

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

STRATEGY FOR AZERBAIJAN

As approved by the Board of Directors at its meeting on 30 April 2014

TABLE OF CONTENTS

EXECUTIVE SUMMARY	2
1. THE BANK'S PORTFOLIO	5
1.1. Overview over Bank activities to date	5
1.2. Implementation of the previous Country Strategy	6
1.3. Transition impact of the Bank's portfolio	8
2. OPERATIONAL ENVIRONMENT	10
2.1. Political context	10
2.2. Macroeconomic context	11
2.3. Structural reform context	12
2.4. Business environment	13
2.5. Social context	14
2.6. Legal context	15
2.7. Energy efficiency and climate change context	16
3. STRATEGIC ORIENTATIONS	16
3.1. Promoting market-driven diversification	17
3.2. Developing a sustainable financial sector to support private sector development	20
3.3. Improving governance and the business environment	22
3.4. Environmental and social implications of the Bank's proposed activities ..	23
4. ACCESS TO FINANCE	24
4.1. Private sources of capital	24
4.2. MDB finance and collaboration with other IFIs	25
4.3. Cooperation with the European Union	29
Annex 1 – Political Assessment	30
Annex 2 – Assessment of Transition Challenges	38
Annex 3 – Legal Transition	48
Annex 4 – Small Business Support	52
Annex 5 – Technical Cooperation	56
Annex 6 – Selected Economic Indicators	57
Annex 7 – Gender Equality	58

EXECUTIVE SUMMARY

Azerbaijan is committed to the principles of multiparty democracy, pluralism and market economics outlined in Article 1 of the Agreement Establishing the Bank. A more consistent application of these principles would enhance political accountability, strengthen the rule of law, and help overcome the country's remaining challenges.

Azerbaijan has a presidential form of government with powers concentrated heavily in the executive branch. President Ilham Aliyev has been in office since October 2003 and was re-elected for another five years in October 2013. Since coming to power, President Aliyev has steadily established his political authority. The ruling presidential party has a dominant position in the legislature and in the political system. The October presidential and upcoming parliamentary elections are unlikely to significantly alter the distribution of power during the Strategy period.

The rate of economic growth has declined sharply from the pre-crisis boom years as the pace of hydrocarbon extraction has slowed. In 2011, GDP grew only 0.1 per cent on the back of 10.6 per cent fall in oil output. In 2012 growth picked up to 2.2 per cent as milder decline in oil production has been more than offset by the encouraging expansion of the non-oil sector (9.7 per cent), led by construction and services. More recently, growth was 5.1 per cent for the first 9 months of 2013. The authorities' recent statements suggest that the oil sector is likely to recover somewhat in 2013-14, although some observers believe it may have reached its historic peak and will continue to decline. Gas production is expected to grow significantly over the next Strategy period, which will partly mitigate the decline in oil production. The country's large oil fund (50 per cent of GDP) provides a significant buffer against shocks. Thanks to sustained growth driven primarily by oil production as well as social transfers, the poverty rate dramatically dropped from almost 50 per cent in 1999 to 6 per cent in 2012.

Azerbaijan has made uneven progress in structural reforms. The government has made some improvements in tax administration with a view to both reducing tax compliance costs for businesses and increasing the tax collection rate. The new Customs Code, which came into effect in January 2012, includes strengthened provisions in various areas that are expected to bring regulations into line with international standards, including verification of the country of origin, valuation methods, single window principle in customs administration, customs audit, and electronic submission of information on goods to the customs authorities. The government has also continued to improve infrastructure and diversify routes for hydrocarbon exports, and the central bank has taken steps to strengthen the financial system.

Azerbaijan has reached a critical stage in its development. With oil output set to decline from 2017 and the economy's dependence on accumulated hydrocarbon revenues very high, diversification of the economy will be critical to ensure that Azerbaijan enters the post-oil period with a modern and vibrant private sector. Although the authorities have adopted ambitious targets for diversification under the Vision 2020 strategy and have made some progress in modernising the economy, structural reforms needed to support self-sustaining growth in the non-oil sectors should be accelerated.

In the next Strategy period it will be crucial for Azerbaijan to make material progress in diversifying its economy away from reliance on hydrocarbons. Challenges remain in the reform process with significant transition gaps across most indicators. In particular, it will be crucial for Azerbaijan to develop a sustainable financial sector that is able to support private sector development and economic diversification, especially in the regions outside of Baku and Absheron.

The Bank will remain engaged in the hydrocarbons sector in order to support increased competition, the introduction of best governance practices, and policy dialogue on the regulatory framework, as well as to stimulate the development of privately and competitively provided ancillary services. Involvement in strategically important projects such as the southern gas corridor will contribute to export route diversification and regional energy security in Europe.

In addition, it is vital that Azerbaijan complement its efforts at economic diversification and financial deepening by measures to promote competition and improve the business environment. The authorities have initiated reforms to strengthen the judicial system, but further progress is needed to improve the investment climate, particularly in the areas of corporate governance, competition policy and fighting corruption.

Strategic directions

The Bank's priorities in Azerbaijan during the next Strategy period will focus on promoting market-driven economic diversification and developing a sustainable financial sector to support private sector development. Specifically, the Bank's operational activities in Azerbaijan will focus on the following areas:

- **Promoting market-driven economic diversification.** The Bank will support leading local corporates with direct financing while helping EBRD partner banks to remain active in the corporate segment through MCFF. In the MSME sector the Bank will place a special emphasis on the agribusiness sector, and will support local banks to develop their capacity to support agricultural and regional lending. The Bank's continued support for regional roads will also help facilitate the development of a viable agricultural sector while facilitating integration of smaller communities.
- **Developing a sustainable financial sector to support private sector development.** The Bank will aim to strengthen financial intermediation to ensure efficient financing of the private sector, particularly SMEs and MSEs, including in the regions. The Bank will promote high standards of corporate governance and risk management, which should contribute to increased competition, setting new standards and opening new markets for banks, and will support consolidation in the banking sector through potential equity investments. The Bank will extend its co-operation with existing partner banks and assist in the development and promotion of new financial instruments to target improved access to finance for women-owned and women-run businesses, and will aim to promote energy efficiency investment projects through local banks via the Caucasus Energy Efficiency Programme. To develop local capital markets, the Bank will seek to

bring corporate (non-FI) issuers to the corporate bond market, expand the institutional and retail investor base.

- **Improving governance and the business environment.** In order to support the authorities' goals of promoting competition and improving the business environment, the Bank will prioritise engagement with private and public sector clients who can demonstrate commitment to high standards of corporate governance and transparency and who have a commitment to improving management practices. In parallel, the Bank will work closely with the Government of Azerbaijan to deepen institutional and regulatory reform. Drawing on the lessons of hydrocarbons and financial sectors, EBRD will strive to create a more favourable investment climate in the real sector by promoting improvements in the legislative framework, enhancing competition and reducing the incentives for corruption. In order for these measures to be successful, opening new channels for constructive policy dialogue with key government agencies will be crucial. The Bank will also continue to pursue investments in energy projects that improve energy security, create new generating capacity, stimulate competition, diversify energy sources, increase efficiency, and create wider and larger markets through regional integration.

The Bank will continue to cooperate closely with other international financial institutions and multilateral and bilateral partners, including the European Union, in its operations as well as through policy dialogue to maximum transition impact in Azerbaijan.

1. THE BANK'S PORTFOLIO

1.1. Overview over Bank activities to date

As at end-November 2013 the Bank has signed a total of 138 projects with cumulative investment value of EUR 1,577 million since initiating its operations in Azerbaijan in 1991. The total value of these projects was EUR 6.6 billion. 35 per cent of the Bank's cumulative investments were made in the energy sector, 33 per cent in the financial institutions sector, 21 per cent in the infrastructure sector and 11 per cent in the corporate sector.

During the previous Strategy period, from end-2010 through end-November 2013, EBRD's operating assets in Azerbaijan decreased by EUR 102 million, affected by high reflows in 2011 and 2012 from the Azdres power plant project as well as prepayments from a cement plant. The portfolio remained almost flat, similarly affected by reflows. The Bank's current portfolio of EUR 606 million across 58 projects is concentrated in the infrastructure sector with 41 per cent (Azeri Roads Upgrade project accounting for 30 per cent of total portfolio), 29 per cent in the energy sector, 19 per cent in the financial sector and 11 per cent in the corporate sector. By number of projects the portfolio is dominated by ICA, at 42 per cent, and FI, at 28 per cent.

The portfolio ratio calculated on a five-year rolling basis was 71 per cent private at end-November 2013, which is above the Bank's mandated 60/40 ratio. This is likely to decrease to 63 per cent at year-end following the signing of a large public transport sector transport project.

Over the previous Strategy period the Bank signed 40 projects for a total value of EUR 435 million. Year-to-date the Bank has signed 12 projects with a value of EUR 63 million, all in the private sector.

