulnerability of IDPs.	PER	UNHCR	Better and more efficient targeting of IDPs in national safety net approach.
Improvement of social statistics.	Analyze health and education expenditures to strengthen their effectiveness and poor targeting.	Improved institutional capacity in Ministries of Health and Education for better analysis and targeting of health and education spending.	Poverty Update		MTEF and PIP aligned with SPPRED priorities.
Incorporation of plan for poverty monitoring of IDPs into Household Budget Survey.			IBTA 2		
Providing poverty monitoring and finance to support poverty reduction priorities.			SAC 2		
			PRSC 1-2 (FY05)		
			PER		
			PER Update		

CAS OBJECTIVE II: GENERATING JOBS AND NON-OIL GROWTH

II. a. Financial Sector Development

<p>Restructure and privatize state – owned banks (IBA and BUS Bank) and increase the regulatory capacity of the National Bank of Azerbaijan. (NBA).</p>	<p>Strengthen safety and stability of the banking system through privatization, improved regulations and better enforcement.</p>	<p>Privatization of IBA and BUS Bank completed. Improved capacity of the NBA to legislate and enforce prudential standards in line with best international practices. International Accounting Standards (IAS) introduced and operating in banking sector. Local population and businesses feel more confident in entrusting their savings to local banks.</p>	<p>SAC 2 FSTA IFC-- Support for UUB Bank Privatization FSAP FSAP follow-up</p>	<p>IMF EBRD USAID ADB</p>	<p>No majority state ownership in the banking system. No banks in unstable financial condition. Improved confidence in the banking system as evidenced by increased savings by firms and population. Increase of banking markets as evidenced by growth of banking sector assets in relation to GDP. Proportion of banking sector using IAS rises to over 90%.</p>
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<p>Develop privately owned banking sector by increasing minimum capital, further liberalization of access for foreign banks and improving governance</p>	<p>Stimulate competition in the banking sector. Improve governance and institutional capacity of privately owned banks.</p>	<p>Consolidation of banking system and entry of strategic investors and foreign banks results in increased availability of financial services at reduced costs.</p>	<p>FSAP FSTA IFC -- Credit lines to local private banks. IFC -- PEP Program</p>	<p>EBRD EU/TACIS</p>	<p>Minimum capital increase to Euro 5 million strictly enforced. Number of banks drops from 46 to less than 38. Better access to trade and working capital finance. Total value of short term finance increased by 100%. Average interest rates for trade finance drop by 20% Better access to investment finance. Total volume of investment finance increased by 200%</p>
<p>Develop banking infrastructure, including small value payment system, introduction of deposit insurance and stimulation of non-cash transactions.</p>	<p>Improve financial infrastructure for domestic banks.</p>	<p>Large and small value payment systems completed, significantly reducing transaction costs for businesses and consumers and improving profitability of banks. Credit Card clearing system built permitting widespread acceptance of non-cash payments Credit Risk Registry operational, resulting in improved access to finance for small and inexperienced borrowers.</p>	<p>FSTA</p>		<p>Reduced cost of financial services and improved profitability of banks. Bank fees for processing payments decrease by 25% Use of non-cash payment mean rises by over 500% Improved financial performance of large utility companies due to improved payment of utilities.</p>

