

**DOCUMENT OF THE EUROPEAN BANK  
FOR RECONSTRUCTION AND DEVELOPMENT**

**STRATEGY FOR AZERBAIJAN**  
Approved by the Board of Directors on 17 December 2002

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## ABBREVIATIONS

ADB	Asian Development Bank
ACG PSA	Azeri, Chirag, Guneshli Production Sharing Agreement
AIOC	Azerbaijan International Oil Consortium
BP	British Petroleum
BSTDB	Black Sea Trade and Development Bank
CEC	Central Electoral Committee
CIS	Commonwealth of Independent States
DIF	Direct Investment Facility
EAP	Environmental Action Plan
ECAs	Export Credit Agencies
EFF	Extended Fund Facility
ESAF	Enhanced Structural Adjustment Facility
EU	European Union
FDI	Foreign Direct Investment
FIs	Financial institutions
GDP	Gross Domestic Product
GUUAM	Georgia, Ukraine, Uzbekistan, Azerbaijan, Moldova (Organisation for Regional Co-operation)
IDA	International Development Agency
IFC	International Finance Corporation
IFIs	International Financial Institutions
IMF	International Monetary Fund
INOATE	International Oil and Gas to Europe
IsDB	Islamic Development Bank
JEBIC	Japanese Bank for International Co-operation
KfW	Kreditanstalt für Wiederaufbau und Entwicklung
MBFFF	Multi-bank Framework Financing Facility
MIGA	Multilateral Investment Guarantee Agency
MOT	Ministry of Telecommunication
NEAP	National Environmental Action Plan
NGOs	Non-governmental Organisations
ODIHR	Office for Democratic Institutions and Human Rights
OSCE	Organisation for Security and Co-operation in Europe
PSAs	Production Sharing Agreements
SMEs	Small and medium-sized enterprises
SOCAR	State Oil Company of Azerbaijan Republic
TAM	Turn-around Management
TC	Technical Corporation
TRACECA	Transport Corridor Europe-Caucasus-Asia
TurkExim	Turkish Export Import Bank
USD	United States Dollar
WB	World Bank

## I. EXECUTIVE SUMMARY

Azerbaijan is committed to the principles of Article 1 of the Agreement Establishing the Bank. However, the progress achieved in the implementation of these principles has been slow and many challenges remain. There are many political parties, including genuine opposition, and a growing network of NGOs. The admission to the Council of Europe in January 2001 marked an important benchmark in the democratic transition and committed Azerbaijan to implement wide-ranging reforms. A recent national referendum on constitutional changes (although the OSCE did not formally monitor the referendum, its local office noted irregularities in its actual conduct) aimed at bringing the country's basic law in line with international standards.

Some progress has been made on the delineation of the Caspian seabed, with Russia, Kazakhstan and Azerbaijan now sharing similar views. However, there is no consensus with Iran and Turkmenistan as yet. The Nagorno-Karabakh conflict remains unresolved, although the continuing dialogue between the Presidents of Azerbaijan and Armenia, remains a positive sign. A final settlement would be of great political as well as economic importance.

Azerbaijan's macroeconomic performance has been impressive over the period of the last strategy. Gross Domestic Product growth across a broad range of sectors has been 10 per cent on average over the last two years and inflation has been held below two per cent. However, *the economy continues to be highly dependent on oil and gas-related activities, with extraction and processing contributing more than 30 per cent of GDP in 2001. With the implementation of major oil and gas projects this percentage is expected to increase substantially.* While the consolidated government budget recorded a surplus of 1.5 per cent of GDP in 2001, measures to bring energy subsidies on budget and the elimination of some preferential tariffs are likely to result in a small deficit and a slightly increased inflation in 2002. The external debt ratio continues to be moderate at about 22% of GDP in 2001. Already strong foreign exchange reserves are expected to grow substantially with increased revenues from oil and gas projects.

Notwithstanding these overall sound macroeconomic achievements, poverty and inequality remain a significant concern. The results of a household budget survey conducted by the state statistics committee indicates that 49% of the population were living in poverty in 2001<sup>1</sup>. In order to reduce the level of poverty, the government has prepared a comprehensive State Programme on Poverty Reduction and Economic Growth in co-operation with international institutions, including the active participation of the EBRD, bilateral institutions as well as NGOs and the wider civil society. The implementation of this Programme has been officially launched by President Aliyev on 25 October 2002.

Azerbaijan faces many challenges to its transition process. Against the background of the high poverty level in Azerbaijan, it is crucial to ensure the continuing support of the population for the transition process. In this context it is critical for the country's social stability and sustainable economic development that the substantial state

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<sup>1</sup> Household budget of less than 120,000 Manats per month (= USD 25 p.m.)

revenues accumulating in the State Oil Fund, which was established in co-operation with the IMF and the World Bank in 2001, are transparently managed and effectively utilized.

In addition, with the implementation of large-scale oil and gas projects, the country faces the challenge to ensure broad-based economic growth. A major obstacle to the development of the so-called non-oil sector continues to be a challenging business environment. The most pressing investment climate issues are the widespread corruption, an inadequate legal/regulatory environment, arbitrary enforcement of laws and regulations by law enforcement agencies as well as the judiciary, an underdeveloped infrastructure and lack of access to financing.

One of the Bank's strategic objectives is to significantly contribute to poverty alleviation in the context of the implementation of the State Programme on Poverty Reduction and Economic Growth, within the boundaries of its mandate. Opportunities for new, sound investment projects will, however, largely depend on the climate created for them. Thus, the level and nature of the Bank's activities will be strongly influenced by the government's commitment to reform. In summary, the strategic priorities presented below respond to Azerbaijan's current transition challenges, are consistent with the Bank's operational priorities for the medium-term, are in line with measures identified in the State Programme for Poverty Reduction and Economic Growth and are, whenever possible, aimed at fostering regional economic co-operation.

- **SMEs & Non-oil Private Sector** – The Bank will promote micro, small and medium-sized enterprises and non-oil private sector projects through the provision of direct financing and via the financial sector and through policy dialogue aimed at improving the investment climate;
- **Financial Sector** – The Bank will focus on building an effective and competitive financial sector that commands the confidence of the population and efficiently intermediates between savers and investors - in particular with a view to supporting micro, small and medium-sized enterprises;
- **Infrastructure** – The Bank will continue to support the creation of a market-based economy through the promotion of commercialisation, the strengthening of the institutional and regulatory frameworks, private sector involvement and the financing of sound infrastructure projects. The Bank's activities in the transport infrastructure area will in particular focus on projects of regional importance with the aim to foster regional co-operation.
- **Natural Resources** - While supporting measures to aid the diversification of the economy, the Bank recognizes the importance of the appropriate development of the oil and gas sector in Azerbaijan's future. The Bank will therefore continue to assist the development of this sector, with due regard to the environment and an active policy dialogue to ensure the transparent management and sensible utilisation of the significant revenues accumulating in the State Oil Fund. The Bank's activities in this area will aim to help Azerbaijan to realise substantial economic growth, ensure sound business practices, catalyse commercial co-financing and foster regional competition for the transport of oil and gas.

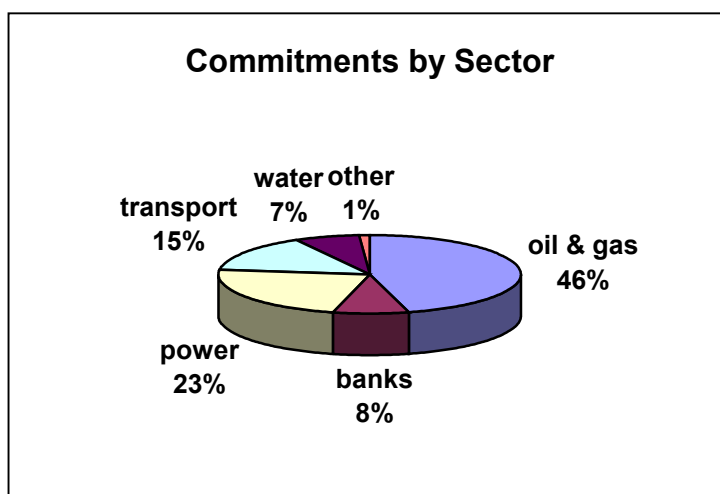
In order to ensure the successful implementation of the above priorities, the Bank will continue to have an active policy dialogue with government authorities with the objective to improve the investment climate as well as an ongoing dialogue with the private sector and NGOs. The Bank will also continue to support the application of international environmental standards and while implementing this strategy the Bank will closely co-ordinate and co-operate in its work with other international and bilateral institutions to ensure a complementary approach in their activities to support the transition process in Azerbaijan.

## II. STRATEGY

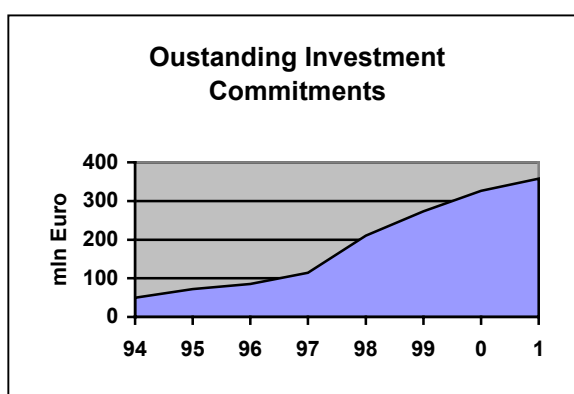
### 1. THE BANK'S PORTFOLIO

#### 1.1 Overview of Activities (see Annex 1)

At the end of September 2002 the Bank's portfolio in Azerbaijan consists of 17 signed investment projects with outstanding financing commitments of Euro 329 million. The Bank's investments have been directed to power and energy, transport, municipal and environmental infrastructure, oil & gas, financial sector and property and tourism.



The size of the Bank's annual new commitments fluctuates considerably due to irregular, large-sized oil and gas sector and infrastructure projects. In 2002 the level of new commitments will be moderate in terms of investment volume, as they will be mainly directed to the financial sector and the promotion of SMEs. In 2003, however, the portfolio is expected to increase substantially subject to the realisation of major oil and gas as well as infrastructure investments.



In addition to the investment activities the Bank has arranged and managed 50 technical co-operation operations with cumulative financing commitments of Euro 10.9 million in Azerbaijan. The sectors most benefiting from these funds are financial institutions (43%), transport sector (40%) and the power sector (11%).

## **1.2 Portfolio Performance**

### **1.2.1 Sound Banking**

Overall the Bank's portfolio in Azerbaijan is performing well. Provisions against the existing portfolio are minimal. Covenants compliance in connection with private sector projects is generally good. The implementation of a number of public infrastructure projects has been slower than expected due to delays caused by longer than expected procurement processes and lacking covenant compliance. Generally covenant compliance of public sector transactions has been challenging at times because of the slower than originally expected implementation of reforms and commercialisation of state-owned enterprises.

### **1.2.2 Transition Impact**

The Bank's projects have had a considerable transition impact. With its investments in infrastructure, the Bank fosters the commercialisation and reform of utilities and of transport services. The Bank's activities in the oil and gas sector helped to create a reliable legal framework for investments, ensured due regard to the environment and attracted substantial private sector co-financing. The provision of financing and technical assistance to the local banking sector and SMEs have enhanced the capacity of the beneficiaries and contributed to the diversification of the economy.

### **1.2.3 Mobilisation of Co-financing**

In association with ongoing investment projects, the Bank mobilised complementary financing of Euro 2.0 billion for projects worth a total of Euro 2.3 billion in Azerbaijan. This high mobilisation ratio is mainly the result of large projects in the oil sector. To date the activities of international commercial banks have been very limited and mostly concentrated on short-term trade financing. As a result of the Bank's and the IFC's syndication of Euro 77 million in connection with the Chirag Early Oil financing, international commercial banks provided for the first time long-term financing to an Azerbaijani project.

### **1.2.4 Lessons Learned**

Important lessons have been learnt from the Bank's operations over the last years, including the need to:

- conduct policy dialogue and define reform-related project conditionality in close co-operation with other international and bilateral institutions;
- carefully assess eventual vested interests of third parties, to analyse in detail the integrity of individual managers and shareholders and to review the corporate governance standards and practices of prospective clients;
- ensure the close monitoring of the implementation of public sector projects by Bank staff in co-operation with high-quality external support; and
- carefully assess the financial, technical as well as managerial capabilities of eventual local suppliers to Bank financed investment projects.

## **1.3 Portfolio Ratio**

At the end of September 2002, eleven out of the Bank's seventeen investment projects have been classified as private sector. These operations represent 55% of the Bank's



investment commitments in Azerbaijan. The private sector operations can be broken down as follows:

	<i>Oil &amp; Gas</i>	<i>Financial Institutions</i>	<i>Property &amp; Tourism</i>
No. of operations	6(1)	4(2)	1
Commitments in million Euro	152.2	25.1	1.8

(1) Chirag Early Oil has been recorded as 5 investment projects as this transaction includes 5 different borrowers.