Table 1: Cumulative Business Volume and Portfolio in Azerbaijan as of 30 November 2013

Sector Group	Sector Team	NCBV number of operations	Net Cumulative Business Volume (NCBV)	% NCBV	Portfolio number of operations	Portf.	% Portfolio	Operating Assets	% Operating Assets
Energy	Natural Resources	16	338	21%	3	65	11%	65	17%
	Power and Energy	4	209	13%	2	107	18%	104	27%
		20	547	35%	5	173	29%	169	43%
Financial Institutions	Depository Credit	57	488	31%	21	100	17%	80	20%
	Insurance	1	1	0%	0	0	0%	0	0%
	Leasing Finance	2	3	0%	0	0	0%	0	0%
	Non-depository Credit	14	25	2%	9	16	3%	14	4%
		74	517	33%	30	116	19%	94	24%
ICA	Agribusiness	11	29	2%	7	20	3%	18	5%
	Equity Funds	4	6	0%	2	3	1%	1	0%
	ICT	2	3	0%	1	3	0%	3	1%
	Manufacturing & Services	15	137	9%	10	46	8%	40	10%
	Property and Tourism	4	6	0%	0	0	0%	0	0%
		36	181	11%	20	72	12%	62	16%
Infrastructure	Municipal & Env Inf	1	17	1%	0	0	0%	0	0%
	Transport	7	315	20%	3	245	41%	64	16%
		8	331	21%	3	245	41%	64	16%
Summary		138	1,577	100%	58	606	100%	389	100%

Table 2: Portfolio Development in Azerbaijan, 2010-November 2013

	2009	2010	2011	2012	Nov-13
Net Cumulative Business Volume (NCBV)	971	1,224	1,503	1,554	1,577
TFP NCBV	16	199	242	272	293
NCBV Number of operations	103	108	116	128	138
Portfolio	622	598	711	657	606
Portfolio number of operations	66	59	57	56	58
Operating Assets	410	491	471	427	389
% Undrawn excl. Guarantees	32%	14%	31%	31%	33%
Annual Business Volume	161	59	289	83	63
Annual number of operations	9	13	12	16	12
Annual Disbursements	101	126	71	52	40
Annual Cancellations	8	1	16	7	5
Pipeline Stock - Reported Rate	127	135	427	635	551
Private Sector Share (% Portfolio)	63%	62%	43%	43%	42%
Non Sovereign Share (% Portfolio)	63%	62%	43%	43%	42%
Equity Share (% Portfolio)	4%	4%	4%	5%	6%
Portfolio ratio (5-year rolling basis)	69%	73%	64%	71%	71%

1.2. Implementation of the previous Country Strategy

The Bank's 2010 Strategy for Azerbaijan aimed to improve the business environment, help integrate Azerbaijan into the global economy, deepen financial intermediation, and advance public infrastructure reform. Over the previous strategy period the Bank has signed 40 new projects for a total of €435 million. The average investment size, excluding the loan for regional roads development, was under €6 million, highlighting the relevance of the ETC Initiative for Azerbaijan. The Bank's impact on the corporate sector was strengthened over the previous Strategy period as local companies' management skills and competitiveness were enhanced through strict loan conditionalities as well as technical assistance, including via the EGP and BAS programmes. The Bank continued to support foreign direct investment, but this was limited to existing clients in manufacturing and the financial sector. Average transition impact potential score for projects approved during the previous Strategy period was 4.86, just above the bank-wide average of 4.75. As of end-2012, the average rating of the active TIMS portfolio for all operations in Azerbaijan stood at 4.16, marginally worse than the Bank-wide average of 4.05, reflecting in part the country's challenging business environment and weak institutional capacity.

The Bank has remained the leading provider of long-term financing and technical assistance to the financial sector. Through its equity investments the Bank raised corporate governance standards in local financial institutions. The Bank also improved risk management practices as well as the credit appraisal and micro-lending skills of its partner institutions. In addition, it introduced new financial products to the market, including the country's first convertible bond and subordinated debt to bolster tier II capital.

In this strategy period the Bank has focused on providing credit lines for on-lending to small businesses in Azerbaijan. By increasing tenors and encouraging banks and micro-finance institutions to lend outside Baku, EBRD is increasing the availability of lending to entrepreneurs throughout Azerbaijan. Many partner banks and MFIs have expanded their MSME lending in the regions outside of Baku with a particular focus on agricultural lending. In addition the provision of longer tenor financing has strengthened the balance sheets of partner banks and strengthened their business models by improving the diversification and maturity of funding. Initially as a crisis response measure, the bank also provided the first subordinated debt and invested in convertible bonds issued by investee banks as a means of strengthening their tier I capital.

Levels of financial intermediation have increased over the previous Strategy period, particularly in the last year. However, the sector is still characterised by a low level of capitalisation of local banks (many of which are too small), dominance by the large state-owned bank, and weak governance. All of these are barriers to further improvement in access to finance despite the Bank's and the authorities efforts to encourage the modernisation of the banking sector.

In the FI sector the previous strategy prioritised consolidation and improvements in transparency and corporate governance. Over the strategy period the number of banks decreased from over 60 to 43 with foreign participation in 23 of those banks. In 2012 the Central Bank announced an increase in the minimum accumulated capital requirement to AZN 50 million (AZN 10 million previously) but so far no appropriate consolidation proposals have been forthcoming for EBRD participation. Levels of transparency and corporate governance have improved among EBRD partner institutions and across the sector aided by strict central bank regulation and crisis response, as well as a three year tax holiday for financial institutions to the end of 2012.

The sector remains dominated by the International Bank of Azerbaijan, which still accounts for more than a third of all assets, down from one half in 2010. In the previous Strategy period the Bank provided a TC-funded privatisation advisor and in 2011 the government indicated that it would privatise IBA. However in 2012 the Central Bank provided IBA with two large subordinated loans to support capital in the face of high levels of NPLs and IBA's privatisation was put on hold.

In December 2011, the Bank signed a three-phase facility for the reconstruction of selected sections of the road network in Azerbaijan, of which the first tranche of USD 190.4 million has been committed. Conditionalities aim at stimulating reform by ensuring both the national and regional road networks are managed and maintained at the required level and the role of the private sector is enhanced. Each of the subsequent tranches will be conditional on fulfilment of further key transition milestones during the coming Strategy period. Subject to ratification of a framework agreement with the Government of Azerbaijan, EIB may participate in the financing of this project.

In 2013 the largest thermal power plant in Azerbaijan, AzDRES, became the first in the world to sell carbon credits. These were generated thanks to an energy efficiency rehabilitation project undertaken in 2006, and supported by a USD 207 million EBRD loan that enabled rehabilitation of old and inefficient turbines and boilers, repair of

chimneys, and improvements to other systems. Not only did the project increase efficiency and capacity at the plant, it also improved Azerbaijan's energy security and increased reliability of its energy infrastructure. Azerenergi made noticeable progress in implementing IFRS accounting and environmental reporting, which was reflected in February 2013 with an investment grade rating from one of the major rating agencies. However, progress on tariff reform has been slow.

Improving energy efficiency remains a major challenge in Azerbaijan, which is rich in energy resources. The economy of Azerbaijan and in particular the residential sector is one of the most energy intensive in the region. The amount of energy it consumes per U.S. dollar of gross domestic product (GDP) adjusted to purchasing power parity is almost 1.2 times more than EU-27 average. Companies with energy efficiency action plans have implemented more energy efficiency projects and invested more in them than have those without organizational arrangements in place. However, these early achievements still leave room for significant improvement, both in terms of regulatory support for energy efficiency, and in terms of real efficiencies gained by Azerbaijani industry. In March 2013 EBRD signed the first energy efficiency loan with an Azeri bank in Azerbaijan under the Caucasus Energy Efficiency Programme.

The Bank's activities in the real sector were constrained by a challenging business climate outside the relatively well-governed oil sector, which compels most companies to operate with minimal disclosure. This effectively restricts the number of corporates that meet the Bank's eligibility requirements. The Bank's attempts to improve transparency in some of its clients have been complicated by the challenging business environment. The Bank supported corporate governance improvements as well as efficiency and productivity gains among others through the introduction of technological improvements in its investee companies. The Bank also encouraged its investee companies to improve financial disclosure by implementing management information systems and adopting international financial reporting standards (IFRS) and enhanced local companies' management skills and competitiveness through its EGP and BAS programmes.

The Bank has made use of the ETCI products, particularly MCFF, which have proven effective. The growth in ICA portfolio and pipeline since 2012 reflects the move of Azerbaijani entrepreneurs away from the primary construction sector, where returns are now modest, and into light manufacturing, much of which is import substitution.

1.3. Transition impact of the Bank's portfolio

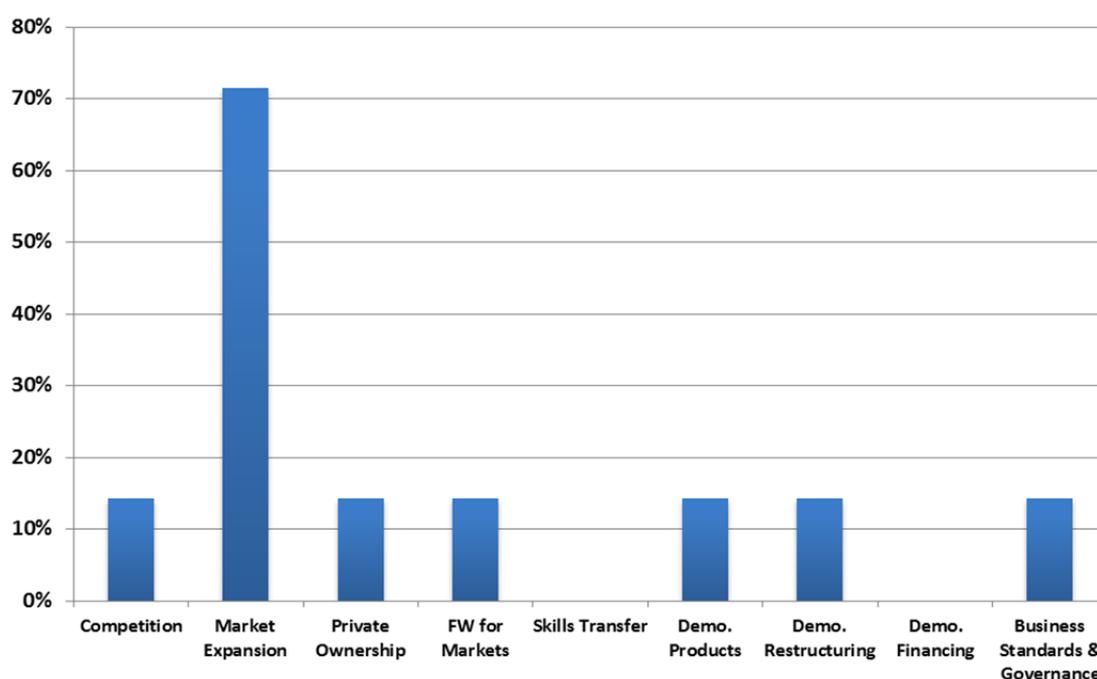
In the period since the previous strategy was adopted in December 2010 (to end-November 2013), seven individually transition-rated operations were signed by the Bank in Azerbaijan. The majority of the signed operations during the strategy period were extended in the financial sector (six projects), most of which target support to micro, small and medium enterprises, including those located in country's underserved areas. The remaining operation, a roads network reconstruction and upgrade project in the transport sector, has the potential of introducing institutional reforms and wider involvement of private sector. All seven operations were rated as

having “Good” transition impact potential¹, which is well above the institution-wide target of 80 per cent of projects to be assessed “Good” or better.