<p>Promoting expansion of the banking network by establishing financial institutions in the regions and creating conditions for development of micro-credit institutions to provide loans for individuals and small and medium enterprises.</p>	<p>Improve access to financial services, especially in rural areas by:</p> <ol style="list-style-type: none"> (1) facilitating bank expansion outside Baku. (2) Providing access to financial services through the postal system and other non-bank access points. 	<p>Significantly larger number of access points for delivery of financial services out of Baku and in rural areas.</p> <p>More private banks active outside Baku, providing greater availability of credit and other financial services to residents of rural areas and smaller cities.</p> <p>Access to credit history increases willingness of 6 Banks to lend to SMEs.</p>	<p>FSTA IFC – Azerbaijan Microfinance Bank</p>	<p>Swiss Government EBRD ADB</p>	<p>Number of Banks with branches outside Baku increases from 2 to 10.</p> <p>Number of Bank branches outside Baku increases from 50-75.</p> <p>Number of postal access points to financial services increases to over 600 postal offices.</p> <p>Total number of access points to financial services outside Baku increases 10 fold.</p>
<p>II. b. SME/Private Sector Development SME action program to facilitate SME access to markets and strengthen entrepreneurship rights protection</p>	<p>Improve business and tax environment.</p> <p>Improve effectiveness of public/private sector interfaces (licensing, certification, inspections) and reduce opportunities for corruption.</p> <p>Improve market and trade related functions.</p>	<p>Significant reduction in cost of doing business for SMEs results from decreasing number of inspections and licensing requirements.</p> <p>Lowering of tax burden and rise in tax compliance by SMEs.</p>	<p>SAC 2 IBTA II FSAP Business Environment study Trade Diagnostic Study Trade Facilitation Policy Dialog IFC - Investors Conference</p>	<p>IMF TACIS EBRD USAID</p>	<p>Increase of private sector share of the economy by 7.5% Improvement in Azerbaijan's results in next BEEPS survey. Increase in number of jobs in SME sector by 10%. Increase in FDI in non-oil sector by 15%.</p>

<p>Provide assistance to stimulate structural changes and technological progress in SME sector; Provide technical assistance to SMEs in human resource development.</p>	<p>Improve competitiveness of SMEs by:</p> <ol style="list-style-type: none"> (1) building SME support infrastructure; (2) developing infrastructure for quality testing and quality assurance; (3) improving SME access to modern technology, training and consulting services; 	<p>More successful import substitution; greater range of Azeri production competitive in international markets.</p>	<p>PSD Project (FY 04) IFC – PEP Program IFC – SME TA Project IFC – SME Linkage Program</p>	<p>TACIS EBRD USAID</p>	<p>Increase in number of jobs in SME sector by 10%. Increase in FDI in non-oil sector by 15%. Increase in value of SME exports by 10%.</p>
<p>Accelerate regional development of entrepreneurship</p>	<p>Stimulate entrepreneurship development outside Baku by</p> <ol style="list-style-type: none"> (1) Improving access to training and TA (2) Establishing industrial parks and SME support infrastructure and (3) Developing models of incubation centers that can be replicated throughout Azerbaijan. 	<p>Development of SME Support Centers outside Baku improves technical skills of SME's entrepreneurs and secondary school graduates. Establishment of industrial parks and incubation centers improve competitiveness of SME sector outside Baku.</p>	<p>PSD Project (FY 04) IFC – SME TA Project IFC – SME Linkage Program IFC – Investors Conference</p>	<p>EBRD USAID TACIS</p>	<p>Increase in value of production by rural SMEs by 20%. Increase in employment by rural SMEs by 10%. Increase in share of FDI in non-Baku non-oil sector 15%.</p>