(2) Excluding regional venture funds.

As demonstrated above, the majority of the private sector operations and commitments are in the oil and gas sector. The six public sector operations represent 45% of the Bank's commitments in Azerbaijan and are in the following sectors:

	<i>Power</i>	<i>Transport</i>	<i>MEI(1)</i>
No. of operations	2	3	1
Commitments in million Euro	75.7	50.7	23.0

(1) Municipal and Environmental Infrastructure

Based on the current project pipeline and with the implementation of this strategy, it is expected that the Bank's activities in the private sector will continue to increase. Therefore it is assumed that the targeted 60/40 private to public sector ratio will be reached within the coming strategy period.

## 2. OPERATIONAL ENVIRONMENT

### 2.1 Political Environment (see Annex 2)

Azerbaijan has an important geo-strategic position as a gateway from Central Asia to Europe. Due to its location in the South Caucasus bordering Georgia, Armenia, Turkey, Russia and Iran and major investments of international oil companies in its territory, Azerbaijan is bound to take into account many interests.

Over the last two years Azerbaijan has made some progress in its democratic transition. The admission of Azerbaijan to the Council of Europe in 2001 was important for advancing towards democracy and pluralism. Azerbaijan has a presidential system of government whereby broad powers are vested by the Constitution on the President. The incumbent President Heydar Aliyev announced his intention to run for another five-year term in office in the presidential elections in October 2003.

Azerbaijan has a one-chamber parliament and the last parliamentary elections took place in November 2000. Following a national referendum in August 2002, many provisions of the Constitution of 1995 have been amended to bring Azerbaijan in line with international standards. Some of the constitutional amendments were, however, contested by the opposition. Many challenges remain in the area of the rule of law, freedom of the media and respect for human rights. The expected progress in this area has been slow although many formal commitments regarding ratification of international treaties have been honored. The ongoing process of reforming the

electoral code and media legislation is essential for advancing democratic development of the country.

The Nagorno-Karabakh conflict remains unresolved and is a cause of serious concern given its domestic, regional and international consequences. However, the continuing dialogue between the Presidents of Azerbaijan and Armenia, is a positive signal. A final settlement is of great political as well as economic importance.

## **2.2 Economic Condition (see Annex 3)**

Between 1991 and the end of 1995 Azerbaijan suffered a turbulent political and economic dislocation associated with the collapse of the Soviet Union and the conflict with Armenia over Nagorno-Karabakh. As a result of this conflict, 20 per cent of Azerbaijan's territory was occupied by Armenia and about one million Azerbaijani citizens (around 12 per cent of the population) became internally displaced or refugees. By the end of 1995, measured GDP stood at only 34 per cent of its 1988 value, inflation had been in three and four digits, budgetary deficits were out of control and the overall economic and social situation was extremely fragile. However, following the assumption of power by President Aliyev in 1993 political order was re-established, a cease-fire with Armenia accomplished and the government started to embark on serious economic reforms. These factors enabled the start of a recovery in Azerbaijan, with the country achieving positive real GDP growth and a substantial reduction in inflation in 1996.

More recently Azerbaijan has recorded impressive macroeconomic performance, with real GDP growth averaging 10 per cent over the duration of the Bank's last strategy. In the first eight months of 2002 real GDP increased by an annualised 9 per cent, across a broad range of sectors — industry, agriculture, construction, transport and communications. OCE currently estimates that growth for the whole of 2002 is likely to reach 8.8 per cent. The economy continues to be highly dependent on oil and gas-related activity, with extraction and processing contributing more than 30 per cent of GDP in 2001. Although the State Programme for Poverty Reduction and Economic Growth, which received Presidential Approval in October 2002, aims to address the inter-related issues of diversification and poverty alleviation, the difficult business environment is a significant obstacle to more broad-based growth.

While annual average inflation was reduced to between 1.5 and 1.8 per cent over the duration of the Bank's last strategy, it increased significantly to 3.2 per cent in the first half of 2002. This largely reflects the inflationary consequences of increased energy prices as preferential tariffs for certain social groups (such as refugees, internally displaced people and pensioners) were replaced with explicit subsidies from January 2002. The authorities have agreed with the IMF on a revised inflation target of 3 per cent for 2002, but on current trends OCE expects annual average inflation of around 2.6 per cent for the full year.

The exchange rate has remained broadly stable in recent years, with National Bank intervention limited to the prevention of large fluctuations while permitting a steady nominal depreciation of the Manat. The current account deficit declined from 3.2 per cent of GDP in 2000 to 0.9 per cent of GDP in 2001. The deficit is likely to increase significantly in the next two or three years, as import expenditure associated with the

capital requirements of the major oil and gas deals.

Government finances remain strong with a consolidated government budget surplus of 0.9 per cent of GDP in 2001 (equivalent to a deficit of 2.9 per cent of GDP excluding the Oil Fund). It is expected that current measures to bring energy subsidies on budget are likely to result to reverse this into a small deficit for the whole of 2002, following a consolidated budget deficit of 1.5 per cent of GDP in the first half of the year. In its 2003 draft budget the government has set an upper target on the consolidated deficit of 1 per cent of GDP.

There remains, however, a great need for the government to engage in longer term planning of public finances. As the government is only likely to accrue significant oil and gas-revenues in the latter half of this decade, there exists a mismatch between current expenditure requirements and future revenues. However, prudent fiscal management since 1999 has allowed the accumulation of an expected USD 700mn by the end of 2002 in the State Oil Fund. The utilisation of these funds has been agreed in the context of the State Programme for Poverty Reduction and Economic Growth (SPPREG). The SPPREG identifies key priorities and associated funding and is to be implemented at the budget level through the Medium-Term Expenditure Framework (MTEF) and Public Investment Programme (PIP), all of which have been agreed with the IMF and the World Bank, and are supported by other donors. The process will determine the appropriate mix of budgetary and State Oil Fund reserves in order to finance identified key infrastructural priorities. Under an average oil price of USD 20 per barrel, the State Oil Fund's resources are expected to increase to as much as USD 13 billion by the end of 2015 — making it an extremely significant source of funding for the future infrastructure and social development that is crucial to enable more broad-based growth in Azerbaijan. The SPPREG, MTEF and PIP are thus the key policy instruments linking oil revenues, donor funds and multilateral assistance directly with the aim of poverty reduction and balanced growth. Their successful implementation will play a fundamental role in the sustainability of Azerbaijan's economic development.

### **2.3 Access to Capital and Investment Requirements**

Azerbaijan's external public debt continues to be moderate, at less than 25 per cent of GDP at the end of 2001. More than 70 per cent of aggregate external debt is to official creditors, largely long-maturity, relatively low interest, lending by International Financial Institutions. Although Azerbaijan enjoys one of the best credit ratings in the region (Fitch: BB-) the government has not yet tapped the international capital markets for financing. The domestic capital market remains at an early stage of development, and domestic public debt is minimal.

Foreign direct investment inflows, which are predominantly directed towards the oil and gas sector, reached USD 883 million in 2001. FDI in other sectors remains minute due to the difficult business environment, perceived high political risks and a relatively small market with very limited purchasing power. The level of FDI is expected to increase considerably in the coming years as major investments in the oil and gas sector proceed, largely offsetting the associated increase in the current account deficit. Moreover as the oil and gas projects move forward the increased revenues will lead to a significant increase in foreign exchange reserves in the future, further

improving Azerbaijan's risk profile. Net reserves increased to USD 473 million in the first half of 2002 (USD 758 million in gross terms), exceeding the IMF target under the Poverty Reduction and Growth Facility.

Nonetheless, Azerbaijan continues to have substantial funding requirements for infrastructure projects. While some of these requirements will be financed through the use of budgetary and State Oil Fund resources under the Public Investment Programme, significant reforms and progress in the privatisation of electricity distribution companies and the upcoming privatisation of gas and water utilities should help to open the infrastructure sector to private sector investments. Other areas like transport infrastructure, will, however, continue to rely on state-guaranteed financing until further progress in the commercialisation of the various state enterprises has been achieved.

In addition to the problems created by poor infrastructure, economic diversification opportunities are further constrained by a banking sector that is underdeveloped and in which competition is limited. The depository base of the sector continues to be dominated by the International Bank of Azerbaijan, and private companies and in particular small and medium-sized enterprises continue to suffer from limited access to financing. Private credits represented only 9 per cent of GDP at the end of 2001. Access to international commercial bank financing to date has been very limited and short-term.

#### **2.4 Environmental Condition (see Annex 4)**

Environmental pollution continues to impose high economic and social costs on Azerbaijan. The government approved a National Environmental Action Plan (NEAP) in January 1998. The main environmental problems identified in the NEAP and requiring urgent actions include industrial pollution resulting mainly from oil exploration and production, poor water quality, degradation of fertile agricultural land, threats to protected areas leading to losses in biodiversity, damage to the Caspian coastal zone caused by flooding from sea level rise and pollution, natural deterioration of the cultural heritage and threat of irreversible reduction and extinction of the sturgeon species triggered by loss of reproductive capacity, oil pollution, and overfishing.

Against the background of these challenges the NEAP sets the following objectives: the clean up of oil contaminated land; efficient refinery waste management; oil spill prevention and contingency planning in the Caspian Sea; improved pollution monitoring in the coastal zone of the Caspian Sea; the reduction of natural gas discharges into the atmosphere; mitigation of mercury emissions from industrial sources; mitigation of air emission from power plants; and forest and biodiversity conservation.

#### **2.5 Social Condition**

As a result of the armed conflict with Armenia and the occupation of 20% of its land by Armenian forces, Azerbaijan has a refugee and IDP population of about one million. While poverty in Azerbaijan cannot be explained solely by this fact, refugee and IDPs represent the most vulnerable group of the population with poor living standards, low income and employment level and increased health risk. Despite the

measures undertaken by the government and international humanitarian organisations, there is a need to provide some part of the refugees and IDPs with food on a monthly basis, improve the social living conditions of those with the worst living standards and upgrade health and education services and create employment and income generation opportunities.

According to a household budget survey conducted in 2001, 49% of Azerbaijan's population lives poverty. According to this survey the urban population has consistently higher poverty rates than the rural population. The higher risk of poverty in towns can be attributed to the importance of land and home produce as a safety net. The rural population is relatively better off because of the value of produce consumed from the household's own agricultural plot or livestock. The survey data does not give any clear indication of regional differences in living standards. Poverty appears to be spread quite broadly over the country. Baku and the Absheron peninsula appear to be more privileged than other regions in terms of infrastructure and services, but a large section of the poor population are also situated there.

Social assistance benefits consist of child benefits for low-income families, childbirth allowances and childcare allowances. Other types of social assistance include food allowances for IDPs and allowances paid to pensioners, children of families of martyrs and the disabled. Overall the system of social assistance is poorly targeted and lacks transparency. In 2001 the unemployment rate based on registered unemployed was 1.2%. The level of non-registered unemployment is, however, estimated at 15.8%. Rural employment is slightly better than urban, due to the opportunities for agricultural self-employment promoted by land reform. Youth employment is high, especially among young people with secondary special and vocational education.

### **3. PROGRESS IN TRANSITION & TRANSITION CHALLENGES**

#### **3.1 Progress in Transition**

##### **3.1.1 Stabilisation & Liberalisation**

Following the end of the armed conflict with Armenia over Nagorno-Karabakh the government initially focused on achieving macroeconomic stabilisation, structural adjustment and the resumption of economic growth. Initial steps in this direction included price liberalisation, strict management of public finances, the attraction of foreign investors to the oil and gas sector and privatisation. Since 1995 macroeconomic stability has been achieved, foreign trade and all prices, except for a few exceptions like prices for services provided by public utilities, have been liberalised. In June 2002 the government eased restrictions on foreign currency transactions and is now in process of addressing the last outstanding issues related to Article VIII of the IMF's Articles of Agreement.

##### **3.1.2 Private Sector Development**

A liberal policy to attract foreign investment in the oil and gas sector was adopted in 1994. As a result Azerbaijan signed 21 production-sharing contracts with more than 30 international oil companies, which could result into investments of more than USD 50 billion. In parallel the government proceeded with the privatisation of

small and medium-sized enterprises and more recently the privatisation of large enterprises. As of the end of 2001 more than 29,000 small enterprises and over 1,000 medium-sized and large enterprises have been privatised through cash and voucher auctions. Furthermore, Azerbaijan was among the first CIS countries in implementing land reform, which resulted in 1.3 million hectares of agricultural land being distributed among rural residents and thereby the creation of 40,000 individual farms, and 5,000 other farming units such as co-operatives. Today the private sector accounts for more than 70% of GDP.