Apart from these seven operations, 21 projects signed in Azerbaijan from December 2010 to end-November 2013 were not individually rated for transition impact. The majority of these projects are sub-operations extended under the Medium-Sized Loan Co-Financing Facility (MCFF), rated “Good” and monitored on framework level only. Sub-projects under MCFF in Azerbaijan were extended to commercial banks with the main objective of market expansion by enhancing banks’ capacity to extend larger loans with longer maturities to MSMEs, as well as setting standards of corporate governance and business conduct, such as improving financial reporting procedures and transparency in disclosure of financial statements. The sub-projects under DLF were extended to corporate clients, with the main goal of improving their operational efficiency and introducing better corporate governance standards.

The transition objectives of projects signed in Azerbaijan during the strategy period mainly reflect the sector distribution of the Bank’s activities in this country in 2011-2013. Since most projects were signed in financial sector, with the focus on addressing the key transition challenge of supporting availability of finance for development of private sector MSMEs, including in underserved regions. The transition objectives were therefore heavily concentrated around supporting market expansion (Figure 1).

Figure 1. Targeted transition objectives in Azerbaijan (share of projects), Dec 2010 – November 2013



The transition performance of projects in the Bank’s active TIMS portfolio² in Azerbaijan has been good. As at end-November 2013, all 19 operations in the active

¹ See <http://www.ebrd.com/pages/research/economics/transition.shtml> for transition impact assessment and monitoring methodology.

portfolio are assessed as being on track from the transition impact perspective. This includes eight operations (or 42 per cent of the country's active TIMS portfolio) that have already largely achieved their envisaged transition impact. The remaining 11 operations are currently identified by TIMS as on their way to achieving the expected transition impact potential. The average rank³ of Azerbaijan's active TIMS portfolio at end-November 2013 stood at 4.16, better than the institutional target of 4.35. The average rank of the country's active TIMS portfolio, currently slightly worse than that for all Bank's operations (4.02 as at end-November 2013), is expected to further go down (i.e., improve) as the country's portfolio matures and risks associated with the transition potential subsequently diminish. The sub-projects signed under the MCFE framework in Azerbaijan have also so far performed well from the transition impact perspective, with success in achieving transition targets, such as improved management and financial skills and the presentation of financial data reported.

Nine operations, all in the financial sector, were completed (i.e., fully re-paid and therefore no longer part of the TIMS active portfolio) during the Strategy period. Seven of these completions have fully achieved their expected transition impact, i.e., have been successful in extending MSME loans to targeted enterprises and improving business standards. Two completed operations have only partially delivered their transition objectives, as the MSME support project with the country's commercial bank fell behind in reaching the expected number of small and medium sized sub-borrowers due to the crisis, despite success in delivering the institutional building objective, such as successful implementation of new lending methodologies.

2. OPERATIONAL ENVIRONMENT

2.1. Political context

Azerbaijan is situated at an important crossroads connecting Asia and Europe with the country declaring its pro-European aspirations and pursuing policies aimed at integration with European structures.

In this respect, Azerbaijan's membership in the Council of Europe and its obligations under the European Neighbourhood Policy (ENP) and Eastern Partnership (EaP) provide the government with a platform to demonstrate commitment to political and economic reforms for bringing the country's legal framework and practice in line with European standards. The latest ENP progress report of March 2013 stated that despite progress compared to the past, Azerbaijan needs to continue its efforts to meet its commitments on democracy, including electoral processes, the protection of human rights and fundamental freedoms, and the independence of the judicial system.

According to the Constitution, the Republic of Azerbaijan has a presidential form of government. President Ilham Aliyev has been in office since October 2003. Since

² i.e. All active operations more than 6 months since signing and are monitored for their transition impact at least once

³ The rank is a combination of the transition impact potential rating and risks to transition impact. The expected transition of each operation is usually monitored once a year and is ranked numerically from 1 to 8, with 1 to 3 indicating mostly realised impact, 3 to 6 – generally on track to achieve transition objectives, and 7 to 8 – minimum transition impact achieved or excessive risks.

coming to power, President Aliyev has steadily consolidated his political authority, and has been re-elected twice, most recently in October 2013. The ruling presidential party (Yeni Azerbaijan Partiyasi – YAP) retains a dominant position in the legislature and in the political system. The October 2013 presidential election and the parliamentary elections in 2015 are unlikely to significantly alter the distribution of power during the strategy period.

The conflict with Armenia over Nagorno-Karabakh is still unresolved despite continuing efforts at international mediation by the OSCE Minsk Group, co-chaired by France, Russia and the United States.

See Annex 1 for a detailed assessment of the political context.

2.2. Macroeconomic context

The rate of economic growth has declined sharply from the pre-crisis boom years, as the pace of hydrocarbon extraction has slowed. In 2011, GDP grew only 0.1 per cent on the back of 10.6 per cent fall in oil output. In 2012 growth picked up to 2.2 per cent as milder decline in oil production has been more than offset by the encouraging expansion of non-oil sector (9.7per cent), led by construction and services. More recently, growth remained moderate at 3.1 per cent in the first quarter 2013 and expected to stay around 3.5-4.0 per cent for a year. The authorities' recent statements, confirmed by British Petroleum (BP), suggest that oil sector is likely to recover somewhat in 2013-14 although some observers believe oil output may have reached its historic peak and would continue to decline. Gas production is expected to grow significantly over the next Strategy period, which will partly mitigate the reduction of oil production. The non-oil sector, supported by expansionary fiscal and monetary policies, will continue to drive the economy over the medium term.

Inflation has been subdued recently, averaging 1.1 per cent in 2012, largely due to favourable base effects and lower international food prices. More recently, inflation accelerated to 2.5per cent in May from -0.7 per cent in September last year. Responding to low inflation, last year the Central Bank of Azerbaijan (CBA) eased monetary policy but expressed its readiness to tighten should inflation risks emerge.

The CBA continues to maintain the policy of stable exchange rate of the manat against the US dollar after abandoning the policy of targeting a currency basket in early 2011. Nominally, manat has appreciated only 1.6 per cent against the US dollar since 2011, while its trade-weighted REER has revalued by 4.5 per cent over the same period.

Credit growth stayed buoyant, averaging 20 per cent in 2012 and early 2013. According to the central bank, the banking sector loan book quality improved slightly, with NPL falling from their local high of 6.9 per cent in April 2012 to 5.6 per cent in April 2013. However, while official NPL numbers are low, the figures may be underestimated after the recent credit surge.

The non-oil primary fiscal deficit remains very large, widening to 45 per cent of non-oil GDP in 2012 from 41 per cent in 2011. This year non-oil deficit is projected to increase further as the budget includes a large-scale investment program.

Nevertheless, the public sector balance sheet remains strong given the support from a large oil fund of USD 35 billion (50 per cent of GDP) and low external debt.

The current account surplus declined from 26 per cent of GDP in 2011 to 22 per cent in 2012 on the back of lower oil and gas exports, although it remains high. At the same time, non-oil current account deficit shrank from 20 per cent of GDP to 18 per cent. Current account balance will likely deteriorate but remain in surplus for the next few years supported by high oil prices, and thus will continue to ensure that external position of Azerbaijan remains favourable during the next Strategy period.

See Annex 7 for a table with Selected Economic Indicators.

2.3. Structural reform context

Azerbaijan has made some progress in structural reforms. The government has made some improvement in tax administration with a view to both reducing tax compliance costs for businesses and increasing the tax collection rate. The new Customs Code, which came into effect in January 2012, includes strengthened provisions in various areas that are expected to bring regulations into line with international standards (including verification of the country of origin, valuation methods, single window principle in customs administration, customs audit, and electronic submission of information on goods to the customs authorities). However, the reform process has had limited impact on corruption and should be intensified (see below). The government has also continued to improve infrastructure and diversify routes for hydrocarbon exports. The central bank took steps to strengthen the financial system. Access to credit was aided by an online platform allowing financial institutions to provide information to, and retrieve it from, the public credit registry.

The North-South rail corridor, linking Azerbaijan with Russia and Iran, as well as country's main East-West railway transport corridor, are being upgraded with the support of World Bank and other IFIs. Construction of a new international sea port, the largest in the Caspian region, near Baku recently commenced. The port should help strengthen the country's role as a trade link between Europe and Asia.