II. c. Development of Agriculture and Rural Sector				
<p>Develop transparent and functioning land market</p> <p>Develop sustainable rural financial system</p> <p>Improve farmers' entrepreneurial and technical skills, reform research system and strengthen veterinary services.</p> <p>Raise rural incomes by improving basic infrastructure and value added Agricultural production.</p> <p>Encourage private sector involvement in agro-processing, and provision of technical services.</p>	<p>Decentralization of registration services for land transactions.</p> <p>Create an accessible unified real estate registration system on a pilot basis.</p> <p>Development of agricultural credit system.</p> <p>Further strengthening of extension service;</p> <p>Modernization of agricultural research system;</p> <p>Establishment of private veterinary services.</p> <p>Rehabilitation of basic infrastructure and enabling environment for agro-processing</p>	<p>Land transactions are conducted at the regional level by the Regional Land Cadastre Offices.</p> <p>Establishment of institutional basis for realization of unified real estate registration system all over the country</p> <p>Farmers and rural entrepreneurs have access to short and medium term credit</p> <p>Widespread adaptation of new technologies, crops and methods in agriculture as a result of improved availability of technical services and research;</p> <p>Accessibility of private veterinary services:</p> <p>Implementation of community based investments in basic infrastructure and agro - processing .</p>	<p>Ag. Devel & Credit Project (ADCP- phase I-ongoing)</p> <p>Rural Community Investment Project (04)</p>	<p>Number of land transactions registered reaches at least 3,000 a year;</p> <p>Pilot unified real estate registration system established and tested;</p> <p>7,000 farmers and rural entrepreneurs have access to financial services through Borrowing Groups and Credit Unions;</p> <p>250 rural financial institutions established;</p> <p>75% of farmers benefiting from advisory services use improved practices and demonstrate improved farm management.</p>
<p>Increase agricultural production through better irrigation water delivery, ultimately leading to improvement in income of rural people;</p> <p>Rehabilitate irrigation and drainage infrastructure;</p> <p>Make farmers responsible for managing tertiary irrigation and drainage infrastructure</p>	<p>Rehabilitate critical irrigation infrastructure;</p> <p>Improve management of irrigation infrastructure;</p> <p>Strengthen Water Users Associations. (WUAs)</p>	<p>Improved irrigation infrastructure allows adequate and timely water supply to irrigated fields.</p> <p>Better management of irrigation infrastructure and strengthened WUAs results in increased user contribution to O&M.</p> <p>Adequate legal framework</p>	<p>ADB</p> <p>IsDB</p>	<p>Completion of Samur-Absheron canal and Main Mill Mugan Collector.</p> <p>Maintenance at 80% of required level within WUAs supported by IDSMIP.</p> <p>Amended law on amelioration and irrigation enacted.</p>

	for WUAs developed and implemented.	300 WUAs legally established according to amended law. Crop yields increase by 10% in areas with legally established WUAs.			
CAS OBJECTIVE III. IMPROVING INFRASTRUCTURE AND SOCIAL SERVICES					
III.a. Improvement in the quality of education services					
<p>Improve the quality of education and introducing new education technologies.</p> <p>Improve linkages between education and the labor market.</p> <p>Improve efficiency in allocation and utilization of limited resources.</p> <p>Reform education finance.</p> <p>Strengthen education management, planning and accountability.</p> <p>Monitoring quality of and access to education.</p>	<p>Revise general school national curriculum according to market economy needs.</p> <p>Empower school principals and improve management of school facilities.</p>	<p>Improved learning outcomes in selected general schools.</p> <p>Revision of national general school curriculum completed for all grades.</p> <p>MOE and local education authorities equipped with managerial skills to lead education reforms.</p>	<p>Education LIL Second Education Project (APL) (FY 03) Higher Education Sector Note</p>	<p>EU OSI UNICEF</p>	<p>The National Center for Student Assessment established, staffed and functioning by 2004.</p> <p>Completion of pilot sample-based reliable assessment of grade 4 student achievement in mathematics and Azeri language.</p>
<p>Improve equality of opportunity in basic education through provision of free text books to school children.</p>	<p>Improve access to education for the poor.</p>	<p>School drop out rate improved, especially among poor households.</p>	<p>Second Education Project (APL) (FY 03) SAC-2 education benchmarks IBTA-2 technical assistance</p>		<p>At least 90% of children in grades 1-5 have free of charge textbooks in core subjects.</p> <p>General education enrollment ratio increased from 94% in 2001 to 98% in 2005.</p> <p>Enrollment rates of population 17 year and older increased from 13% in 2001 to 15% in 2005.</p>

III. b. Improvement in the quality of, and equity in access to, basic health				
Reorient health resources towards Primary Health Care (PHC).	Advocate for comprehensive reforms in the health sector at the national level, through support of PHC- focused reforms in selected pilot districts.	Significant improvement in delivery of PHC services in pilot districts results in acceptance of objectives of health reform LIL by major stakeholders.	Health Reform LIL project	PHC centers in all pilot districts are fully staffed, equipped and provided with essential drugs.
Rationalize district health services.	Work with local authorities in Pilot Districts to improve PHC services through strengthening of health centers, training activities and supply of essential drugs and equipment.	Measurable improvement in health outcomes in pilot districts.		Revolving drug funds and community health councils are operational in all pilot districts.
Improve the management of health services.				Increase of 40% in the number of patients seen at reformed PHC facilities.
				Increase of 20% in patient satisfaction in access to and quality of care in pilot districts.
				Increase in hospital occupancy ratio from 30% to 50% in district hospitals and polyclinics.
				Decrease of 25% in the number of beds in district hospitals and polyclinics.
				30% increase in the proportion of women having at least six ante-natal visits in pilot districts.
				50% decrease in home deliveries in the low income group from about 40% to 20% in pilot districts.