With the overall aim to foster private sector development and the diversification of Azerbaijan's economy, the government launched a State Programme for the Development of Small and Medium-sized Enterprises on 17 August 2002. More specifically the objectives of this programme are to: simplify the registration and licensing procedures; improve access to information for SMEs; provide training; assist in forming international business contacts; provide technical and financial assistance to exporting SMEs; provide financial assistance to SMEs active in manufacturing; ensure the development of SMEs in rural areas; foster co-operation among SMEs; provide technological support; and to ensure the protection of the rights of SMEs.

At the same time the government continues its efforts in improving the investment climate. For example, the government has substantially reduced licensing requirements, streamlined licensing procedures, simplified the tax regime, curtailed excessive powers of law enforcement agencies, improved public procurement rules and established a Chamber of Accounts. Further measures like the reform of the customs and tax authorities, the strengthening the judiciary, and the preparation of a comprehensive anti-corruption programme are ongoing. The decisive and effective implementation of these measures and further actions will, however, be required to achieve the government's objective to accelerate non-oil, private sector development (see Section 3.2.2).

### **3.1.3 Legal Transition (see Annex 5)**

The flurry of legislative activity in Azerbaijan since 1999 shows no sign of abating. As anticipated, the trend towards codification has continued with the adoption, over the last couple of years, of a new Land Code, Labour Code, Civil Code, Civil Procedures Code and Tax Code. A number of other laws also have been passed over the same period including laws "On the Land Market", "On Environmental Protection", "On Insurance", "On Transportation" and "On Commercial Secrets". As a recent development, the Azerbaijan Parliament has adopted the laws "On Execution of Court Decisions", "On the Protection of Atmosphere" and "On Obligatory Ecological Insurance". The motivation for these reforms was the need to pave the way for Azerbaijan's application to enter the World Trade Organisation, as well as holding the successful membership of the Council of Europe which is joined by Azerbaijan in 2001.

The Law on International Private Law dated 6 June 2000, recognises that upon agreement, the choice of governing law (which could be any foreign law) may govern the contractual aspects of the relationship between parties to a contract except where the events necessitate the imperative application of Azeri law. A

more significant development is Azerbaijan's accession to the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards which is effective in Azerbaijan from May 29 2000, together with the Civil Procedures Code providing the basis for the enforcement of foreign court and arbitral awards. This is an important structural component in building investor confidence, the need for which has not been diminished by the passing of the laws "On advocates and advocacy", "On the Procuracy" and "On Courts and Judges", which establish the court system in Azerbaijan. These laws together with the reforming of judges' corpuses were intended to establish the independence of the judiciary and provide for the selection and training of judges. Unfortunately it is widely believed that necessary constitutional recommendations have not been adopted in their entirety and that the judiciary, with no meaningful independence, is effectively subject to government control.

#### **3.1.4 Banking Sector**

The National Bank of Azerbaijan continues to foster the consolidation of the banking sector through mergers and the closure of banks by gradually increasing the minimum capital requirement for banks. As a result of this policy the number of banks has been reduced from more than 250 in 1994 to 43 as per the end of September 2002. The National Bank of Azerbaijan is also in the process of strengthening the regulatory with the introduction of a new law on banks, which is due to be approved by the Parliament before the end of the year. Furthermore, it reorganised the bank supervision function with the aim to improving its efficiency and effectiveness, initiated the establishment of a deposit insurance fund, created a modern inter-bank payment system, introduced international accounting standards and is in the process of setting corporate governance standards for banks. The majority state-owned International Bank of Azerbaijan has been successfully restructured and state-owned United Universal Bank is under restructuring with the assistance of the World Bank.

#### **3.1.5 Infrastructure**

The government has recognised the large scale and unsustainable nature of indirect subsidies to electricity, gas and water consumers and started to take important decisions to restructure these sectors. To this effect, management changes have been made at Azerenerji and four regional electricity distribution companies have been set up and handed over under 25-year contracts to the private sector following a public tender process. The private sector involvement in gas distribution and water utilities is under consideration. In March 2002, the President of Azerbaijan signed a decree on measures to strengthen financial discipline in the energy and water sectors. The Decree has approved a comprehensive energy sector reform programme following consultations with the IMF, with input from the World Bank and the EBRD. The key elements of the programme are: direct budget subsidies to socially disadvantaged and strategically important consumers; improvement of collections and enforcement mechanisms; creation of a Tariff Board and tariff regulation; close monitoring and accounting of utilities; private sector involvement in gas distribution and water utilities; and the restructuring of Azerenerji and Azerigas.

The reformation of the transport infrastructure sector should gain momentum following the long-awaited creation of the Ministry of Transport and the appointment of a Minister in early August 2002. Progress in reforms of the telecommunication sector on the other hand has come to a halt.

## **3.2 Transition Challenges**

### **3.2.1 Fighting poverty and achieving balanced economic growth**

On a GDP per capita basis Azerbaijan remains one of the poorest countries in Europe, despite encouraging economic growth figures over the last years. The results of a household budget survey conducted in 2001 by the state statistics committee found that 49% of Azerbaijan's population continued to live in poverty<sup>2</sup>.

In order to fight poverty, the government prepared in co-operation with all relevant stakeholders, including the active participation of the EBRD, a comprehensive State Programme for Poverty Reduction and Economic Growth. The implementation of this programme was launched on 25 October 2002 and will cover policy actions and the financing of various projects in the following areas: social protection, pension system, health, education, refugee and IDPs, fiscal policy, monetary policy and financial sector development, investment policy, private sector development, energy sector, rural development, environment, judicial reforms, tourism and culture.

The government's medium-term expenditure framework will provide the financial basis for the implementation of the investment components of this programme. These investments are expected to be financed by domestic sources consisting of the state budget and the State Oil Fund as well as external sources provided by multilateral and bilateral institutions. As the State Oil Fund will be a major source of funding of these expenditures, the successful implementation of the major oil and gas projects and related pipeline projects are a fundamental requirement to ensure the successful implementation of the State Programme for Poverty Reduction and Economic Growth. The programme also stresses the urgent need to achieve balanced economic growth and therefore aims at fostering private companies in the so-called non-oil sectors. In order to achieve this goal the government is facing the challenge to improve the investment climate, attract foreign investment, accelerate the privatisation of medium-sized and large enterprises, strengthen the financial sector and to improve the infrastructure.

### **3.2.2 Improving the investment climate**

Azerbaijan enjoys macroeconomic and to date political stability and thereby fulfils two basic requirements for a predictable investment climate. With the introduction of production sharing agreements, a reliable, internationally recognised investment framework has been established for the development of the oil and gas sector.

The business climate for investors in other sectors, however, continues to be very challenging. While over the last few years Azerbaijan has introduced notable

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<sup>2</sup> Household budget of less than 120,000 Manats per month (= USD 25 p.m.)



reforms to its legal system and has recently initiated further reform measures, the country continues to face considerable difficulties in implementing legal rules and entrenching institutions and culture upon which its successful transition to a market-oriented economy will depend. This implementation gap both undermines the utility of the specific laws in issue and diminishes the confidence that both Azerbaijani and foreign investors and traders have in the legal system as a whole, in particular in its ability to uphold contract rights. These problems are exacerbated by wide-spread corruption within law enforcement agencies and the judiciary as well as reported vested interests of government officials. The challenge facing Azerbaijan is to upgrade its commercial laws, implement regulations to standards that are generally acceptable internationally and to make those laws and regulations fully effective, particularly through the completion of the court system reform, the tackling of corruption, and other measures to strengthen the rule of law. The government recognises that these areas need urgent attention and various measures described in greater detail in Section 3.1.2 above have been initiated. The decisive and effective implementation of these measures and further actions will, however, be required to achieve the government's objective to accelerate non-oil, private sector development.

### **3.2.3 Strengthening the financial sector**

Despite the wide-ranging reform efforts outlined above (see Section 3.1.4), the financial continues to constitute a significant bottleneck to private sector development. The withdrawal of the main foreign-owned bank, HSBC, in July 2002 was a significant setback to the development of, and competition in, the banking sector. The banking sector is still fragmented with a total of 43 banks. Most of Azerbaijan's banks remain under-capitalised and illiquid and therefore lack the confidence of the population. Aggregate banking sector assets are approximately USD 0.7 billion, representing about 12.5% of GDP. The level of bank deposits and loans are low at approximately 7% and 9% respectively. Due to the lack of effective competition and the absence of a level-playing field, the state-owned International Bank of Azerbaijan and United Universal Bank continue to dominate the banking sector. As of the end of 2001 the state-owned banks controlled 65 per cent of the total banking assets. The planned privatisation of International Bank of Azerbaijan has been repeatedly delayed and the restructuring of the other state-owned bank United Universal Bank has yet to be completed.

Non-banking financial institutions are at a very early stage of development. The insurance sector is undercapitalised and poorly regulated. The pension system has yet to be reformed and as a result there are no private pension funds active in Azerbaijan.

### **3.2.4 Rehabilitating infrastructure**

A substantial degradation of Azerbaijan's infrastructure is a major obstacle to private sector development and, in particular, to companies operating in the rural areas such as agribusinesses. Companies face frequent power outages, gas shortages, unreliable water supplies, poor transport infrastructure and inadequate telecommunication services.

Poor payments discipline and low tariff levels led to a substantial quasi-fiscal deficit as the utilities were unable to pay for the provided fuel and the State Oil Company was therefore unable to pay taxes. As a result, the government provided generous implicit subsidies to the majority of electricity, gas and water consumers, which were in 2001, according to the IMF, about 50% greater than the state budget for health and education. At the same time utilities accumulated substantial debts and were unable to undertake necessary investments for the maintenance and modernisation of their facilities. Against this background the effective implementation of the above mentioned programme on the commercialisation of energy and water utilities (see Section 3.1.5) will be a major challenge over the forthcoming strategy period.

Although the reformation of the transport sector has recently gained momentum with the long-awaited creation of the Ministry of Transport, many transition challenges remain to be addressed. With the creation of the ministry the separation of policy and regulatory functions from commercial activities has to be effectively implemented. The commercialisation of state-owned enterprises in the sector should be advanced and competition enhanced through the further opening of the sector to private sector investments by granting necessary licenses and permits as well as via the implementation of the planned privatisation of state-owned transport enterprises.

The restructuring of the telecommunication sector has stalled. The Ministry for Telecommunication continues to combine commercial, regulatory and policy functions. As a result, the sector continues to lack transparency and the quality of the regulatory framework remains poor. The announced privatisation of state-owned telecommunication companies has yet to be realised. Investors will continue to hold back major investments until groundbreaking reforms in this sector have been implemented.

#### **4. STRATEGIC ORIENTATIONS**

First and foremost the Bank will continue to actively manage its existing portfolio in order to realise its transition impact potential. Opportunities for new, sound investment projects will largely depend on the climate created for them. Thus, the level and nature of the Bank's activities in Azerbaijan will be strongly influenced by the government's commitment to reform. The strategic priorities presented below respond to Azerbaijan's current transition challenges, are consistent with the Bank's operational priorities for the medium-term, are in line with measures identified in Azerbaijan's State Programme for Poverty Reduction and Economic Growth and are, whenever possible, aimed aim at fostering regional economic co-operation.

##### **4.1 Promotion of Micro, Small and Medium-Sized Enterprises and non-oil private sector**

**Background** – Historically, Azerbaijan economy was dominated by a small number of large enterprises producing and exporting predominantly raw materials and semi-finished products. The break-up of the Soviet Union and the armed conflict with Armenia in the first half of the last decade resulted in the collapse of most of these

large enterprises. However, the economic contraction has been partially compensated by the emergence of private small and medium sized enterprises, which are mainly active in trade and services sectors. At the end of 2001, the total number of registered enterprises were approximately 58,600, about 80% of these enterprises were small- and medium-sized. According to the government the share of SMEs contributing to the GDP increased from 24.7% to 42.7% over the last 5 years.

**Activities to date** - To date the Bank provided SMEs with financing via credit lines extended to International Bank of Azerbaijan and Azerdemiryolbank. SMEs also benefit from the Bank's trade facilitation programme, which the Bank offers via International Bank of Azerbaijan. In addition, the Bank supported SMEs through four equity investments, three through the regional AIG Silk Road Fund and through the Bank's Direct Investment Facility. Furthermore a number of SMEs benefited from technical assistance provided under the Bank's TAM programme. Indirectly the Bank supported SMEs through its investments in infrastructure and the banking sector. As mentioned above, the number of bank-able large-scale, private companies operating outside the oil and gas sector and related industries continues to be small and as a result the Bank has yet to finance such a company.