In June 2013, the Shah Deniz consortium chose the TAP pipeline as a potential export route to Europe. Also, Azerbaijan signed an intergovernmental agreement with Turkey on the construction of the TANAP pipeline, which will carry gas to Europe and Turkey. In December 2013, Azerbaijan signed a memorandum of understanding on future gas supplies to Albania, Croatia and Montenegro. The new route should diversify Azerbaijan's export routes to international markets and Europe's access to energy imports.

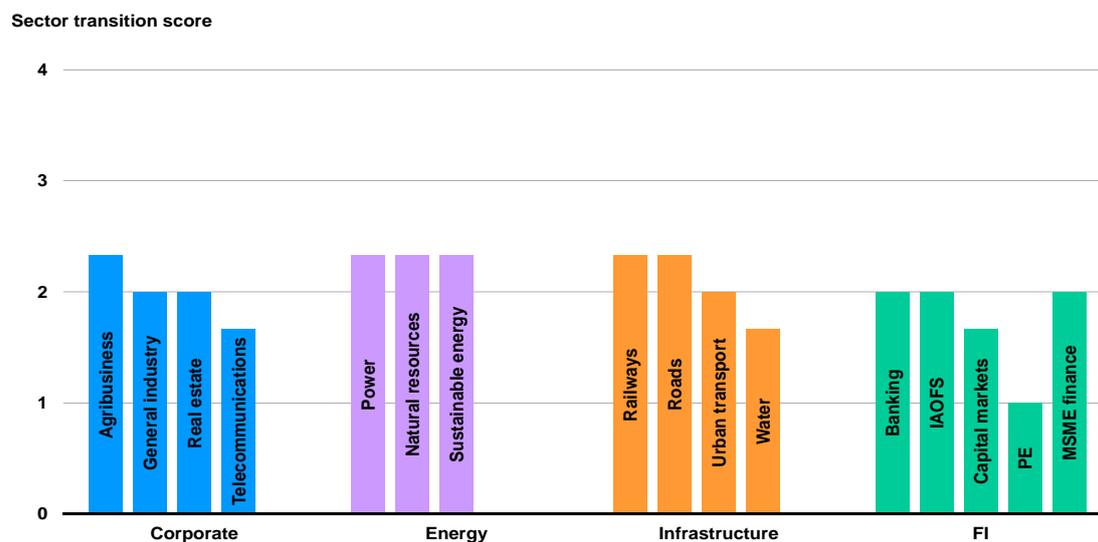
The Central Bank of Azerbaijan (CBA) continues to improve the regulatory framework and has started to build analytical capacity for inflation targeting. In July 2012, the CBA increased the threshold of aggregate capital of operational banks, as well as authorized capital for newly established banks to AZN 50 million. The new norm on the minimum capital requirement is to take effect from January 2014. Once implemented, the new norms should help strengthen capital position of Azerbaijani banks. The central bank has also continued developing analytical skills and capacity

to pursue the policy of inflation targeting over time, although it has continued to target exchange rate as a nominal anchor.

Little progress has been achieved in the restructuring of the International Bank of Azerbaijan. Following an audit, in February 2012 the government injected new capital into the International Bank of Azerbaijan (IBA) and the central bank provided liquidity. An international consortium of companies has been advising the state property fund on IBA's privatisation since mid-2011, although little actual progress has been made so far to begin implementing the privatisation.

Negotiations continue on WTO accession. Azerbaijan remains the only country in the region outside the WTO. In June 2013, at the 11th meeting of the working party on the accession of Azerbaijan, members reviewed Azerbaijan's trade-related reforms, examined legislative developments and evaluated the progress made in the bilateral negotiations on market access for goods and services. Azerbaijan is currently negotiating with 13 members.

Figure 2. EBRD transition indicators for Azerbaijan



Source: 2012 Transition Report.

For a detailed assessment of the remaining sector transition challenges see Annex 2.

2.4. Business environment

Azerbaijan ranks relatively well on cross-country business environment if compared to other countries in the Eastern Europe and Caucasus region. Azerbaijan's score in the World Bank's Doing Business report changed little over the past three years. It ranks 67th among 185 countries in the 2013 World Bank's Doing Business index, ahead of Moldova and Ukraine but behind Belarus and its Caucasus neighbours. Starting a business and registering property (that involves only four procedures, takes 11 days and costs on average 0.5 per cent of the property value) are reviewed very favourably. However, trading across borders, getting electricity and dealing with construction permits (that involves as many as 28 procedures and takes 212 days) are

the areas of serious concern. Moderate improvements were made last year in the ease of paying taxes and resolving insolvency.

The authorities initiated reforms to strengthen the judicial system and reduce corruption, including by strengthening the anti-corruption committee and launching an anti-corruption campaign. This led to the approval of presidential decrees mandating the implementation of the National Anticorruption Plan; the establishment of the State Agency for Public Services and Social Innovations (ASAN); a single-window agency for public service delivery and the implementation of a new Urban Construction Code. All these decrees were targeted to improve governance and the institutional framework. In addition, in recent years a number of offices that help citizens to defend their rights in cases of corruption have opened across the country, and the government entered into a dialogue with civil society groups through a network of local anti-corruption NGOs.

Despite these measures, corruption remains a serious concern in Azerbaijan, as acknowledged by the authorities. While recent efforts to tackle corruption have had some impact – Azerbaijan climbed 12 places in the 2013 Transparency International Corruption Perceptions Index – the country is still ranked 127th out of 177 countries. A Transparency International report in July 2013 recognised that recent reforms have started to translate into a significant decrease in citizen’s perception of corruption in many sectors but also that there is a long way to go in making anti-corruption reforms effective.

Azerbaijan was 39th among 148 countries in the “Global Competitiveness Index 2013-2014” report released by the World Economic Forum in September 2013, climbing nine positions since the previous year. Azerbaijan performed particularly well in the areas of ‘macroeconomic environment,’ and recorded strong improvements in the areas of ‘technological readiness’ and ‘financial market development’. As a result Azerbaijan remained the top-ranked country in the CIS for the competitiveness of the economy. The 2009 EBRD/World Bank Business Environment and Enterprise Survey identified access to finance and high tax rates as the major obstacles to doing business, followed by corruption and informal sector practices.

2.5. Social context

Azerbaijan’s rapid economic growth over the past decade generally been broad-based, lifting all income groups and reducing poverty rates dramatically from 49.6 per cent in 2001 to 6 per cent in 2012. Official unemployment dropped from 12.7 per cent in 1999 to 5 per cent in 2012 and maintained a downward trend even during the economic crisis. Wages grew by an average of 13 per cent in real terms annually between 2001 and 2008. With a high labour force participation of poor sections within the population this increase in real wages also had a significant impact on the welfare of the working poor. According to the ILO’s World of Work Report 2013, the share of low-wage earners whose incomes fluctuate between USD 4 and USD 10 per day has also risen since 2000, reaching 60 per cent of the population in 2012. Another key factor in the reduction of poverty rates is social transfers, without which the poverty rate would have been around 25 per cent. In 2010, 63.2 per cent of households in Azerbaijan receive at least one type of social transfer, with public pensions being the most effective mechanism of reducing poverty rates. The 2011 Life in Transition

report confirmed that overall life satisfaction in Azerbaijan seems to have increased with economic growth and improved living standards.

However, as with other transition countries in the region, economic growth has been marked by low employment content. In Azerbaijan, just 20 per cent of GDP growth is attributable to employment growth, the rest resulting from productivity gains. This has a particularly strong effect for young people as they transition from school to work. Azerbaijan has a young population, with some 40 per cent of people aged below 24 years. Youth employment is comparatively low at 14 per cent (2008), having fallen from 42 per cent in 1999, but challenges remain particularly in relation to the transition towards a more diversified economy.

Enrolment in primary and secondary education is almost universal and has increased for tertiary education, reaching 21 per cent, with equal levels of attendance among men and women. However, education quality continues to be important challenges. Relative to men, women still have fewer opportunities for participation in social, economic and political life. EBRD's gender gap analysis for Azerbaijan highlights significant levels of inequality, particularly in relation to women's participation in the labour force and access to finance.

Economic opportunities also vary between urban and rural areas. Whilst the unemployment and inactivity rate is usually higher in urban areas, it is mainly the high prevalence of subsistence agriculture that drives up labour force participation rates in rural areas.

About 600,000 people report themselves as internally displaced people (IDPs), according to the Internal Displacement Monitoring Centre. Whilst some IDPs have integrated into mainstream society, most still live in IDP settlements and about 86 per cent live in urban or surrounding areas. Although they have been displaced for more than a decade, most are heavily dependent on state transfers and lack self-reliant economic opportunities.

2.6. Legal context

Over the years, Azerbaijan has carried out extensive reforms of its legal framework but problems of implementation and enforcement remain. The legal environment is complex and uncertain. Although there have been significant improvements in the legislation relating to the establishment and licensing of businesses, the recent changes in law restricting access to information on ownership of the companies incorporated in Azerbaijan has created certain impediments for the Bank's activities in Azerbaijan. Similarly, in company law, the major shortcomings relate to the rules on disclosure and transparency. Corporates would benefit from clarifications as to the role of supervisory boards and independent directors. Although all companies are required to produce audited financial statements that include balance sheet and income statement, many companies do not seem to abide.