<p>Increase public health financing Improve health information system. Maintain immunization coverage. Control TB, AIDS, Malaria. Promote rational drug use healthy lifestyle programs.</p>	<p>Improve capacity of Ministry of Health to analyze health spending and target it to the poor.</p>	<p>Government expenditures in the health sector are higher and better targeted to the poor.</p>	<p>SAC-2 and IBTA-2 benchmarks and technical assistance</p>	<p>Health sector expenditures increase to 6% of government expenditures by 2005.</p>	
<p>III. c. Social Sector Reform: Pensions, social assistance and labor</p>					
<p>Begin implementation of the pension system reform. Improve social services for the elderly and people living alone.</p>	<p>Assist the government in the implementation of Pension Reform Concept Paper by introducing changes in the current pay-as-you-go system, and creating individual records.</p>	<p>New pension legislation, ensuring long term sustainability of the system, endorsed by Parliament and implemented by Government.</p>	<p>SAC 2 IBTA 2 Pension and Social Assistance Project (FY04) Pension and Social Assistance Note</p>	<p>TACIS EU UNDP</p>	<p>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.</p>

<p>Develop a Social Assistance Strategy.</p> <p>Develop a targeting mechanism for social assistance and a monitoring and evaluation system for its implementation.</p> <p>Develop a social care system for families with children that need of special care. Create alternative child care centers and family support services.</p>	<p>Assist the government in preparation of a comprehensive social assistance reform strategy and its implementation.</p>	<p>Comprehensive social assistance reform strategy prepared and endorsed by the government.</p> <p>New social assistance legislation endorsed by Parliament; a detailed social assistance implementation plan prepared and started being implemented, resulting in improved targeting of limited social protection funds.</p>	<p>SAC II</p> <p>IBTA II</p> <p>Pension and Social Assistance Project (FY04)</p> <p>Pension and Social Assistance Note</p>	<p>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.</p> <p>Social assistance benefits better targeted so that the bottom consumption quintile receives 50% of the social assistance benefits.</p> <p>The social assistance targeting pilot completed and evaluated and a national rollout prepared.</p> <p>Social assistance and social insurance benefits separated financially and administratively.</p> <p>Labor Force Survey introduced and conducted regularly</p>
<p>Develop a strategy to cushion the effects of mass redundancies (e.g. labor redeployment programs).</p> <p>Improve the cost effectiveness of employment services.</p> <p>Improve labor statistics, and establish a national information system on the labor market, employment and industrial safety norms and standards</p>	<p>Assist the Government in the design and implementation of labor redeployment programs and in improving employment services.</p> <p>Assist the Government in introducing regular labor force survey</p>	<p>Labor redeployment programs designed and tested in enterprises undergoing restructuring and privatization.</p> <p>Employment services improved. Capacity of the State Employment Service staff enhanced</p>	<p>SAC II</p> <p>IBTA II</p> <p>Labor Market Study</p>	
<p>III. d. Improvement in living conditions and opportunities for refugees and Internally Displaced Person (IDPs)</p>				
<p>Ensuring financial transparency through explicit budget allocations for IDP support.</p> <p>Improving social living conditions of IDPs and refugees in the worst living conditions.</p>	<p>Encourage the Government to move towards a needs-based approach for provision of benefits of IDPs and promote transparency in budgeting of IDP assistance. Support government's efforts to promote sustainable livelihoods for vulnerable IDPs.</p>	<p>Redirection of IDP benefits towards needs based approach results in a more efficient targeting of resources towards most vulnerable IDPs and lowering of the percentage of IDPs living in poverty</p>	<p>Pilot Reconstruction Project</p> <p>Social Investment Fund for IDPs</p> <p>Poverty Update</p>	<p>Social assessments reveal satisfaction with relocation process; no evidence of involuntary resettlement.</p> <p>Increase in IDP per capita income to equal the national average by 2005.</p>