**Operational Priorities** – In order to foster the diversification of Azerbaijan's economy the Bank will continue to promote micro, small and medium-sized enterprises and private sector projects outside the oil and gas sector such as agribusiness, property, shipping and manufacturing companies. In order to achieve this objective the Bank will:

- ensure the successful start-up of the microfinance bank in Azerbaijan;
- ensure the effective utilisation of existing SME credit lines and trade facilities;
- provide SME credit lines and trade facilities to additional local banks;
- develop an innovative loan instrument for medium-sized companies in co-operation with local banks;
- consider additional investments under the Bank's Direct Investment Facility;
- expand the EU-TACIS funded TAM and BAS programmes;
- enhance the policy dialogue with the government on impediments for business start-ups and the development of existing micro, small and medium sized enterprises;
- explore to co-operate with the National Fund for Entrepreneurship;
- actively pursue the financing of viable, environmentally sound, and transparent manufacturing, property, agribusiness and shipping companies mostly alongside foreign strategic investors.

## **4.2 Financial Sector**

**Background** – Despite wide-ranging efforts to strengthen the banking sector (see Section 3.1.4), it remains a major bottleneck for private sector development (see Section 3.2.3) with under-capitalisation, lack of effective competition and a deficient regulatory framework being the most pressing transition challenges.

**Activities to date** – To date the Bank has pursued the development of a sustainable and competitive financial sector by closely co-operating with the National Bank of Azerbaijan and by the provision of financing and technical assistance to local banks.

Under the Bank's USD 20 million Multi-Bank Framework Financing Facility (MBFFF) three loans to local banks have been signed. The utilisation of these credit lines has been improved over the last two years and the quality of the various sub-loans has so far been good. In connection with these credit lines the Bank provided EU-TACIS funded technical assistance to the participating banks with the aim to strengthen their capacity in reviewing credit proposals and ensure the application of the EBRD's environmental due diligence procedures. In addition to the above mentioned SME credit lines, the Bank included the International Bank of Azerbaijan into the Trade Facilitation Programme and invested in the equity capital of the newly established Microfinance Bank of Azerbaijan.

**Operational Priorities** - In order to build the financial sector and therefore enhance the provision of financial services to enterprises. The Bank will pay special attention to competition, decentralisation and variety in the provision of products. In order to achieve these goals the Bank will:

- seek to participate in the privatisation of the International Bank of Azerbaijan and in the medium-term that of the United Universal Bank;
- ensure the successful start-up of the recently created micro-finance bank;
- support the consolidation of private banks, through a potential equity investment in a sound pilot merger and thereby promote the competition within the sector;
- provide additional credit lines and trade facilities to local banks;
- continue capacity strengthening and corporate governance standards of local banks via the provision of technical assistance;
- explore the provision of further environmental due diligence training in connection with the Bank's investments in banks.

### **4.3 Infrastructure**

In order to improve Azerbaijan's infrastructure and therefore create the basis for accelerated private sector and rural development as well as enhanced regional economic co-operation, the Bank will primarily focus its activities on the power, energy and transport sub-sectors outlined in greater detail below. Provided that enabling conditions improve, the Bank will, however, also consider further investments and technical assistance operations in the municipal, environmental and telecommunication sectors.

#### **4.3.1 Power & Energy**

*Background* – Regional electricity distribution companies have been transferred to private operators under long-term management contracts. Power generation and transmission on the other hand continues to be controlled by the state-owned company Azerenerji. Azerenerji's power generating capacity is 23 billion kWh/year and includes nine thermal and five hydro-electric power stations. The restructuring of Azerigas and the eventual privatisation of gas distribution is under consideration. As described in Section 3.2.4 both, the power and domestic gas sectors are in urgent need of modernisation. High level of debts, still relatively low collection rates and low tariff levels undermine the financial viability of Azerenerji and Azerigas.

*Activities to date* - The Bank has provided two sovereign guaranteed loans to

Azerenerji for the rehabilitation of the Yenikend and Mingechaur hydro-power plants. In addition, the Bank has provided technical assistance to Azerenerji, designed to improve the collection practices, to develop financial projections and most recently to identify priority, least cost investments in power generation and transmission.

*Operational Priorities* –Operational priorities for the power and energy sector are to:

- assist the government in implementing its comprehensive energy sector reform programme via selected investments and technical assistance operations;
- improve the efficiency in the sector through the provision of sovereign guaranteed financing for power generation and transmission projects until the necessary conditions for non-sovereign financing have been established;
- explore the financing of renewable power generation projects;
- explore the financing of privatised electricity distribution companies.

#### **4.3.2 Transport**

*Background* – Due to its favourable geographic location Azerbaijan is developing into a major transit country between Central Asia and Europe as well as between Russia and Iran. Azerbaijan’s transport sector comprises of aviation, railways, maritime transport and roads network. As a consequence of lack of investments over the last decade, transport infrastructure is in urgent need of rehabilitation and modernisation.

*Activities to date* - The EBRD has provided three sovereign guaranteed loans and substantial technical assistance to the transport sector. The recipients of these loans were Azerbaijan State Airlines for the modernisation of Azerbaijan’s air navigation systems, Azerbaijan State Railways for the infrastructure improvements along the main line to Georgia and Baku International Sea Port for the reconstruction of the ferry terminal in Baku. All these projects support the transport corridor linking Eastern Europe, the Caucasus and Central Asia (TRACECA) and introduce institutional strengthening and commercialisation initiatives.

*Operational Priorities* – In the Transport sector the Bank will:

- in line with the objectives of the EU-TRACECA (Transport Corridor, Europe-Caucasus-Asia) initiative ensure the implementation of the Baku Port and Trans-Caucasian rail link projects and explore further investments transport infrastructure of regional importance such as road, rail, port and aviation projects;
- emphasising the need to introduce commercial principles and appropriate regulation, including environmental regulation, in transport infrastructure projects during the Bank’s policy dialogue;
- actively pursue the financing of private investments in the transport sector.

#### **4.4 Natural Resources**

**Background** – The oil and gas sector and related industries remain the primary source of economic growth in Azerbaijan. Due to the government’s liberal approach to foreign direct investment into the oil and gas sector and its willingness to provide a stable and internationally recognised framework for the investments in the sector, 21 production-sharing agreements (PSA) with more than 30 international oil companies have been signed. Subject to successful exploration these agreements could lead to investments of more than USD 50 billion. The most significant oil project to date is the development of the Azeri, Chirag and Guneshli fields (the “ACG PSA”). In order to be able to export the oil produced during the full field development of the ACG fields and in order to increase competition among oil export modes from the Caspian Sea area, a consortium of major oil producers in Azerbaijan and Kazakhstan decided to construct a new, major export pipeline from Baku via Tbilisi in Georgia to Ceyhan (“BTC”) on the Turkish Mediterranean coast. This pipeline project has been sanctioned in September 2002 and is scheduled to be completed in 2005.

The second largest discovery to date, has been the Shah Deniz gas / gas condensate field with estimated reserves of more than 1 trillion cubic metres of condensate and gas. Under a long-term gas sales and purchase agreement, Shah Deniz gas is expected to be delivered to Turkey via a newly constructed gas export pipeline starting from 2006.

**Activities to date** - To date the Bank provided long-term financing to seven oil companies operating in Azerbaijan, including five participants in the ACG PSA. The financing of the early phase under the ACG PSA had a considerable demonstration effect as it was the first long-term, syndicated project finance transaction in Azerbaijan. In connection with these projects, the Bank undertook complementary technical assistance operations and ensured their compliance with the Bank’s policies by ensuring that environmental assessments and audits were undertaken, Environmental Action Plans (EAP) prepared and implemented as well as adequate public consultation processes followed.

**Operational Priorities** - With due regard to the environment, corporate governance standards and the transparent management and utilisation of the revenues created by this sector the Bank will:

- consider financing regional oil and gas transportation infrastructure such as the BTC oil export pipeline and major oil and gas upstream projects;
- continue to catalyse commercial co-financing to projects in the sector;
- enhance the co-operation with the state oil company SOCAR and promote its commercialisation through the provision of commercial financing;
- pursue the financing of suppliers to the oil and gas industry;
- ensure the application of international environmental standards and promote public consultation in connection with oil and gas projects;
- finalise the provision of technical assistance for the preparation of Azerbaijan’s national oil spill response plan;
- encourage the continuing transparent management and effective utilisation of the State Oil Fund and seek to co-finance with the State Oil Fund sound public sector infrastructure projects.

## **5. CO-OPERATION WITH OTHER MULTILATERAL AND BILATERAL INSTITUTIONS**

The Bank will seek to co-ordinate and complement its financing activities, technical assistance and policy dialogue, based on its particular strengths and abilities, with those of other IFIs and bilateral institutions. In particular, the Bank will work closely with other multilateral and bilateral institutions in supporting the implementation of the State Programme on Poverty Reduction and Economic Growth, and in this context on energy sector and banking sector reforms, the transparent management and sensible utilisation of revenues generated by the oil and gas sector, and the improvement of the investment climate.

For example, the Bank co-operates closely with the IFC on the financing of the BTC oil export pipeline and the ACG Phase I oil upstream projects. In association with the financing of these large-scale projects, the Bank works together with the IFC on the arrangement of major commercial bank syndicates, the promotion of backward linkages, environmental risk mitigation, the provision of financing and technical assistance to the local supply industry and the improvement of the investment climate facing these local companies.

For more information on the activities of other multilateral and bilateral institutions see Annex 6.

## **ANNEXES**

- Annex 1      The Bank's Operations in Azerbaijan
- Annex 2      Political Assessment in the Context of Article 1 of the Agreement  
Establishing the Bank
- Annex 3      Selected Economic Indicators
- Annex 4      Environmental Condition
- Annex 5      Legal Transition
- Annex 6      Multilateral and Bilateral Assistance



## THE BANK'S OPERATIONS IN AZERBAIJAN (as per 30 September 2002)

### I. ONGOING INVESTMENT OPERATIONS (as per 30 September 2002)

<i>Project</i>	<i>EBRD Commitment in million Euro</i>	<i>Total Project Costs in million Euro</i>
<b>Infrastructure</b>		
Baku Water Rehabilitation Project	23.0	95.7
Yenekind Renewable Energy Project	53.8	75.9
Mingechaur Power Project	21.9	49.2
Trans-Caucasian Rail Link Project	20.4	36.5
Baku Port Development	16.4	22.5
Air Navigation Systems Upgrading	13.9	15.8
<b>Sub-total</b>	<b>149.4</b>	<b>295.6</b>
<b>Oil &amp; Gas</b>		
Chirag Early Oil – Amoco	33.2	605.3
Chirag Early Oil – Lukoil	19.5	356.1
Chirag Early Oil – Turkish Petroleum	13.2	240.0
Chirag Early Oil – UNOCAL	19.6	358.0
Chirag Early Oil – Early Oil Fin. Co.	15.6	284.3
Moncrief	51.1	174.2
<b>Sub-total</b>	<b>152.2</b>	<b>2,017.9</b>
<b>Financial Institutions</b>		
Azerdemiryolbank CL	1.5	1.5
International Bank of Azerbaijan CL	7.7	7.7
International Bank of Azerbaijan TFP	9.6	9.0
Microfinance Bank of Azerbaijan CL	6.3	10.2
<b>Sub-total</b>	<b>25.1</b>	<b>28.4</b>
<b>Property &amp; Tourism</b>		
Silk Road Motel	1.8	5.1
<b>Sub-total</b>	<b>1.8</b>	<b>5.1</b>
<b>Total</b>	<b>328.5</b>	<b>2,347.0</b>

### II. TECHNICAL COOPERATION OPERATIONS UP UNTIL THE END OF SEPTEMBER 2002

<i>Sector</i>	<i>Commitment in Euro million</i>	<i>Number of Operations</i>
Power	1.1	6
Transport	4.3	14
Financial Institutions	4.6	9
Legal Reform	0.2	5
Other	0.4	16
<b>Total</b>	<b>10.6</b>	<b>50</b>

## **POLITICAL ASSESSMENT IN THE CONTEXT OF ARTICLE 1 OF THE AGREEMENT ESTABLISHING THE BANK**

### **Political Assessment**

Azerbaijan is committed to the principles of multi-party democracy, pluralism and market economics as stipulated in Article 1 of the Agreement Establishing the Bank. Azerbaijan's macroeconomic achievements are impressive, although the country is still facing many challenges to its transition process. Over the last two years some progress has been made in democratic transition. The country has a diversified multi-party structure, which includes genuine opposition parties, emerging civil society and a growing network of the NGOs.

The admission of Azerbaijan to the Council of Europe in January 2001 marked an important benchmark in the country's transition towards pluralistic democracy. Membership in the organisation has led to the establishment of an important mechanism allowing monitoring implementation of the democratic commitments undertaken by the country.