Azerbaijan laws on secured transactions require updating. In particular, improving the enforcement of secured creditors' rights, removing ambiguities and limitations of the present secured transaction system, especially for pledge over movable property, and creating legal underpinning that could facilitate credit bureau operations would

contribute to enhancement of the access to finance in Azerbaijan. Azerbaijan's Bankruptcy Law would benefit from whole-scale revision. The liquidation provisions are relatively adequate, but the law offers limited scope for reorganisation in bankruptcy. Importantly, Azerbaijan remains one of the very few countries in the EBRD region that still has no legal framework for Public Private Partnerships ("PPS") or modern day concessions. The introduction of PPP/concessions law could bolster investments in infrastructure and healthcare sector.

Although Azerbaijan has made progress in developing a modern functioning judicial system, particularly in terms of physical infrastructure, much remains to be done. Key priorities include bolstering the impartiality of the judiciary, particularly in relation to matters where the state is a party or has a substantial interest, and training of the judiciary, with a greater focus on commercial and administrative laws areas.

See Annex 3 for a more detailed assessment of the legal environment.

2.7. Energy efficiency and climate change context

Azerbaijan is a country where energy efficient technologies have very low market penetration and there exists therefore a significant potential for development. The deficiencies within the existing regulatory structure present the largest obstacle to the exploitation of alternative energy. The regulatory framework may be strengthened by enacting and enforcing laws that promote renewable energy projects. The consolidation of existing, disparate laws that affect renewable energy may be required.

Azerbaijan's Second National Communication to the UNFCCC identifies a number of projected climate change impacts on key sectors of the economy. These are increasing water scarcity, reduced agricultural production (driven by heat stress and water scarcity), sea level change in coastal areas and extreme heat events in urban areas.

3. STRATEGIC ORIENTATIONS

Following a decade of rapid economic growth, Azerbaijan has reached a critical stage in its development. With oil output set to decline from 2017 and the economy's dependence on accumulated hydrocarbon revenues very high, diversification of the economy will be critical to ensure that Azerbaijan enters the post-oil period with a modern and vibrant private sector. The authorities have adopted ambitious targets for diversification under the "Development Concept – Azerbaijan 2020: The Vision of the Future" and have made some progress in modernising the economy. However, the structural reforms needed to support self-sustaining growth in the non-oil sectors should be accelerated.

In the next Strategy period it will be crucial for Azerbaijan to make material progress in diversifying its economy away from reliance on hydrocarbons. Challenges remain in the reform process with significant transition gaps across most indicators. In particular, it will be crucial for Azerbaijan to develop a sustainable financial sector that is able to support private sector development and economic diversification especially in the regions outside of Baku and Absheron. Therefore, main challenges

for the Bank's operations during the next Strategy period will be: (i) promoting market-driven diversification and (ii) developing a sustainable financial sector to support private sector development.

In addition, low levels of transparency and corporate governance remain a serious challenge. In recent years, the authorities have demonstrated an ability to increase levels of transparency and governance in the hydrocarbon and financial sectors based on sound regulation and decisive implementation. The lessons from oil and gas and financial institutions should now be applied to the real sector, where transparency remains low, and poor corporate governance remains an impediment. These are closely related systemic issues which inhibit competition and create distortions in the non-oil, non-financial sectors.

There are early signs of progress in reducing administrative corruption, confirmed by recent surveys. While the government has improved tax administration procedures with a view to reducing tax compliance costs for businesses and increasing the tax collection rate and set up a single window for citizen services, significant challenges remain in the areas of competition policy, the business environment and corporate governance. The Bank is encouraged by the recent approach of the Ministry of Economy and Industry with the request to work together on improving corporate governance standards. The Bank is working with the Ministry on a corporate governance programme which will build on the work already conducted by IFC in this field and will include elements of BAS, Accountancy Improvement Programme.

In the next Strategy period, the Bank's engagement in the oil and gas and financial sectors should help support further improvements of corporate and public governance. In the hydrocarbons sector EBRD involvement in strategically important projects will give the Bank sufficient influence to apply the lessons of improved governance and transparency in this sector to other parts of the economy and to help to reduce corruption in the private sector. In financial institutions the Bank will work closely with the Central Bank and the State Securities Commission to develop greater sophistication and diversity of financing instruments – especially local capital markets and financing in local currency.

3.1. Promoting market-driven diversification

Key challenges

Until now, state-led economic activity, especially infrastructure construction has been the main driving force behind recent development of the non-oil sectors. Private sector activity in the non-hydrocarbon sectors is low but developing. Strengthening competition in product markets and creating a level playing field for business should be top priorities. Successful and sustainable diversification policies will depend, inter alia, on increased productivity in the corporate sector and modernisation of the agribusiness sector, which is of particular importance. The government is also prioritizing the development of the IT, chemicals and other export orientated sectors which may present opportunities in the next strategy period. Specific sectoral transition challenges related to diversifying Azerbaijan's economy include:

- The competitiveness of Azerbaijani companies should be strengthened by the application of a modern competition policy and streamlining procedures for market entry.
- Enterprises need to move up the value chain by expanding and upgrading their production facilities and access international markets to benefit from the economies of scale. Opening of the economy to non-oil FDI and deepening of the financial sector would help achieve the needed modernisation and improve market access. Transport and logistics infrastructure is under-developed throughout Azerbaijan and this is stifling the development of local production, particularly in the regions. Investment in private distribution and warehousing is required to ensure that local producers can get their goods to market and compete with imports. The development of modern municipal infrastructure is at an early stage and the government is targeting regional investments in water and waste water, solid waste management. Urban transport is under developed across the country and requires significant investment if traffic and environmental issues are to cease to be bottlenecks for further development.
- There is strong potential for developing the regions, in particular around the largest cities outside Baku and the agricultural sector as a whole where access to finance remains lower than in the capital.
- The government has prioritized the IT sector for development as part of its “Vision 2020” programme and a burgeoning IT sector is developing rapidly.
- The prevailing low energy tariffs are not fully cost-reflective and do not include environmental costs. Price incentives to invest in using energy efficiently do exist but need to be strengthened as does the capacity for developing and promoting energy efficiency investment projects for housing, commercial and industrial activity.

Bank’s operational response

To promote diversification of the economy the Bank will support local corporates that are leaders in their respective sectors and are willing to demonstrate a commitment to improving corporate governance and transparency, by providing long-term investment and working capital financing. This will be primarily under the Direct Lending, Direct Investment and Medium Sized Co-Financing facilities, with the latter playing a particularly important role in providing local corporates with long-term funding, while helping EBRD partner banks to remain active in the corporate segment.

Given the high potential of Azerbaijan's agricultural sector and its importance in terms of regional development, the Bank will place a special emphasis on the agribusiness sector and consider offering an agricultural financing instruments and technical assistance to the Azerbaijani banks with the view to developing their capacity for support agricultural and regional lending.

To enhance the competitiveness of the MSME sector, the Bank will combine advice and mentoring at the enterprise level with the development of a sustainable infrastructure of MSME support at the market level through its SBS operations. Planned operations will strengthen enterprise performance in areas such as organizational development, information and communication technology, marketing and quality management. Key priority sectors include agribusiness and other local

manufacturing in the non-oil sector. The Bank will also actively promote rural development, energy efficiency and female entrepreneurship.

The Bank will seek out further opportunities to support local manufacturing and processing, warehousing and logistics and IT outside of the oil sector. SBS will continue to provide advisory support to MSMEs in the real sector and the co-location of the SBS and banking departments in the same office will increase the opportunities for cooperation and cross referral resulting in a holistic approach to services provided to clients.

The next two phases of the regional roads project, to be implemented during the next Strategy period, will help facilitate the development of a viable agricultural sector, while enabling better integration of smaller communities in the economy, thus further promoting economic diversification. The impact of the Bank's regional roads development programme can be further enhanced by investments in urban transport, distribution and logistics sectors and to seek out opportunities to introduce commercial discipline in the provision of municipal services and to promote municipal credit worthiness.

The Bank will continue to pursue investments under the heading of the Sustainable Energy Initiative (SEI), pushing for investments in energy projects that improve energy security, create new generating capacity, stimulate competition, diversify energy sources, increase efficiency, and create wider and larger markets through regional integration.

In addition to its activity focusing on energy efficiency, EBRD is initiating its Sustainable Resource Initiative (SRI), which will help the country address resource related issues (e.g., water and materials efficiency, etc.). This will add value to the production chain and enhance productivity, as well as ensuring waste reduction, and thus cost and resource optimisation. The ESCO model of financing could possibly open a niche for further development in the sector.

In that respect, EBRD will look into providing the necessary technical assistance for capacity building and awareness, as well as establishing policy dialogue channels that would help pave the way for future investments in the area of energy efficiency, resource efficiency, and renewable energy.

The EBRD will launch by end 2013 a dedicated Sustainable Energy Financing Facility in Azerbaijan to on lend through local banks to support EE projects in the country. The EE credit line includes free of charge technical assistance which will be provided by international and local Consultants which are already operating under the "Caucasus Energy Efficiency Programme" (CEEP). Energy audits, training and marketing come as part of the loan package; the TA will also support building local capacity in the country.

The Bank will also enhance activities to support micro, small and medium sized enterprises (MSMEs) in key sectors through Business Advisory Services (BAS) and the Enterprise Growth Programme (EGP).

Policy dialogue and TC

Policy dialogue with the government of Azerbaijan will continue in the context of implementing the bank's investment programme, particularly in the area of consolidation of the banking sector and road sector reform. More generally the Bank will work with government, IFIs and donor to improve the business climate in regions outside of Baku and the Absheron peninsula.