<p>Upgrading infrastructure in IDP camps.</p> <p>Addressing employment problems of refugees and IDPs.</p> <p>Improving health care services to refugees and IDPs.</p>	<p>Signal Bank concerns that any relocation programs be voluntary and involve informed consent and participation by stakeholders.</p> <p>Work with Education Ministry to review current system of parallel education for some IDPs.</p>	<p>and extreme poverty</p> <p>Improvement in IDP access to housing, land, other agricultural assets, credit and training resulting in higher incomes and lower unemployment rates for IDP population .</p> <p>More efficient use of educational resources and improvement of social links between IDPs and most populations.</p>		<p>USAID Mercy Corps FINCA</p>	
<p>III e. Energy sector reform</p>					
<p>Implementation of structural reforms in the energy sector.</p> <p>Improving energy supply to the population through strengthening financial discipline in the energy sector and making implicit subsidies explicit in the State Budget.</p> <p>Full payment of utility bills by budget funded organizations.</p>	<p>Enhance transparency and financial discipline in the utility sector.</p> <p>Reduce implicit subsidies to utilities and SOEs through restructuring and private sector participation.</p>	<p>Phased program eliminates implicit subsidies from the energy and water sectors resulting in greater transparency and more reliable provision of energy and water to consumers.</p> <p>Establishment of user pays principle for public utilities with private sector suppliers results in greater private sector investment in energy and water sectors.</p>	<p>SAC II IBTA II Energy sector study Municipal Infrastructure Study</p>	<p>EBRD USAID IMF TACIS KFW JICA</p>	<p>Total subsidies in the energy and water sectors are reduced by 35% by 2005 as compared with 2002. Subsidies can be reduced through increased collections and/or increased tariffs, with no new transfers from the state budget to end consumers, and no reductions in end consumers' liabilities to the state</p> <p>Budgetary institutions become 100% current with utility payments by 2003.</p>
<p>Utility tariffs review and appropriate adjustment.</p> <p>Introduction of card payment system for collection in utility sector.</p>	<p>Develop a strategy to ensure that impact of rising tariff increases is mitigated for poor segments of the population when energy and water tariffs are raised to sustainable levels.</p>	<p>Better targeted subsidies mitigate impact of tariff increases on the poor.</p>	<p>Energy Sector Study Study on Social Impact of Utility Price Changes</p>	<p>UNICEF USAID</p>	<p>Program for phased increase of utility tariffs for cost recovery and economic prices is legally enforced and duly implemented. Direct subsidies introduced in utility sector.</p> <p>Household Budget Surveys show that subsidies for tariff increases are targeted to most vulnerable groups.</p>

<i>III.f. Improving the delivery of utility services</i>				
Restructuring of utility companies to establish financial viability.	Strengthen utility sector reforms to establish an appropriate environment for private sector involvement in the utility sector.	Transparent and clearly defined conditions for private sector operations result in greater efficiency and more private investment in utilities.	Energy Project (FY 04)	IMF
Continuing structural reforms in SOCAR, Azerenerji and Azerigaz.	Establish regulatory framework and independent regulatory institution with an adequate capacity. Support emergency investments as well as achievement of financial recovery in and electricity transmission.	Privatization program of downstream utility sector is completed. Concession/management contracts for gas distribution signed and legally endorsed. Emergency investment program is ongoing in electricity transmission and dispatch.	Energy Sector Study Gas, Oil & Electricity Advisory TA	EBRD IFC PPIAF IsDB
				Ability to meet utility sector O&M expenses. No serious collapse of critical midstream infrastructure leading to energy supply interruptions. Transactions for private sector involvement in gas distribution are completed.