The national referendum on constitutional changes in August 2002 was aimed at bringing the country's basic law in line with the European Convention on Human Rights and other commitments undertaken in connection with the membership in the Council of Europe. Although the OSCE did not formally monitor the referendum, the OSCE's local office noted numerous irregularities in the actual conduct of the referendum.

### **Separation of power, electoral process and political parties**

The government structure in Azerbaijan is based on a strong executive branch of power. As in many post-Soviet states, other branches of power - the legislature and the judiciary - are considerably weaker. Executive power is vested in the President of the republic. The incumbent President Heydar Aliyev was re-elected for a five-year term in October 1998 and his current term in office expires in 2003. The 79 year-old President announced his intention to run for the office again in the next year's presidential polls.

The Constitution confers broad powers on the President. He appoints members of the executive at both central and local levels. The President is empowered to settle by decree any other matter that the Constitution does not make the responsibility of the Milli Mejlis (parliament). The President appoints the Prime Minister, subject to approval of the Milli Mejlis and has the right to call referendums.

The country's parliament – one-chamber Milli Mejlis - consists of 125 seats, of which 100 seats were elected by a majority system and 25 through proportional representation on party lists. The last parliamentary elections took place in November 2000. Although they fell short of the OSCE standards, the elections were considered a positive progression from previous elections, in particular enhancing political pluralism. The parliament is becoming a forum for political debate but much needs to

be done to strengthen its independence from the executive.

The first local government elections were held in December 1999 and March 2000 and were viewed by international monitors as a first step towards local democracy.

A national referendum on 24 August 2002 introduced substantial amendments to the Constitution of 1995. The referendum was passed with an overwhelming majority of 96 per cent of the votes in favour of the amendments and had a national turnout of 88 per cent of the registered voters. The changes were designed to bring Azerbaijan in line with practice in other democratic countries.

Some of the amendments were strongly contested by the opposition such as the introduction of a simple majority to replace proportional majority system for parliamentary elections (thus eliminating 'party lists') and the change allowing to cede power to the Prime Minister (instead of the Parliamentary Speaker), who is appointed by the President, in case of the latter's death or incapacitation, for an interim period of three months, pending the holding of new presidential elections.

In a move, which did not contribute towards national cohesion, 27 opposition political parties decided to boycott the referendum. At the same time, the opposition participated in a series of televised round tables, conducted prior to the constitutional referendum with the representatives of the government. These round tables were chaired by the Head of the OSCE local office in Baku.

One of the features in Azerbaijani politics is the emergence and consolidation of a multi-party political system. Unlike many countries in the post-Soviet area, where opposition politics is in the state of constant flux, Azerbaijan saw establishment of several major political parties in the 1990s that remain the main opposition forces to this day. The country's four major opposition parties are Musavat, AMIP (Azerbaijan National Independence Party), the Democratic Party and Azerbaijan Popular Front. Leftist forces, represented mainly by the Social Democrats and the Communists, have little public appeal. The largest party is the ruling Yeni Azerbaijan Party (YAP), representing the government bloc. Genuine dialogue between the ruling party and the opposition, including the opposition groups not-represented in the parliament, is essential for development of pluralistic democracy in Azerbaijan.

### **Rule of law and human rights conditions**

The government's human rights record remains uneven and many problems have been reported. Most of the formal commitments undertaken by Azerbaijan upon accession to the Council of Europe have been honored in particular with regard to ratification of important conventions and legislative reforms. Particularly welcoming recent events were the creation of the Ombudsman Institution and the improved possibilities of access to the Constitutional Court.

The legislation on Ombudsman was adopted at the end of 2001 and in August 2002 the provisions on the institution of Ombudsman were incorporated in the Constitution. The Milli Mejlis appointed the first Ombudsperson of the country in July 2002.

The Constitutional Court was established in 1998 and the authorities co-operated closely with international experts to amend the conditions governing access to the Court. The August 2002 referendum approved amendments, which granted access to the courts of all levels, the newly created Ombudsman Institution and in specific cases to individuals.

The country continued on the path of significant legal reforms concerning the Constitutional Court, advocacy, media, civil and criminal procedure aimed at bringing the Azerbaijani legislation into full compliance with international standards.

The government acknowledges the need to fight widespread corruption and is undertaking measures to reduce corruption and increase transparency in the public administration. Several presidential decrees on fighting corruption have been issued and a draft Law on Combating Corruption passed the first reading in the Milli Mejlis in 2002. The adoption of the law is linked to Azerbaijan's international commitments. At the time of joining the Council of Europe, Azerbaijan has committed to sign and ratify before January 2003 two conventions on combating corruption: the Criminal Law Convention on Corruption and the Civil Law Convention on Corruption.

According to international observers, the expected progress was slow in improving the situation of human rights and fundamental freedoms and implementation of the freedom of expression, association and peaceful meetings as well as strengthening the separation of powers. The ongoing effort of reforming the electoral code and media legislation is aimed at promoting civil and political rights of the citizens. The Council of Europe is urging the Azerbaijani authorities to make further progress on the issue of political prisoners.

### **Nagorno-Karabakh conflict**

The conflict in Nagorno-Karabakh remains unresolved and is a continuing cause of concern for the entire international community on account of its domestic, regional and international consequences. The negotiations concerning the conflict have been under way since 1992, under the aegis of the OSCE Minsk Group, whose three co-chairs are the United States, France and Russia.

No breakthrough has been achieved yet on the settlement of the conflict. The parties – Armenia and Azerbaijan – continue to talk to each other at various levels, including the Presidents of both countries. Many observers believe that it would be unrealistic to expect the final settlement of the conflict prior the two sets of upcoming presidential elections in 2003 – in February in Armenia and in October in Azerbaijan.

In the meantime, nearly one million of Azerbaijani refugees and IDPs (Internally Displaced Persons), continue to live in temporary refugee camps and prefabricated houses. The country's economic, social and political development is hindered by the fact that 20 per cent of Azerbaijani territory, including regions beyond the limits of Nagorno-Karabakh, has been occupied by Armenia for nearly ten years.

**External relations**

Azerbaijan's geo-strategic position requires the country to pursue balanced external relations taking into consideration close proximity to Russia in the North, as well as Iran and Turkey in the South. Azerbaijan is a member of the CIS, although it does not participate in its collective security arrangements. Azerbaijan is also a founding member of the GUUAM (Georgia, Ukraine, Uzbekistan, Azerbaijan and Moldova). The grouping, which has recently lost Uzbekistan as a full member, aims at establishing close economic co-operation among its members along the East-West energy and transportation corridor.

Azerbaijan's relations with Russia are balanced. In October 2002 bilateral relations received an additional impulse during the Azerbaijani President's visit to Moscow. The two sides signed an important agreement on delimitation of the seabed of the Caspian Sea on the basis of the modified median line. Now three out of five littoral states – Russia, Kazakhstan and Azerbaijan – advocate a similar stance vis-à-vis the complex issue of the legal status of the Caspian Sea.

Azerbaijan	Updated 09/2002										
	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
									Estimate	Projection	
<b>Output and expenditure</b>											
GDP	-23.1	-19.7	-11.8	1.3	5.8	10.0	7.4	11.1	9.9	8.8	8.0
Industrial gross output 1/	-19.7	-24.7	-21.4	6.7	0.5	2.2	4.2	6.9	4.7	na	na
Agricultural gross output	-15.4	-13.0	-6.8	3.0	6.1	6.2	7.0	12.1	9.7	na	na
<b>Employment 2/</b>											
Labour force (end-year)	-0.6	-1.4	1.0	2.5	-11.0	0.3	0.1	0.0	0.1	0.2	na
Employment (end year)	-0.2	-2.3	-0.5	2.0	0.2	0.2	0.0	0.0	0.0	0.1	na
Unemployment (end-year)	0.5	0.6	0.7	0.8	1.0	1.1	1.2	1.2	1.2	na	na
<b>Prices and wages</b>											
Consumer prices (annual average)	1129.0	1694.0	412.0	19.7	3.5	-0.8	-8.5	1.8	1.5	2.6	2.5
Consumer prices (end-year)	1294.0	1786.0	85.0	6.5	0.4	-7.6	-0.5	2.2	1.5	1.9	4.1
Producer prices (annual average)	na	na	1734.0	122.7	29.8	0.0	-6.1	27.4	na	na	na
Producer prices (end-year)	na	na	na	87.2	2.2	-21.5	17.9	14.5	-4.4	-5.2	na
Gross average monthly earnings in economy (annual average)	708.3	601.5	307.6	43.1	58.5	18.9	9.5	20.2	15.7	18.5	na
<b>Government sector</b>											
General government balance 3/	-15.3	-12.1	-4.9	-2.1	1.1	-3.9	-4.7	-0.6	1.4	-0.1	0.1
General government expenditure 3/	55.9	45.9	27.2	21.3	20.7	23.9	23.6	20.8	20.1	23.9	na
General government debt	na	25.7	19.6	14.1	13.5	14.9	24.2	25.7	29.4	32.4	na
<b>Monetary sector</b>											
Broad money (M3, end-year)	618.0	1114.6	24.0	18.9	33.6	-17.0	22.2	89.5	-13.4	-8.2	na
Domestic credit (end-year)	460.0	941.0	61.0	33.2	11.1	13.0	-15.2	17.6	-13.5	na	na
Broad money (M3, end-year)	54.9	55.9	12.2	11.3	13.1	10.0	11.1	16.8	12.9	10.6	na
<b>Interest and exchange rates</b>											
Refinance rate (6 months)	na	na	80.0	20.0	12.0	14.0	10.0	10.0	10.0	na	na
Interbank interest rate (3 months) 4/	na	na	na	36.0	22.9	23.2	20.5	22.5	19.8	na	na
Deposit rate 5/	34.0	406.0	90.0	13.0	11.5	10.9	9.9	12.2	12.0	na	na
Lending rate 5/	257.0	406.0	107.0	33.0	21.5	27.7	27.5	27.2	28.1	na	na
Exchange rate (end-year)	256.0	4300.0	4440.0	4098.0	3888.0	3890.0	4378.0	4685.0	4775.0	4985.5	5106.5
Exchange rate (annual average)	120.0	1433.0	4417.0	4300.0	3983.0	3869.0	4120.0	4472.0	4656.6	4884.9	5050.8
<b>External sector</b>											
Current account	-160	-123	-318	-821	-915	-1,364	-600	-168	-51	-1,365	-2,209
Trade balance	-122	-163	-275	-549	-567	-1,046	-408	-319	614	-462	-860
Merchandise exports	697	682	680	789	808	678	1,025	1,858	2,079	1,593	1,753
Merchandise imports	819	845	955	1,338	1,375	1,724	1,433	1,539	1,465	2,055	2,613
Foreign direct investment, net	0	22	330	627	1,115	1,023	510	119	227	1,300	2,300
Gross reserves (end-year), excluding gold 6/	0	2	119	214	467	447	673	680	897	717	na
External debt/stock	52	239	425	521	602	717	1,034	1,259	1,402	1,632	na
Gross reserves (end-year), excluding gold 6/	na	0.0	1.1	1.5	2.7	2.2	4.2	4.0	5.1	2.8	na
Debt service	na	0.4	5.2	7.4	7.3	4.7	4.8	4.5	5.7	7.3	na
<b>Memorandum items</b>											
Population (end-year, millions)	7.5	7.6	7.7	7.8	7.9	8.0	8.0	8.1	8.1	8.2	na
GDP (in millions of manats)	157,082	1,873,400	10,669,000	13,663,200	15,791,400	17,203,000	18,875,000	23,591,000	26,619,000	29,703,121	32,892,332
GDP per capita (in US dollars) 7/	173	171	313	407	503	559	572	653	706	742	na
Share of industry in GDP (in per cent)	24.9	20.4	27.3	25.8	25.2	22.0	28.2	32.0	0.2	na	na
Share of agriculture in GDP (in per cent)	26.9	32.2	25.1	24.7	20.0	17.9	18.4	18.1	0.1	na	na
Current account/GDP (in per cent)	-12.2	-9.4	-13.2	-25.8	-23.1	-30.7	-13.1	-3.2	-0.9	-22.4	-33.9
External Debt - Reserves, in US\$ millions	52	237	306	307	361	270	361	579	505	na	na
External Debt/GDP (in per cent)	4.0	18.3	17.6	16.4	15.2	16.1	22.6	23.9	24.5	26.8	na
External Debt/Exports of goods and services (in per cent)	6.3	29.2	49.9	55.5	52.3	71.0	80.7	59.4	59.2	na	na

Note: Data for 1992-99 represent official estimates of outflows as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, and the OECD. Data for 2000-2001 reflect EBRD evaluations, partly based on information from these sources.