The Bank will continue to draw on its investments projects and EGP and BAS experience to raise specific issues with the government to improve the investment climate particularly with partners such as Ministry of Economy and Industry and the Central Bank. The Bank through SBS will continue to contribute to the development of a viable and conducive environment for small and medium sized businesses by facilitating public/private dialogue and supporting local institutional development.

The Ministry of Economy and Industry requested EBRD assistance with introducing higher corporate governance and transparency standards. Drawing on the experience of other countries in the region, the Bank will work with the Azerbaijani Authorities, local and international investors and other stakeholders to develop an investment climate improvement programme. The programme will aim at practical, project based interventions to increase transparency, in its real-sector client groups including beneficiaries of the BAS, EGP, DLF, DLF and MCFE programmes. The Bank will support well defined business-enabling initiatives of other IFIs and the government. Policy dialogue will focus on improving corporate governance, strengthening dialogue between government and the corporate sector and moving SME clients towards financial audit as soon as the business environment permits.

Based on continued and tangible improvements in the business climate, the Bank will aim to assist government counterparts in attracting foreign direct investment. This will focus on key sectors including agribusiness, manufacturing and non-bank financial services with the aim of technology transfer, efficiency and productivity, governance improvements, and the expansion of the transparency to new sectors of the economy.

Furthermore the Bank will seek opportunities to finance projects which promote efficient energy usage supported by technical assistance and, where possible, policy dialogue.

3.2. Developing a sustainable financial sector to support private sector development

Key challenges

Despite rapid growth in recent years, the financial sector remains relatively small and access to finance by various segments of the economy is limited. The problem is acute in the regions outside of Baku. Financial institutions need to be strengthened in order to promote intermediation across the country serving business clients large and small and ensure efficient financing of the private sector, particularly MSMEs in Azerbaijan's regions. Support is also required for the expansion of under-developed local capital markets and the non-bank financial sector. Specific transition challenges in the financial sector include:

- Improvements in levels of financial intermediation are essential to ensure efficient, well directed financing of the private sector. The need to improve access to finance is particularly acute for medium sized corporates throughout the country and small businesses in Azerbaijan's regions. Access to finance for women-owned and -run businesses is relatively poor, especially in rural areas.
- Financial and human capital is dispersed among too many banks and financial institutions in Azerbaijan. This should be addressed through promoting transparent consolidation in the banking sector.
- Improvement is required in the investment environment to support foreign entry into the banking sector, which will increase competition, set new standards for the sector, and further reduce the dominance of the International Bank of Azerbaijan.
- Local capital markets and the non-bank financial sector are under-developed. Bond issuers have so far been mostly financial institutions or state-owned enterprises with only a handful of corporate issuances. The government plans to expand this sector rapidly with regulatory reforms, training and incentives.

Bank's operational response

Through investment and technical assistance, the Bank will aim to strengthen financial intermediation to ensure efficient financing of the private sector, particularly SMEs and MSEs, including in the regions.

The Bank will explore the possibility of developing agricultural financing instruments with local banks and MFIs to enhance Azerbaijan's agricultural sector through providing much-needed finance for primary agriculture and small and medium size agribusiness companies in partnership with other IFIs and donors. In particular, the Bank may try to replicate its successful cooperation with donors in Georgia and Tajikistan.

The Bank will aim to develop and promote energy efficiency investment projects through local banks via the Caucasus Energy Efficiency Programme, which will be rolled out to new partner institutions.

The Bank will extend its co-operation with existing partner banks and assist in the development and promotion of new financial instruments to target improved access to finance for women-owned and women-run businesses.

The Bank will promote high standards of corporate governance and risk management, which should contribute to increased competition, setting new standards and opening new markets for banks. Consolidation in the sector, as well as FDI, would serve the same purpose, and will be encouraged by the Bank as well as supported through potential equity investments.

The Bank will seek to supplement the delivery of management and advisory services by SBS with increased access to finance through the implementation of a targeted Accounting Improvement Programme and linkages with EBRD banking teams, partner banks and other financial institutions in Azerbaijan. In the local capital markets, the Bank will seek to bring corporate (non-FI) issuers to the corporate bond market, expand the institutional and retail investor base.

Policy dialogue and TC

Policy dialogue in the financial sector will centre on regulatory frameworks for the banking sector (including that related to resolution of the post-crisis NPL stock and sector consolidation), policies aimed at developing local capital markets and the development of the non-bank financial sector.

The Bank will work with the government to develop an enabling environment for energy efficiency lending at the same time as establishing standards for low carbon production and construction, which will stimulate demand. The Bank will work with the government, NGOs, donors and other IFIs to understand systemic issues which are affecting women's access to finance.

The Bank will seek to address regulatory and operational obstacles in the local capital markets via technical cooperation with the aim of participating in landmark transactions and will focus on the development of non-bank financial service providers.

3.3. Improving governance and the business environment

Key challenges

It is vital that Azerbaijan complement its efforts at economic diversification and financial deepening by measures to promote competition and improve the business environment. In particular, corruption remains a serious concern in Azerbaijan, as acknowledged by the authorities, who have initiated reforms to strengthen the judicial system and reduce corruption, including by strengthening the anti-corruption committee and launching an anti-corruption campaign. E-government initiatives and incentives to increase the proportion of electronic payments are improving access to state run services and transparency of revenue flows. Further progress is needed to improve the investment climate, particularly in the areas of corporate governance and the prevalence of unofficial facilitation payments. Furthermore, the competition authority should be strengthened to become a credible instrument for ensuring that various players, regardless of their size or political connections, are treated fairly.

Bank's operational response

The Bank will prioritise engagement with private and public sector clients who can demonstrate commitment to high standards of corporate governance and transparency and who have a commitment to improving management practices. Moreover, as competition and the creation of a 'level playing field' in the real sector are stifled by the inability of under-capitalised local banks to finance larger and mid-sized corporates, MCFE will play a crucial role in encouraging EBRD partner banks in this segment. This will provide access to finance for a new wave of Azerbaijani corporates that would benefit from desired improvements in the business climate and a more level playing field. SBS will play a vital role in improving levels of corporate governance in local SMEs.

Azerbaijan was the first country to fully comply with EITI principles. The oil and gas sector stands as an example for what can be achieved with reforms to rapidly and

decisively increase levels of revenue transparency and good governance across a huge and diverse sector. The development of oil and gas resources could be leveraged to further improve governance and the business environment through the development of locally owned services companies which could support not only oil and gas producers but also companies in other technology intensive sectors of the economy and ancillary services.

The Bank will continue to support private sector projects in the oil and gas exploration and production and services sectors, where these are expected to enhance the role of private operators in oil and gas production and have a positive impact in terms of the business environment. The Bank will also support projects of regional significance that enhance regional trade via diversification of hydrocarbon export routes and which favour regional integration of energy infrastructures. In Azerbaijan the Bank may support public sector projects on a selective basis when these projects carry significant transition impact potential in terms of setting higher standards for corporate governance, transparency, revenue management and when these are expected to have a systemic impact in terms of energy efficiency and environmental conduct. In terms of transparency, the Bank will support continued compliance of Azerbaijan with evolving EITI rules.

Policy dialogue and TC

In parallel, the Bank will work closely with the Government of Azerbaijan to deepen institutional and regulatory reform. Drawing on the lessons of hydrocarbons and FI sectors, EBRD will strive to create a more favourable investment climate in the real sector, where possible, by promoting improvements in the legislative framework, enhancing competition and reducing the incentives for corruption. In order for these measures to be successful, opening new channels for constructive policy dialogue with key government agencies will be crucial.

3.4. Environmental and social implications of the Bank's proposed activities

The Bank will ensure that all operations in Azerbaijan comply with the Bank's Environmental and Social Policy, including pertinent requirements of ILO and national labour standards. Efforts will be made to assist clients in achieving compliance, including the preparation of ESAPs for all investments aimed at structuring projects to achieve full compliance with EBRD Policy and Performance Requirements.

The Bank remains committed to providing assistance on the implementation of high priority issues identified on the national level, including projects relating to the development of transportation infrastructure. We will look for opportunities to leverage TC finds for projects in these areas in cooperation with the Government.

To the extent that we are involved in further development of road infrastructure in the country the Bank will promote good international practice/standards in regards to road safety. We will look for opportunities to introduce good international practice in the design phase of such projects, and to leverage our contacts and experience with international organisations involved in road safety design and awareness campaigns.

The Bank will look to continue efforts promoting training on EHS items with existing and new financial intermediary projects. The Bank has recently developed an “E-learning” component and we will look for opportunities to utilise this module for any new FI project in Azerbaijan.

The Bank will work with any clients in the agribusiness or local manufacturing sectors to ensure they understand our EHS requirements, and to ensure that their projects are structured to comply with our Environmental and Social Performance Requirements.

Gender

In line with the recently approved Strategic Gender Initiative (SGI), the EBRD will attempt to develop and implement projects in relevant sectors and areas in Azerbaijan. According to the assessment of gender gaps of the SGI, Azerbaijan is among those countries where the gender gaps are greatest. The Bank will endeavour to work with its clients to support equality of opportunity in the workplace and promote career advancement, and to ensure that women, as well as men, benefit equally from the Bank’s investments. The Bank will also attempt to ensure that the services are designed and implemented in a way that is responsive to the needs of both men and women.

The Bank is currently implementing a project to promote gender equality in the financial sector in Azerbaijan. The project focuses on increasing the number of female loan officers and on providing gender training to loan officers in order to increase the number of women clients in EBRD partner banks and non-bank microfinance institutions. The Bank will continue working with its clients in the financial institutions sector to identify ways, where appropriate, to support women entrepreneurs in terms of facilitating their access to finance and supporting their business activities.