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<p>Improve availability of clean drinking water.</p> <p>Reconstruct Greater Baku water supply system.</p> <p>Reconstruct sewerage system in Baku.</p> <p>Complete sewerage purification system in Ganja.</p> <p>Establish monitoring system for water quality.</p>	<p>Support emergency investments as well as achievement of financial recovery in urban water sector.</p>	<p>Emergency investment program is completed in water sector.</p> <p>Concession/management contracts for Baku water supply are signed and legally endorsed.</p>	<p>Baku Water Supply Project</p> <p>Supplement to Baku Water Project (FY03)</p>	<p>ADB</p> <p>KFW/GTZ</p> <p>UNICEF</p>	<p>Proportion of Azerbaijan's population with sustainable access to an improved water source increases from 75% (estimated) to 77%.</p> <p>Percentage of Baku population that trusts safety of water supply increases from 13% to 50%.</p> <p>Increase the percentage of population with access to improved sanitation by 2%.</p> <p>Incidence of water-borne diseases in Baku decreased.</p>
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<i>III. g. Improving the delivery of transport services</i>					
Restructuring and modernization of transport sector institutions.	Improvement of administration management and financing of roads	MOTC staffed and organized with clear separation of regulatory from commercial functions. Alleviation of overt conflicts of interest in individual transport sectors. Introduction of greater capacity to administer and manage the transport sector and introduce competition and private sector participation in construction, maintenance and utilization of transport infrastructure.	Highway Project	EU/TACIS TRACECA Kuwait Fund Islamic Development Bank (IsDB)	Restructuring of the Road-Administration and its management processes, including corporatization /privatization of most supplier functions.
Foster non-oil sector growth through facilitating trade and transit.	Develop strategies to overcome barriers to trade and transport through greater involvement of private sector stakeholders.	Transport costs and delays minimized as a result of concrete measures developed by private sector/public sector consultative groups.	Trade Facilitation Strategy Trade Diagnostic Study TA for Transit and Trade Facilitation Highway project	TRACECA ADB	Increase in value of non-oil transit traffic to Central Asia. Decrease in freight tariffs from Amsterdam to Baku. Decrease in transport time from Amsterdam to Baku
Rehabilitate the East-West Highway and restructure the Road Administration process. Improve rural local roads, including their management and financing	Conduct a road user charges study and agree on financing and management of all roads through user charges. Conduct a road classification study to ensure equitable access in all areas to services and markets. Investment in infrastructure and maintenance.	Efficient management of all classes of road with a predictable funding source and clear separation of owner, administration, management and supplier functions. User charges covering the costs, with provisions for user side subsidies to the poor to ensure access.		TRACECA IsDB Kuwait Fund	Pavement management system installed and economic analysis used for prioritizing road program. National road safety program prepared and agreed upon. Budget for maintenance of national road network increases 10% per year from base of 12 million in 2002. 60% of road budget tendered via competition.

<p>Promote sustainable use and rehabilitation of natural resources through community involvement.</p> <p>Promote regional cooperation for sustainability of the Caspian environment.</p>	<p>Improve sustainability of funding and effectiveness of natural resources.</p> <p>Clarify ownership and improve management of pasture and forest land.</p> <p>Reforest public lands where appropriate for watershed reasons and/or to improve availability of fuel wood.</p> <p>Build institutional capacity for trans-boundary cooperation in implementation of international agreements.</p> <p>Implement program for monitoring and environmental protection and reproduction of fish stock.</p>	<p>Improved management of pasture and/or forests in participatory fashion by villages, and improved critical ecosystems management.</p> <p>Rehabilitation of sturgeon fish stock.</p> <p>Establish a system for sustainable financing of bio-resources management.</p>	<p>Environment /Natural resource management project (FY 05)</p> <p>Urgent Environment Investment Project.</p> <p>Kura River Delta Rehabilitation project feasibility study.</p>	<p>GEF/UNDP NDF</p>	<p>Project designed, appraised and under implementation, with quantifiable targets for improved forest and pasture management and biodiversity conservation.</p> <p>Sustainable land use plans prepared in project area.</p> <p>Sturgeon nursery operational under EIP, and study of potential for expansion of breeding grounds in Kura delta and river completed (under grant financed studies).</p>
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CAS OBJECTIVE IV. REALIZING THE OIL AND GAS POTENTIAL