- 1/ Industrial output excludes crude oil production.
- 2/ Employment and labour force estimates differ from official statistics. Labour force data is corrected for the working age population outside the labour force. Unemployment is based on survey data. Less than 5% of all unemployed are registered.
- 3/ General government consolidates all levels of government except for municipalities and SOEs, and includes the Oil Fund and other extrabudgetary funds.
- 4/ 90 days interbank offer rate in manats, nominal.
- 5/ 1993-1995: minimum rate for household time deposits, minimum lending rate for private enterprises respectively. From 1996, 3 month deposit and lending rates to "bank-clients".
- 6/ By mid-August 2002, there were additional foreign exchange assets of around USD 600 million in the account of the State Oil Fund.
- 7/ GDP per capita figures for 1992-1993 are estimated from the IMF. The Manat became official legal tender only in January 1994. An improved method of calculating value-added in the oil sector has led to a sharp upward revision in n

## ENVIRONMENTAL CONDITION

### 1. Environmental problems identified by the National Environmental Action Plan

The main environmental problems identified by the National Environmental Action Plan of Azerbaijan and requiring urgent actions include:

- Industrial pollution resulting mainly from oil exploration and production as well as energy generation activities. The use of outdated technology, lack of maintenance and of the pollution abatement equipment and low quality raw materials continue to generate high pollution emissions and waste.
- Poor water quality, especially of drinking water, both in rural and urban areas, causing increase of water born diseases. Piped drinking water supply is available to less than 50 percent of the population. Shortage of water resources is further aggravated by losses during distribution in agricultural sector, which accounts for the 70 percent of the total water usage.
- Degradation of fertile agricultural land caused by erosion, salinisation, pollution with heavy metals and chemicals, and deteriorating irrigation systems; loss of forestry cover, mainly in war-affected areas; and threats to protected areas leading to losses in biodiversity;
- Damage to the Caspian coastal zone caused by flooding from sea level rise and pollution. A total of 807 km<sup>2</sup> of land has been flooded. These damages imply substantial social, environmental and economic costs.
- Natural deterioration of the cultural heritage further aggravated by environmental problems such as acid rain and uncontrolled development. Taking into account the current shortage of funds in the country, this programme must be integrated into the framework of on-going economic development and conservation management plans.
- Threat of irreversible reduction and extinction of the sturgeon species triggered by loss of reproductive capacity, oil pollution, and overfishing.

### 2. EBRD's environmental approach

Given the Bank's significant involvement in the oil and gas and the transport infrastructure sectors in Azerbaijan and the Caspian Sector in general, and the environmental implications of the industrial activities funded by the Bank, it takes a strategic approach towards addressing existing and potential concerns triggered by the development of extensive industrial projects. EBRD closely co-ordinates its efforts with other International Financing Organisations working in Azerbaijan and aims to fostering the application of high environmental standards, encouraging its Clients to developing biodiversity and cultural heritage conservation strategies and bringing about positive socio-economic developments within the framework of the Bank's funded projects.

One of the EBRD environmental initiatives is the development of the Azerbaijan National Oil Spill Plan, which has been proposed in view of increasing petroleum development and shipping activities in Azerbaijan. Such a plan will contain provisions for regulating oil spills and waste discharges in the Caspian Sea, identify

available oil spill combat resources and appropriate response strategies and outline response and notification procedures in line with relevant international conventions (MARPOL 73/78, OPRC 90). EBRD is currently mobilising donor funds to fund the development of Azerbaijan's National Oil Spill Contingency Plan.

In order to improve the co-operation, transparency and communication between the Caspian littoral states on addressing transboundary environmental concerns in the Caspian Region, EBRD would further encourage the government of Azerbaijan to develop mechanisms for implementation of the ESPOO convention. EBRD outlined an approach at a UNEP/UNECE legal workshop for the Caspian littoral states in December 2001, following a request by the government of Azerbaijan and by clients. In Q4 2002, UNEP/UNECE will hold a working meeting in Moscow for the littoral states to agree mechanisms for implementation of Espoo requirements.

EBRD is communicating with oil companies to involve the private sector viewpoint in these discussions. EBRD would also continue to support the application of international environmental standards for its investment projects in Azerbaijan as well as foster community development programmes aimed at improving environmental, health and living conditions of the local population affected by investment projects funded by EBRD (e.g. modernisation/ improvement of sewage system in Sangachal).

The Bank will continue to ensure that all EBRD operations in Azerbaijan are run according to the Bank's Environmental Procedures and incorporate, where appropriate, Environmental Action Plans into the legal documentation in order to address issues raised during due diligence, in line with the Bank's mandate to actively support environmentally sound and suitable development through its investment projects

### **3. Projects with significant environmental benefits by other IFIs**

Among other institutions, the World Bank is currently implementing the following projects:

**Urgent Environmental Investment programme.** The objectives of the project are: (1) restoring the capacity of Azerbaijan to produce sturgeon fry by building a new hatchery; (2) demonstrating mercury clean-up technologies and procedures by cleaning up one area heavily polluted by mercury; (3) testing and demonstrating onshore oil field clean-up methodologies by cleaning up one oil field in the Absheron peninsula; and (4) strengthening the institutional and regulatory capacity of the Azeri environmental management system. The project would provide a sound basis for follow-on or supplement environmental projects.

**Irrigation and Drainage Infrastructure Project.** The objectives of the project are to sustain and possibly increase current agricultural production in the project areas through improvements in water supply and drainage in the service areas. This would be achieved through improvement in irrigation supplies and services and the reduction in water logging and salinity. The project would carry out least-cost rehabilitation of priority irrigation components of the Samur-Absheron Canal System and completion of the final link in the Mill-Mugan Collector Drain. It would also take the first steps



towards institutional reform of the State Amelioration and Irrigation Committee (SAIC) and the District Irrigation Exploitation Units.

**Gas System Rehabilitation Project.** The principal objectives of the project are (1) promoting more efficient use of gas and reduce non-technical losses by replacing obsolete and inaccurate metering, improving measurement instrumentation, installing meters where none presently exist, and establishing associated meter proving facilities; (2) improving the physical accounting for gas and encourage an improved commercial basis for gas trading through the upgrading of metering and instrumentation; (3) ensuring the efficient operation and preserving the value of the existing pipeline assets through investments in cathodic protection, gas analysis and leak detection equipment; and 4) supporting the commercialisation of Azerigas and further development of the sector through technical assistance and training programmes.

**Agricultural Development and Credit programme.** The objective of the programme is to improve incomes and agricultural productivity in rural Azerbaijan through interventions aimed at the development of a well-functioning land market, sustainable agricultural support services, a viable rural financial system for small rural enterprises, and a rural policy analysis and strategy formulation capacity. The project will make an important contribution to putting agriculture onto a sustainable basis through

- (1) helping farmers to adjust to cropping patterns and technologies which are profitable in the new market environment;
- (2) creating a source of assistance to farmers which is designed to be handled primarily by the private sector in the longer term
- (3) developing sustainable policies and forms of support for the rural sector during and beyond the oil boom years.

Ongoing EU TACIS projects include:

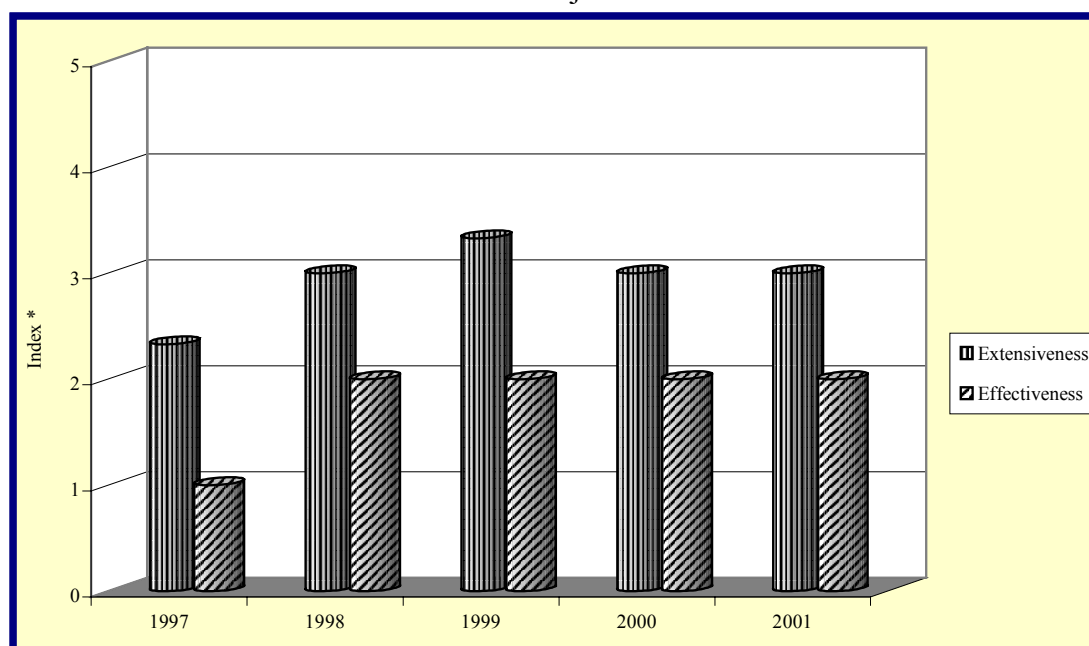
- Caspian Environment Programme (CEP): joint effort of TACIS, GEF, UNDP, ENEP to promote ecologically sustainable management of the Caspian environment (framework convention, data collection, institutional strengthening, pilot projects)
- Widening of the environmental action programme (WEAP): support to Governmental Organisations and NGOs in project preparation and implementation, preparing investments
- Tacis environmental awareness raising programme (TEAP): raising awareness in NIS by supporting the work of environmental NGOs, journalists and parliamentarians
- Regional Environmental Centre for the Caucasus: establishing a forum for environmental stakeholders with a grants programme for the Caucasus, based in Tbilisi, Georgia.

## LEGAL TRANSITION

### COMPARATIVE ASSESSMENT OF AZERBAIJAN'S COMMERCIAL LAW

#### I. Assessment Over Time

##### Extensiveness and Effectiveness of Azerbaijan's Commercial Laws<sup>3</sup>



*Source:* OGC Legal Indicator Surveys; 1997 - 2001

*\*Note:* Indicators along the y axis range from 1 (little progress) to 5 (substantial progress)

While Azerbaijan's commercial laws have been gradually improving over the past three years, they still fall short of standards that are generally acceptable internationally. Azerbaijan's commercial legal rules that affect commercial transactions, such as debt restructuring and formation of joint-stock companies, fare reasonably well compared with more developed countries. However, those legal rules are not as clear and accessible nor as adequately implemented administratively and judicially as would be the case in more developed countries. Annual EBRD Legal Indicator Surveys over the past several years confirm that lawyers familiar with Azerbaijan's commercial laws share this view.

There is a large gap between laws on the statute books and their implementation. The existence of the gap is attributable to weaknesses in the legal system generally, in

<sup>3</sup> The EBRD conducts a Legal Indicator Survey each year to measure the progress in legal reform in Central and Eastern Europe, the Baltic States and the Commonwealth of Independent States, as viewed by local lawyers and academics. The results of such survey are based on responses to the questionnaire sent out to lawyers practising in any given country. The survey represents their perception of the country's legal system and, in particular, the degree to which key commercial and financial laws have reached internationally acceptable standards (extensiveness) and to what extent these laws are implemented and enforced (effectiveness).

particular the problems associated with the courts and difficulties in entrenching adequate respect for the rule of law. The gap suggests that more attention and resources need to be directed towards building effective institutions to build commercial laws.

## II. Comparison with Other Transition Countries

Legal Indicator Survey – Commercial Laws				
<u>Good:</u>	<u>Reasonably</u>	<u>Adequate:</u>	<u>Inadequate:</u>	<u>Detrimental:</u>
None	<u>Good:</u> Bulgaria Croatia Estonia FYR Macedonia Hungary Kazakhstan Latvia Lithuania Moldova Romania Slovenia	<b>Azerbaijan</b> Belarus Czech Republic FR Yugoslavia Georgia Poland Russian Federation Slovak Republic Ukraine Uzbekistan	Albania Armenia Bosnia & Herzegovina Tajikistan Turkmenistan	None

*Source:* OGC Legal Indicator Survey, 2001

*Note:* No country received a rating of "very good"

Although Azerbaijan's normative laws do not yet approximate international standards and the country lacks adequate institutional support to implement these laws, Azerbaijan overall compares reasonably well with other transition countries. Based on the 2001 EBRD Legal Indicator Survey, which measured the perception of lawyers familiar with Azerbaijan law, the commercial laws of Azerbaijan can be characterised as adequate for supporting investment and other commercial activity.