See Annex 8 for an assessment of gender equality.

4. ACCESS TO FINANCE

4.1. Private sources of capital

The financial system of Azerbaijan is heavily dominated by banks, which account for more than 90 per cent of financial sector assets. Banking system is comprised of big state bank, the International Bank of Azerbaijan, which holds 38.4 per cent of total sector’s assets, and 43 smaller private banks. Banks’ assets have grown strongly recently. However, banking penetration remains relatively low, at only 34 per cent of GDP. Banks’ loan portfolios are relatively well diversified, with households (33 per cent), trade and services (21 per cent), industry (11 per cent) and real estate (10 per cent) being the major lenders. SME sector has little access to bank loans, as centralized credit bureau is lacking and banks prefer to engage in large corporate lending or state-led project finance.

Microfinance activity has developed rapidly in recent years to fill the needs of small business in finance. Estimates show that microfinance borrowers rose from 100,000 in 2006 to more than 400,000 in 2012 (4 per cent of population). Even so, the loan portfolio of microfinance institutions is only about 1 per cent of GDP. The market is highly concentrated, with two dominant providers, Accessbank and FINCA, together comprising almost a half of the market. Recently microfinance market has faced some challenges regarding weak sector supervision, outdated regulatory regime, difficulties in information sharing, and low financial literacy of population, which may constrain its development in future. The government has cooperated with Swiss State Secretariat for Economic Affairs (SECO) and the World Bank to overcome these challenges, although much remains to be done.

Non-bank financial sector has grown strongly in recent years, but its financial intermediation is very limited. Insurance sector assets account for 1 per cent of GDP. Insurers' overall premia rose 61 per cent in 2012 and amounted to 0.63 per cent of GDP, of which the majority is non-life insurance (90 per cent). The government supported the sector recently by introducing mandatory insurance. In November 2011, the authorities established a Compulsory Insurance Bureau with a purpose of stabilization and development of the system of compulsory insurance and fulfilment of duties prescribed by law. These reforms are expected to increase the size of the insurance market and, over time, increase the stock of assets in the local capital market. Positive developments have attracted foreign interest to insurance market where now two large and several smaller foreign insurers are present.

Other segments of non-bank financial sector are even less developed. There are no private pension funds operating in the country and the leasing sector is still at early stages of development, both with respect to market penetration and regulatory framework. A commercial private equity sector is yet to develop and to date the country has not attracted significant interest of international private equity funds.

Capital market in Azerbaijan remains nascent. The Baku Stock Exchange turnover increased by 7 per cent in 2012 and totalled AZN 9 billion (17 per cent of GDP). However, the most of the activity concentrated in government securities segment (90 per cent), while the corporate segment turnover almost halved from a year earlier. There were 81 deals in primary corporate bond market and 548 deals in primary stock placements. Total corporate debt and equity capital raised in 2012 amounted to AZN 550 million, or 1 per cent of GDP. Although the basic institutional and legislative framework for the securities markets has been in place since early 2000's, there is still little activity and demand for capital mobilization from private sector.

Azerbaijan is rated at investment grade BBB-, Baa3 and BBB- by Fitch, Moody's and Standard & Poor's, respectively.

4.2. MDB finance and collaboration with other IFIs

The Bank will continue to coordinate its activities with the World Bank, IFC, and Asian Development Bank, with an emphasis on leveraging those relationships to enhance the effectiveness of policy dialogue. The Bank will also explore opportunities for cooperation with the EIB and the Islamic Development Bank.

In identifying appropriate areas for cooperation the Bank will look to add value by contributing elements of transition and systemic change to enhance outcomes, in addition to providing financing. The Bank will aim to take the lead in developing a consensus among IFIs on elements of policy dialogue, particularly in such sectors as infrastructure.

It will be important to closely coordinate policy dialogue with the ADB on the subject of road PPPs and other private sector involvement in the road sector, where changes in legislation will be needed.

In the financial sector, the EBRD will engage with IFC on areas in which the two institutions, acting as co-investors, can work together to enhance the core competencies and viability of these institutions, and will continue to work with IFC to identify opportunities to assist the private sector through joint financing.

Asian Development Bank

The ADB has prioritised regional infrastructure development including power, water supply and sanitation, and roads. The ADB is working on its new country strategy programme for 2014-2018 and is expected to add the financing of MSME credit lines with local banks focusing on rural areas. During the next Strategy period collaboration with the ADB is envisaged in the following areas: a) Continued implementation of the EBRD regional roads programme, which will connect with major road corridors financed by ADB. EBRD and ADB loan conditionalities are currently coordinated and harmonised. b) EBRD and ADB will finance the same partner institutions in order to improve levels of financial intermediation. c) There may be opportunities to cooperate in the MEI and power sectors during the Strategy period.

From 2001 to 2012, Azerbaijan received 19 loans and grants for public sector projects and non-sovereign operations, totalling \$1.49 billion for the following sectors: transport (50.8%), water supply and sanitation (27.2%), energy (12.6%), finance (7.8%), and agriculture (1.5%). The projects support the public sector (\$1.347 billion) and the private sector (\$143 million). Ten loans were closed as of 2012. The ADB also extended its trade finance programme to participating local banks to fill market gaps by providing guarantees and loans in support of trade. ADB approved about \$14.3 million grants from 2001 to 2012 for financing 14 projects' preparatory technical assistance and 13 advisory technical assistances.

International Monetary Fund (IMF)

Between 1995 and 2005 Azerbaijan borrowed from the Fund in support of its economic programmes on several occasions. Since late-2005, relations with the IMF entail standard surveillance through the annual Article IV Consultations with a view to assessing economic and financial developments and discussing economic and financial policies, and technical assistance activities for capacity-building aimed at supporting the government's efforts to improve the design and implementation of economic policies.

The 2013 Article IV Consultation was concluded by the IMF Executive Board on 3 May. The Executive Directors, while noting Azerbaijan's strong buffers against

external instability, encouraged the authorities to adjust the course of economic policies and strengthen the macroeconomic policy frameworks from a position of relative strength to mitigate risks to macroeconomic stability from continued expansionary policies. Directors also noted that ensuring an orderly bank capitalisation process, strengthening supervisory safeguards in line with international best practice, and developing a viable business model for the largest bank are crucial to preserve financial sector stability.

Over the last three years, IMF technical assistance activities in Azerbaijan have focused on monetary and exchange rate policy; AML/CFT legislation; budget and debt management; pension reform; banking supervision; and macro-statistics. Senior government officials have also benefited from training on macro-fiscal analysis and the conduct of monetary policy at the IMF Institute.

World Bank

The World Bank's funding in Azerbaijan has historically been provided to two main areas: transport (48%) and the water and sanitation sectors (22%). Other sectors that received substantial financing and agriculture and rural development (9%); public administration and law; social development, and social protection (5%); and energy and mining (3%).

The World Bank program is carried out under the FY11–14 Country Partnership Strategy (CPS) for Azerbaijan, and aims at building a competitive non-oil economy and strengthening the social and municipal services, with a strong cross-cutting theme of governance and anticorruption. The FY11-14 CPS Progress Report (CPS PR) assesses the relevance of the CPS strategic priorities and refines the World Bank Group program for FY13–14. The Progress Report confirms the strategic vision of the Government as remaining centred on economic diversification and service delivery, and anchored on good governance.

WB's project called Capital Markets Modernisation Program is expected to play significant role in development of capital markets in Azerbaijan. The Bank focuses in three directions which are (i) modernisation of infrastructure, (ii) providing trainings and (iii) developing the legislation for issuance of securities. The program fully complies with the state program focusing to develop the capital markets in Azerbaijan.

IFC

IFC has invested almost US\$409 million and mobilized nearly US\$73 million from other lenders in 69 projects. IFC's commitments have been primarily in the financial sector in the areas of leasing, SMEs, and trade and housing finance, but IFC has also invested in the oil and gas, beverage, hotel, and retail sectors. IFC has implemented advisory projects focused on development of the private sector in areas such as investment climate (one-stop shop for business registration; establishment of Portal of Business Permits and Licenses, an online portal for Azerbaijan's SMEs, and a draft Inspections Law), corporate governance, and financial sector risk management.

The State Oil Fund of the Republic of Azerbaijan (SOFAZ), Azerbaijan's sovereign wealth fund, has committed US\$350 million to funds managed by the IFC Asset Management Company. This includes US\$200 million to the IFC Global Infrastructure Fund, which invests alongside IFC in infrastructure projects in emerging markets; US\$50 million to the IFC Catalyst Fund, which is designed to stimulate the development of funds and projects focused on renewable energy and climate friendly solutions; and US\$100 million to the IFC African, Latin American, and Caribbean Fund, which invests alongside IFC in equity and equity-like projects in those regions.

USAID

USAID's Economic Growth Programme in Azerbaijan focuses on the non-oil economy and overlaps with EBRD objectives in several areas. The Azerbaijan Competitiveness and Trade project is designed to improve the domestic business enabling environment and develop a liberalized, more transparent trade environment; and improve targeted value chains in the agricultural sector in Azerbaijan. USAID is also supporting three EBRD partner banks with guarantees to support lending to SMEs and especially the agricultural sector.

KfW

KfW has been operating in Azerbaijan since 1995. As of today the total portfolio volume is EUR 594 million for the following sectors: municipal infrastructure (50%), energy and transportation (34%), financial sector (14%) and protection and management of natural resources (11%). In financial sector KfW does SME refinancing, works on establishment of Deposit Guarantee Fund funding for MSME lending to local banks. KfW is very active in promoting agricultural development as well where it has invested EUR 85 million to this sector. KfW financed the rehabilitation of water systems in regions of Azerbaijan such as imishli, Ganja and Sheki.