<p>Ensure timely completion of Baku Tbilisi Ceyhan Pipeline (BTC), Shah Deniz, South Caucasus Pipeline (SCP) and other oil and gas developments.</p> <p>SOCAR restructuring.</p>	<p>Enable BTC completion in keeping with key international environmental and social standards.</p> <p>Provide guidance to government in meeting financing obligations as needed.</p> <p>Assist in mitigating political risk.</p> <p>Ensure broader development impacts.</p>	<p>Completion of the BTC pipeline by '05 Or delays leading to loss of xxx million per year in net present value terms.</p> <p>Community development projects underway.</p>	<p>IFC Bank policy dialogue.</p> <p>Possible Trust Fund engagement for SOCAR restructuring.</p>	<p>EBRD, JBIC/NEXI Hermes EXIMBANK SACE ECGD COFACE</p>	<p>Timely completion of stages under Phase I.</p> <p>Gas exports to Turkey and development of Shah Deniz oilfields on schedule.</p> <p>Oil exports through BTC begin by '05.</p>
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Azerbaijan--CAS Summary of Development Priorities

<i>Network area</i>	<i>Country performance a</i>	<i>Major issue h</i>	<i>Country priority c</i>	<i>Bank priority c</i>	<i>Reconciliation of country and Bank priorities d</i>
Poverty Reduction & Economic Management					
• Poverty reduction	Fair	Distrib.of growth espec. in urban areas outside Baku.	High	High	Participatory PRSP & CAS focusing on non-oil sector devel., health, ed., & soc. Protection
• Economic policy	Excellent	Consistent track record of macro stability	High	High	SAC II, PER policy dialogue & close coordination with IMF Program
• Public sector	Poor to Fair	Weak admin. capacity	Mod.	High	SAC II, PER, CPAR, CFAA and IBTA -II Strengthen governance
• Gender	Fair	Poor social assistance for one -parent households	Low	Mod.	Analytical work through surveys to raise awareness
Human Development Department					
• Education	Fair	Low effectiveness	Mod.	High	Bank & Gov. focus on curriculum & management issues
Health, nutrition & population	Poor	Corruption & low political commitment to reform; system at the service of providers, not clients.	Low	High	Enhanced dialogue, evidence-based advocacy, supporting ESW
• Social protection	Low	Poorly targeted social assistance	High	High	Pension & Soc. Assist. Project

Azerbaijan--CAS Summary of Development Priorities
(continued)

Environmentally & Socially Sustainable Development

• Rural development	Fair	High transaction costs/ poorly developed market infrastruct.	High	High	Decent. of infrastruct. services & marketing channels
• Environment	Low	Indust. liabilities & weak protected area management	Mod.	Mod.	Dialogue on improved environ. management of indust. pollution & protected areas
• Social development	Good	Social exclusion of IDPs & other weak groups	High	High	Dialogue on needs- based approach to benefits & transparency in budgeting
	Low	Community participat. in gov. decision making	Mod.	High	Decentralization & dialogue on CDD

Finance, Private Sector

• Financial sector	Fair	Inadequate financ. infrastruct., low access & high cost of financ. services	High	High	SAC II, policy dialogue, FSTA
• Private sector	Fair	Weak business envir., poorly functioning markets, high barriers to SME entry & growth	High	High	SAC II policy dialogue, IBTA, PSD project IFC dialogue
• Energy & Infrastructure	Fair	Poor financial & managerial performance, weak corporate governance	High	High	SACII, IBTA II policy dialogue, energy project
Transport	Low	Weak corporate governance, management, taxation, & cost recovery & poor condition of nearly all infrastructure	High	Mod.	Greater reliance on own resources & cost recovery
Water	Fair	Government engaged in ambitious reform program; too early to assess outcome		Mod.	Government relies increasingly on private sector

a. Use "excellent," "good," "fair," or "poor."

b. Indicate principal country-specific problems (e.g. for poverty reduction, "rural poverty;" for education, "female secondary completion;" for environment, "urban air pollution")

c. To indicate priority, use "low," "moderate," or "high."

d. Give explanation, if priorities do not agree; for example, another MDB may have the lead on the issue, or there may be ongoing dialogue.

MAP SECTION