Compared with other countries in the Caucasus, Azerbaijan's commercial law is perceived by lawyers in the field as broadly on a par with that of Georgia and better than that of Armenia. The commercial law of Azerbaijan ranks as being among the best in the CIS countries, although poorer than the commercial laws of some of the more advanced transition countries of central Europe (and even those do not have laws that can be characterised as meeting international standards).

### LEGAL SECTOR ASSESSMENT

#### **Bankruptcy**

Azerbaijan's bankruptcy and insolvency procedures are perceived as encouraging the liquidation of the insolvent company's assets and distribution of the proceeds from such liquidation to its creditors, rather than rescuing the debtor company. Even if procedures provide for the rehabilitation and reorganization of an insolvent company, the introductory statutory requirements of rehabilitation or reorganisation are very burdensome on the debtor. Also, the law does not provide for statutory priorities to

lenders involved in the financing of a debtor during its rehabilitation and reorganisation.

The Law on Insolvency and Bankruptcy (the “Bankruptcy law”) which regulates bankruptcy, favors creditors in particular because it:

- gives priority to the satisfaction of their claims from the debtor’s assets existing at the time of the debtor’s bankruptcy;
- provides them with the right to control and manage the debtor’s assets through the bankruptcy trustee; and
- requires their unanimous approval for any formal or informal rescue plan.

The satisfaction of creditor’s claims is, however, within the limits of the debtor’s assets remaining after all secured creditors claims are paid.

The debtor’s equity owners and employees cannot veto the debtor’ bankruptcy proceedings. While the debtor’s equity owners may participate in the debtor’s rehabilitation process by providing necessary financing to the debtor, they have no management rights over the debtor.

Secured creditors may sometimes encounter problems in enforcing their security interest. For instance, it is difficult to pledge a debtor’s participatory interest in a limited liability company or to pledge the bank account, as the mechanism for these pledges is not clearly established under Azerbaijan law. The pledge of shares in a joint stock company, however, is relatively straightforward.

### **Capital Markets**

The primary law governing Azerbaijan’s securities market is the Law on Securities, which came into force on 14 July 1998. This law lays down the legislative framework for the issuance, and secondary market for trading, of securities. The principal market regulator is the State Committee for Securities of Azerbaijan (the "ASCS"). The ASCS was created according to the Decree of the President of the Republic of Azerbaijan of 30 December 1998, No 58. The ASCS carries out State policy, State control and State regulation of the activities on securities, including the sphere of formation and development of securities market, control over activities of the related organs of executive authorities and co-ordination of their activities, control over activities of professional members of securities market, protecting the rights and legal interests of investors, shareholders and other holders of securities. In addition, the Parliament of Azerbaijan approved a new piece of legislation “On the Protection of Rights and Interests of Investors in the Securities Market” in June 2000. The law provides for penalties for traders who violate stock market laws, although it does not actually stipulate the fines. The law also allows investors to form organisations to protect their interests. Assisted by the Bank through a legal technical assistance project funded by the UK, the ASCS has prepared a bill to amend the Law on Securities, which is now pending for adoption by the government.

The Baku Stock Exchange (the "BSE") officially opened in July 2000 and was founded by Azerbaijani investment and financial institutions in addition to some Turkish banks and investment companies. The BSE operates a two-tier system of listing. To be listed on the upper tier, a firm must have been in operation for at least

three years, with minimum annual profits of USD 112,000 and have a minimum of five hundred shareholders. A listed company must file financial and cash flow statements certified by international or approved Azerbaijani accountants on a quarterly and annual basis. Requirements for being listed on the second tier are less strict. The BSE became a member of the Federation of Euro-Asian Stock Exchanges in November 2001. Despite these developments, the breadth and depth of the current Azerbaijani capital markets in general remains limited. Trading at the BSE currently remains concentrated on treasury bills.

The government of Azerbaijan has undertaken an insurance reform programme, which includes initiatives to tighten the regulatory system and to strengthen the sector by raising levels of capitalisation and reserves and to develop a life insurance sector. A capital increase schedule was adopted for insurance companies in 2001. Existing insurers are required to increase their charter funds to at least 500,000,000 Manats by 1 January 2002, and, subsequently, in stages, to 2,000,000,000 Manats by 1 January 2004. Newly established insurance and re-insurance companies are required to have an initial charter fund of at least 2,000,000,000 and 5,000,000,000 Manats respectively. In addition, the Banking Law allows banks to engage in leasing activities and places no limits on the participation of banks or of foreign ownership in leasing companies. While the Law on Leasing Services was enacted in late 1994, it does not address all the concerns of parties to financial leasing transactions. The Law on Pensions enacted in 1992 was last amended in 1997. The pension system has been suffering financial difficulties over the past few years leading to a net deficit. The World Bank is assisting Azerbaijan with a project to reform the pension system and its administrative structure.

### **Concessions Legal Framework**

Azerbaijan does not have a general framework Concessions Act. Instead, the country takes a sector-by-sector approach in regulating concession policy. According to the 1998 Law on the Subsoil, licenses for exploration or mining of natural resources can be granted by an executive agency, on the basis of tender offers, auctions, or direct negotiations in special circumstances. The law aims to insure all applicants have an equal chance to obtain a mining license. The maximum term for a license is twenty-five years, extended to thirty if exploration is also involved. The fee and tax structure laid out in the law is overly complex, with fees established for granting a license, in addition to fees for participation in the tender, a special “mountain tax”, general taxes as well as contributions to a national fund for further exploration for extractable resources. Disputes arising under the law can be resolved by the executive agency, as well as in the courts. However, it may be difficult for investors to recoup losses caused by governmental mismanagement or wrongdoing, even following a victory in the courts, because damages are to be covered from the personal assets of individual transgressors.

The 1999 Law on Power Stations allows private entities, both domestic and foreign, to build, renovate and operate power stations on the basis of special permission from the government. Permission to build a new plant is to be granted if the prospective operator can show a need for energy and also demonstrate that the projected output will be cheaper than that of existing sources. Permission also must be obtained for any changes in the regime of operation of a power station; however, stations operating on

renewable resources are exempt and subject to a more favourable and subsidised regime. Similar assistance is available for operators of plants deemed particularly important for national needs. The issue of eventual ownership of the plants remains unclear in the law.

The general tender procedure is regulated by the 1997 Law on Tenders, which was amended in 1999. Tenders are conducted by special tender committees. Tenders are usually open, but can be conducted as closed on the basis of invitations if the number of potential bidders is limited and known, state security is involved, or more vaguely, if funds for the tender are so earmarked. Participants who feel that the committee behaved illegally in its selection can appeal its decision in the courts.

The 1992 Law On Protection of Foreign Investments governs firms with over 30% foreign ownership. Such firms must maintain a reserve fund of 25% of its original start-up value, to guarantee their continued viability. Theoretically, foreign investors are protected from the unfavourable impact of newly passed laws for ten years; however, numerous exceptions such as those for laws passed for the protection of morality, health, national defence, public order, the environment, credits and finances and tax laws make this protection at least questionable. Foreigners are allowed to use their property and contracts in Azerbaijan, which presumably includes concessions, as security for obtaining financing. All concessions contracts to be signed with foreigners are to be made by the Cabinet of Ministers and approved by the Supreme Council. Arbitration, including in international courts, is available if it is specifically agreed upon in the contracts in question. The EBRD has sponsored a new law in the area of foreign investment protection, but it has not yet been adopted by the government.

In addition, Azerbaijan is currently developing a law on the oil and gas sector. This sector is currently governed by the general laws mentioned above as well as individual Production Sharing Agreements that have the force of legal acts upon ratification. The lack of a consistent legal framework for non-PSA concessions weakens the effect of the otherwise quite well written and environmentally progressive individual laws.

### **Corporate Governance**

The existing Law on Joint Stock Companies (the "JSC Law") was promulgated in July 1995, with amendments enacted in 1995, 1996 and 1999. While the JSC Law has covered several fundamental issues relating to the operations of joint stock companies, it is inadequate in many key issues concerning corporate governance. For example, the law lacks clear provisions governing the basic duties of directors and the standards for exercising their functions, etc. The provisions for protecting the rights of minority shareholders are insufficient. In addition, transparency and disclosure requirements are problematic under the JSC Law, thereby making the law inadequate in protecting the company against self-dealing and conflict of interest issues.

In order to address the above issues, the ASCS has prepared a bill to amend the Law on JSC, which is now pending for adoption by the government. In preparing the bill, the ASCS was assisted by the Bank through a legal technical assistance project funded by the UK.

## Secured Transactions

Security rights over movable and immovable assets in Azerbaijan are governed primarily by the 1999 Civil Code, which entered into force on 1 September 2001. The Civil Code has not repealed the Pledge Law of 19 August 1998 that in principle may still be applicable to the extent it does not contradict the Civil Code. However, it is difficult to reconcile both texts, as their respective approaches (especially on registration) are very different.

The Civil Code draws a fundamental distinction between pledges and mortgages, with only a few provisions applicable to both. Pledges can be of various natures. With the charged assets being given in possession to the pledgee (pawn) or not (pledge of goods in circulation), they cover tangible or intangible assets (pledges of rights). The main point is that pledges are mostly not registered. On the other hand, mortgages must by definition be registered in the relevant official registry. For movable assets, the law makes reference to the "movable property official register" but it is unclear whether this would involve the creation of a new registry for all sorts of movable assets or whether this registry refers to existing asset-based registries, such as the motor vehicles registry, ship registry, etc..

In contrast, the Pledge Law envisages a much more general mode of registration for all types of "mortgages" (including an enterprise mortgage), a pledge being defined as a security in which possession of the asset is transferred to the creditor. It should be noted that in 1996, EBRD provided technical assistance on secured transactions reform at the request of the Office of the President of Azerbaijan and provided comments on the existing Azerbaijan Pledge Law and amendments proposed by the National Bank of Azerbaijan.<sup>4</sup> There is report of attempts by the Ministry of Justice to create a unified, centralised, register for mortgages over movable assets but such register has not been developed.<sup>5</sup>

Beyond the question of registration, the relevant provisions of the Civil Code as well as the Pledge Law give rise to numerous areas of potential conflict, and some questions previously clear under the Pledge Law are now much more uncertain. For example, the possibility to take a mortgage over the whole or part of a business/enterprise; the possibility to charge assets that would be generally described in the charging agreement; the possibility for the chargor to sell some of the charged assets in the ordinary course of business with the acquirer acquiring them free from the charge (essential if a charge is taken over the whole enterprise); the possibility for

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<sup>4</sup> The NBA prepared a new draft pledge law based on the EBRD Model Law on Secured Transactions, but this law was never enacted as such. The 1994 Pledge law was finally revised in 1998. The commitment was closed when it became apparent that the ultimate objective of revising the Civil Code was not going to be reached. Yet, the Model Law was largely publicised in the country and the new Law on Pledge introduced some of the features promoted by the Bank.

<sup>5</sup> Information was received that on 4 July 2001, a Presidential decree was signed setting out the different authorities that must register mortgages or pledges, depending on the nature of the asset. Those authorities are reported to be:

- The State Securities' Committee in respect of securities;
- The Ministry of Economic Development in respect of the mortgage (pledge) of State property;
- The Ministry of Justice in respect of immovable property, irrespective of the identify of the owner;
- Other executive authorities in respect of property to be registered.

The actual meaning of this decree and its practical consequences are not clear.

the chargeholder in case of default of the chargor to take possession of the charged assets.

### **Telecommunications**

The telecommunications sector in Azerbaijan is currently governed by the Telecommunications Law of 1997 (the “1997 Law”) and is regulated by the Ministry of Telecommunications (the “MT”). The MT is the regulator for the whole industry and combines the roles of policy-maker and dominant player, acting as state network operator.

The 1997 Law adopts an outdated approach to telecommunication regulation and appears to include vague references to the possibility of introducing some competition, vests the ‘executive authority’ with far reaching powers to take any kind of decision affecting the sector. The law fails to give any policy guidelines to this authority or indicate how this authority is to be established. Under the 1997 Law, it is within the exclusive power of this authority to introduce competition, to award licences, to impose obligations on the various operators etc.. All types of operations and service provision are subject to licensing by the MT. This also applies to Internet service providers, who must agree to pay a share of their revenue to the MT in order to obtain permission to operate. Licensing is governed by non-telecommunications legislation, mostly presidential decrees. No significant changes to this body of legislation and regulation are expected in the foreseeable future.

The MT owns the public telecommunications network (“PSTN”) and operates on a regional and national basis through a number of components. The network comprises Baku City Network, three regional enterprises providing local services and Aztelekom servicing long-distance communications. The MT currently keeps a tight control over the sector by means of a rule that any telecommunications venture must be at least 50% owned by the MT. This rule, together with the MT’s role as operator, regulator and policy-maker makes the playing field considerably unequal and creates significant conflicts of interest that have been a blight on competition for several years. The government of Azerbaijan has indicated, on a number of occasions, that it plans to reduce the MT’s hold on network operation through the privatisation of some of its operating sections, however, little activity of substance appears to be taking place in this regard.

There is some limited competition in the mobile sector and an alternative fixed line operator has been licensed. However, both the quality of telecommunication services provided in the country and the penetration of telecommunications within the population remains one of the lowest in the region. Despite the high level of demand, progress has been limited. While the MT is expanding the ‘telephonisation’ of villages and the development of automatic telephone stations in rural areas, universal service obligations do not appear to be a regulatory issue, despite the insufficiencies of the PSTN and the complete telecom isolation of some settlements.

The government has so far largely failed to facilitate the liberalisation of telecommunications with an appropriate regulatory framework. Despite the entrance of a number of alternative operators on the market, competition has been limited due to the MT's control over infrastructure and tendency to levy high interconnection fees.



In practice, the fundamental absence of an independent regulator hinders the opening-up of the telecommunications sector. This failure and the government's wavering commitment to privatisation has stymied sector growth and significantly retarded the development of Azerbaijan's telecommunications industry to date.

## OTHER MULTILATERAL AND BILATERAL ASSISTANCE

### I. MAJOR MULTILATERAL ASSISTANCE

#### **International Monetary Fund**

On 5 July 2001 the Executive Board of the IMF approved a three-year loan of SDR 80.5 million (about USD100 million) under the Poverty Reduction and Growth Facility (PRGF) to support the government's economic programme and effort to alleviate poverty. This programme has three main objectives: maintenance of macroeconomic stability, improvement of governance, and growth of the non-oil related sectors of the economy. To date the government has been on track with the implementation of the programme. As a result of the programme the Government has finalised a Poverty Reduction Strategy and progressed with reforms in the areas of customs, tax administration, financial sector, the establishment and management of the oil fund, energy sector, governance, fiscal policy and trade policy. Major outstanding issues for successful conclusion of the second review under the programme are related to the adjustment domestic energy prices, the preparation of an Oil Fund law and progress in the privatisation of International Bank of Azerbaijan.

#### **World Bank Group**

The Azerbaijan Republic became a member of the World Bank in September 1992 and the International Development Association (IDA) in March 1995. Azerbaijan joined the Multilateral Investment Guarantee Agency (MIGA) and the International Finance Corporation (IFC) in 1992 and 1995, respectively.

The major focus of the World Bank's work to date has been to assist Azerbaijan by providing policy advice, financing for both investments and the government budget, and co-ordination of aid. In particular, the World Bank is working with the authorities to strengthen the government's institutional capacity to manage its petroleum resources and formulate key policy changes to accelerate reform. In fiscal year 2000, the Irrigation and Drainage Infrastructure Project (USD42 million) was approved to prevent the decline in water supplied to Baku; eliminate further deterioration of the supply of irrigation water along the Samur-Apsheron Canal; and improve drainage and reduce water logging and salinity in irrigation areas along the Main Mill-Mugan Collector. In June 2001 three projects were approved: the Health Reform Project (USD5 million) aimed to test ways to strengthen and reform district primary health care systems; the Financial Sector Technical Assistance Project (USD5.4 million) to provide advisory services to the government of Azerbaijan in support of further implementation of its financial sector development strategy; the Highway project (USD 40 million) to help promote economic growth by improving access and lowering transport costs for goods and passenger traffic on the East-West highway between Ganja and the town of Gazakh, and to improve the quality of transport services for poor people in the vicinity of the road as well as other road users by improving the organisation, efficiency, and maintenance practices of the road organisation Azeravtoyol.

On 12 March 2002 the World Bank approved the Second Structural Adjustment

Credit (SAC-II) to Azerbaijan Republic in the amount of USD 60 million. SAC-II supports important components of the government's structural reform programme that are intended to enhance public sector efficiency; and accelerate non-oil sector growth: in particular, (a) public sector reforms to strengthen policies and institutions for public expenditure management, poverty monitoring, social services and safety nets through better targeting and special initiatives for refugees and IDPs; and (b) accelerated and more broad-based development of the non-oil sector through continuous diagnosis and improvement of the business environment, and improved financial discipline and service delivery in the utility sectors. Finally, on 19 June 2002 the World Bank approved the Second Institutional Building Technical Assistance (IBTA-II) to Azerbaijan Republic in the amount of USD 9.45 million. IBTA II is intended to provide technical assistance to support the policy measures to be implemented under the Second Structural Adjustment Credit (USD 60.0m). In line with objectives of SAC-II, the IBTA-II is prepared with the twin goals of providing assistance in the design and implementation of the government's reform programme, and of helping to build up the institutional capacity and skills to carry out these programmes. The Credit is divided into the following components: (i) to enhance accountability in public financial management; (ii) to strengthen public expenditure management capacities, including the implementation of a fully functional, automated Treasury system; (iii) to reform social expenditures; and (iv) to promote privatisation and private sector development; (v) financing the Project Implementation Unit (PIU) to support the implementation of this Credit.

The International Finance Corporation's strategy in Azerbaijan focuses on strengthening of financial sector through promotion of domestic and foreign competition, establishment of joint venture in non-bank financial sector and provision of technical assistance to private local banks; promoting micro-enterprise and SME development; supporting investment in agricultural and industrial sectors; channeling FDI in non-oil sectors and supporting the investment in the oil and gas related sectors. Funding has been approved for 9 projects, including the recently established microfinance bank in co-operation with the EBRD, representing a total value of IFC investment of USD 134.6 million.

## **UNDP**

The United Nations Development Programme (UNDP) has been represented in Azerbaijan since 1993. As per today the UNDP has implemented more than 60 programmes and projects worth more than USD 31 million. Initially it focused its operations on post conflict assistance, emergency relief and reconstruction. In association with the World Bank and UNHCR, UNDP helped establish the Azerbaijan Reconstruction and Rehabilitation Agency, responsible for co-ordinating initiatives in war stricken areas, supporting temporary resettlement for the million displaced and refugees and funding income generation activities for the vulnerable population. UNDP also assumed a leading role in the establishment of a National mine action programme contributing to the creation of Azerbaijan National Agency for Mine Action (ANAMA). Today, the main objectives of the UNDP's activities in Azerbaijan are to contribute to the eradication of poverty, the consolidation of respect for individual rights, the protection of natural resources, to assist the country in becoming a modern democracy through national level reforms with a special focus on democratic governance in line with the principles of the United Nations Charter.

### **Asian Development Bank (ADB)**

Azerbaijan joined the Asian Development Bank in December 1999 and the Liaison office was established in early 2002. ADB's activities in Azerbaijan are largely concentrated on the development of the social sector in view of urgent need to assist growing numbers of poor people, especially internally displaced persons. This is the major underlying concern in the interim operational strategy, the goal of which is reducing poverty and raising living standards in Azerbaijan by enhancing human development, supporting good governance and institutional strengthening, and promoting sustainable growth. ADB has a two-pronged assistance strategy in Azerbaijan: helping the government improve the delivery of essential public goods and services to those in greatest need, and helping strengthen the environment for competitive private investment and job creation. ADB's policy-driven operations will have special emphasis on good governance and strengthening institutions.

No loans have been approved up to date. ADB's lending programme in Azerbaijan is somewhat constrained by the government's reluctance to borrow on OCR terms, so the interim pipeline is limited to USD 25 million per annum on ADF concessional terms. Eight technical assistance grants totalling USD6 million were approved in 2001-2002. The technical assistance will provide training in ADB policies and procedures, support macroeconomic policy development, facilitate development of a national programme for poverty reduction, help integration of internally displaced people, and prepare ADB's first loan project in Azerbaijan on urban water supply and sanitation. Azerbaijan also joined Central Asia regional economic co-operation programme for in March 2002 that is concentrated in three main areas: energy, transport and trade.

### **Islamic Development Bank (IsDB)**

Azerbaijan joined IsDB in 1992. IsDB's activities have been targeted at improving agriculture development through reconstruction of canal and drainage systems, power generation and construction of a major road. The Bank has financed technical assistance operations in designing infrastructure and agro-industries. IsDB's investments included the co-financing of the EBRD's Mingechar Power Project by issuing a USD 12.5 million loan for retooling the Mingechar Hydro Power Plant and construction of 110 kV voltage transmission line as well as a new substation. In addition, IsDB allocated a loan for the rehabilitation of the Road Alet-Kazimagomed in the amount of USD 38 million; USD10 million loan for the rehabilitation of agricultural lands; USD10 million loan for reconstruction of Samur-Absheron irrigation network and for the construction of the Mil-Mugan Water Collector Canal (IsDB's portion USD 0.9 million). IsDB also participates in providing grants for refugees (USD 1.5 million) and is financing preparation of feasibility studies for investment projects in public and private sector (total USD1.2 million).

### **Black Sea Trade and Development Bank (BSTDB)**

Azerbaijan became a member of BSTDB in 1997. To date its activities in Azerbaijan consisted the provision of trade finance to International Bank of Azerbaijan and of an equity investment in the newly created Microfinance Bank of Azerbaijan alongside the EBRD. Main objectives of BSTDB activities in Azerbaijan are to promote co-operation impact among member countries (inter-regional projects); development of

non-oil sectors; development of projects that would have significant impact for the country like power projects, manufacturing, agribusiness, food processing.

### **European Union**

To date, the EC has allocated to Azerbaijan a total of €369 million of grant-based assistance under the TACIS, ECHO, Food Security, FEOGA, Exceptional Assistance, Rehabilitation and Exceptional Humanitarian Aid programmes. The general objective under the TACIS programme in Azerbaijan is to assist in the transition to a market economy and pluralist democracy based on human rights with specific initiatives for institutional, legal and administrative reform and private sector development. The indicative budget of TACIS for the upcoming three years is €28 million and is targeting areas such as private sector development, pension reform, ecology, social assistance reforms, reform of the public administration.

## **II. MAJOR BILATERAL ASSISTANCE**

### **Japan**

Japan's bilateral assistance (Official Development Assistance/ODA) to Azerbaijan has increased sharply in recent years and reached USD36.4 million in 2000. The aggregate total assistance stood at USD53.9 million at the end of 2000. The largest project has been the Severnaya Gas Combined Power Plant project, to which yen loans of JPY20.7 billion and JPY18.3 billion were committed. Other forms of assistance include grant assistance to purchase equipment for a maternity hospital and to increase food production, as well as various forms of technical assistance. The priority areas are currently economic infrastructure development, mitigating hardships in the social sector, and human resources development.

### **Germany**

Germany within the framework of financial co-operation through the Kreditanstalt für Wiederaufbau (KfW) has invested about Euro 72 million in Azerbaijan and is planning to increase this amount to Euro 90 million in the coming two years. In terms of technical co-operation Germany's Gesellschaft fuer Technische Zusammenarbeit (GTZ) provided to date training and consulting services in the value of Euro 9 million and is planning to increase this amount to Euro 14 million in the coming two years. Priority areas for the German-Azerbaijani co-operation are the promotion of economic reforms and infrastructure investments in the water and waste management sectors. The financing of energy and transport infrastructure, environment and health investments are restricted to projects of regional importance.

### **US**

USAID assistance to Azerbaijan is focused in four general areas: SME development (including agriculture), economic reforms, democracy and governance, and humanitarian relief to IDPs. In the area of SME development, USAID currently implements programmes in credit, SME training, improved use of agricultural inputs, association development, and improved competitiveness of agricultural products. USAID's programme in economic reforms began in 2002 and is focused on three areas: strengthening the banking sector, improving fiscal management, and support to

energy reform. In the area of democracy and governance, USAID concentrates on election reform, support to independent media, and rule of law. USAID's humanitarian relief efforts are aimed at providing refugee and IDP communities with basic health services, community infrastructure development, and business development. In addition to USAID, the government of the United States is implementing or planning the following:

- the US Treasury Department advises the Ministry of Finance working on implementation of the Budget Systems Law and the Ministry of Tax on tax policy.
- the US Trade and Development Authority (TDA) provides technical assistance in the oil and gas and petrochemical sectors and will assist the Ministry of Economic Development on WTO accession issues.
- the US State Department implements a wide variety of student exchange programmes.

### **Turkey**

Turk Eximbank has extended a sovereign guaranteed credit line to International Bank of Azerbaijan (IBA) of USD 250 million of which USD 92 million has been disbursed to date. In addition, Eximbank has allocated and disbursed a USD 20 million loan for the rehabilitation of the airport in Baku.