SECO

The official Swiss development assistance for the Republic of Azerbaijan will amount to around CHF 29 million over the period from 2013 until 2016. The new Swiss Cooperation Strategy defines three priority domains to which several Swiss government entities contribute each with their core competences.

Under the domain Economic Development and Employment Switzerland will maintain its focus on improving business environment, fostering stronger financial sector, and will provide support for enhancing entrepreneurial skills. Under the Governance and Public Services domain to promote high-quality public services Switzerland will provide assistance to continue decentralisation and increase the management capacities of utility companies in addition to its contribution to the construction of physical infrastructure. Furthermore, Swiss support will focus on strengthening governance in public financial management and economic policies. With the purpose to increase efforts in the field of conflict transformation a Human Security and Protection domain was created where high-level diplomatic initiatives will be coupled with local level peace-building actions.

Since 2001 to the date the government of Switzerland allocated more than CHF 85 million for a bilateral development and cooperation program with the republic of Azerbaijan. These funds were channelled as non-reimbursable grants for interventions and projects managed by the World Bank, IFC, KfW, IMF and other IFIs in the areas of rural development, macroeconomic policy support, and non-oil private sector development.

4.3. Cooperation with the European Union

The EU has provided cooperation assistance to the Azerbaijani government through four budget support operations with a focus on energy, justice, agriculture and rural development. Technical assistance and twinning projects have been focusing on many other sectors related to approximation to EU standards and best practices. Through the NIF the European Commission has provided grants for the implementation and advisory work associated with the EBRD regional Roads Rehabilitation Programme and is the main donor to supporting SBS activities throughout Azerbaijan.

Under the new EU multi-financial framework 2014-2017 one of the priorities will be rural development. The EBRD should seek to collaborate with the EDU and other development partners on the implementation of its own programmes in this area, in particular with regard to the programme to promote local initiatives in regional and rural development in Azerbaijan. The EU Bilateral Allocation for 2011-2013 was €22.5 million, with most of the assistance is channelled through the Government institutions, via the European Neighbourhood and Partnership Instrument (ENPI).

EIB

European Investment Bank signed a Framework Agreement with the government of Azerbaijan in August 2013 to allow investment activities to begin. However, through EBRD the EIB has already been involved in one project in the energy sector through the purchase of carbon credits from via the EBRD-EIB Multilateral Carbon Credit Fund (MCCF) from Azerenerji's Azdres power station, which was rehabilitated with the help of an EBRD loan.

ANNEX 1 – POLITICAL ASSESSMENT

Azerbaijan is committed to the principles of multiparty democracy, pluralism and market economics outlined in Article 1 of the Agreement Establishing the Bank. A more consistent application of these principles would enhance political accountability, strengthen the rule of law, and help overcome the country's remaining challenges.

For the strategy period, the political system of the country continued to operate in a centralised manner with significant power concentrated in the presidency. There are many political parties, including opposition parties and the country continues its efforts in developing political pluralism. The judiciary and the legislature are not sufficiently balancing strong executive powers. Corruption remains a serious problem, as acknowledged by the authorities, and fighting corruption is a priority for them.

According to international observers from the OSCE, the parliamentary elections of 2010 and the October 2013 presidential elections did not meet a number of the OSCE standards for democratic elections, despite being conducted in a calm atmosphere and with the participation of opposition parties.

The conflict with Armenia over Nagorno-Karabakh is still unresolved despite continuing efforts at international mediation by the OSCE Minsk Group, co-chaired by France, Russia and the United States.

As a member of the UN, the OSCE, and the Council of Europe, Azerbaijan undertook to honour a number of obligations and commitments, which are being systematically monitored by the respective institutions and published in progress and election observation reports, which constitute the basis of this assessment. The legal expertise of the European Commission for Democracy through Law (Venice Commission) was used with regard to the assessment of the compliance of a number of Azerbaijani laws with Council of Europe standards.

Azerbaijan's membership in the Council of Europe and its commitments under the European Neighbourhood Policy (ENP) Action Plan, provide the country with a platform to demonstrate its commitment to European democratic values and bring its legal framework in line with European standards. The latest ENP progress report, published on 20 March 2013, concluded that “despite progress compared to the past⁴, Azerbaijan needs to continue its efforts in order to meet its commitments on democracy, including electoral processes, the protection of human rights and fundamental freedoms, and the independence of the judicial system”.⁵

Similarly, other monitors identified the areas which require attention in terms of further progress to include freedom of assembly, freedom of expression, the decriminalisation of defamation, independence of the judiciary, and the consistent

⁴ The elements of progress have been identified as “starting to implement the Human Rights Action Plan, continued judicial reform and some steps to address the problem of demolitions and forced evictions”, ENP Country Progress Report 2012 – Azerbaijan, Brussels, 20 March 2013, Memo, European Commission, p4

⁵ ENP Country Progress Report 2012 – Azerbaijan, Brussels, 20 March 2013, Memo, European Commission, p1

implementation of the commitments undertaken under international treaties in the area of civil and political rights.

Representative and Accountable Government

Free, fair and competitive elections

The Constitution provides for a democratic government with universal suffrage. General elections are held on a regular basis.

Since its independence in 1991, international observer missions have found shortcomings in the country's electoral processes as confirmed by the judgments of the European Court of Human Rights in seven cases out of 35 considered admissible relating to the 2005 parliamentary elections. Numerous cases relating to the 2010 parliamentary polls are pending before the Court. The shortcomings revealed in the Court's judgments were related to the composition of the electoral commissions, candidate registration, and complaints and appeals procedure.⁶

The parliamentary elections of 2010 were monitored by the OSCE/ODIHR. According to the final report of the OSCE/ODIHR Election Observation Mission, while the elections were characterised by a peaceful atmosphere and participation of all opposition parties, "the conduct of these elections overall was not sufficient to constitute meaningful progress in the democratic development of the country", and "overall, these elections failed to meet a number of the OSCE commitments for democratic elections and important elements of Azerbaijani domestic legislation".⁷

Parliamentary elections in Azerbaijan were conducted under a majoritarian system with members of parliament elected in 125 single-mandate constituencies for a five-year term. The primary legislation for the elections consists of the Constitution and the Election Code (last amended in 2010). The legal framework also includes the Law on the Freedom of Assembly (2008), the Law on Radio and TV Broadcasting, the Code of Civil Procedures, and relevant provisions of the Criminal Code and the Code of Administrative Offences.

The presidential election of 9 October 2013 was monitored by a large group of international observers. The OSCE Office for Democratic Institutions and Human Rights (OSCE/ODIHR) and the OSCE Parliamentary Assembly (OSCE PA) issued a statement of their preliminary findings, saying that "the 9 October election was undermined by limitations on the freedoms of expression, assembly, and association that did not guarantee a level playing field for candidates. Continued allegations of candidate and voter intimidation and a restrictive media environment marred the campaign. Significant problems were observed throughout all stages of election day processes and underscored the serious nature of the shortcomings that need to be addressed in order for Azerbaijan to fully meet its OSCE commitments for genuine and democratic elections."⁸

⁶ Parliamentary Assembly of the Council of Europe, Resolution 1917 (2013), The Honouring of Obligations and Commitments by Azerbaijan, p2.

⁷ OSCE/ODIHR EOM 2010 Parliamentary Elections, Final Report, p2

⁸ International Election Observation Mission, Republic of Azerbaijan – Presidential Election, 9 October 2013, Statement of Preliminary Findings and Conclusions, p.1

The Parliamentary Assembly of the Council of Europe (PACE) and European Parliament (EP), which sent a small delegation, concluded that the electoral process was “free, fair and transparent” with many observers invited and no “evidence of intimidation against voters” on election day. They also noted that improvements to the electoral framework are still desirable, “notably concerning the respect of fundamental freedoms during the months before the election.”⁹

The Election Code has been amended several times since its adoption. The latest amendments to the Election Code, passed in June 2010, have shortened the official campaign period, thus limiting candidates’ opportunities to campaign.¹⁰ These amendments did incorporate some of the recommendations of the Venice Commission but fell short of addressing the recommendations regarding the composition of the electoral commissions. While a broad range of media exists in Azerbaijan, voters had limited access to alternative views as noted by the International Election Observation Mission of the OSCE/ODIHR and the OSCE PA.¹¹

Separation of powers and effective checks and balances

According to the Constitution, the Republic of Azerbaijan has a presidential form of government with the presidency exercising significant influence over the legislature and the judiciary.

President Ilham Aliyev has been in office since October 2003. Since coming to power, President Aliyev has steadily consolidated his political authority, and has been re-elected twice, in 2008 and 2013. The 2008 and 2013 elections did not fulfil all OSCE commitments. The 2008 election was peaceful but lacked robust competition and vibrant political debate. Despite the shortcomings, the *ad hoc* committee of the PACE concluded that the election reflected the will of the country’s electorate.

Legislative authority is vested in the Milli Mejlis (National Assembly), a unicameral body composed of 125 MPs elected for five years. The presidential Yeni Azerbaijan Partiyasi (YAP) retains a dominant position in the legislature and in the political system. Parliament is evolving as a forum for political debate and a body balancing the strong executive power.

Effective power to govern of elected officials

Azerbaijan’s elected officials have effective power to govern without restraints. The military is under civilian control and does not play a decisive role in the country’s political decision-making process. Although big business plays an important role in the country, it does not possess excessive powers to influence elected officials.

Civil Society, Media and Participation

⁹ Parliamentary Assembly of the Council of Europe, 10/10/2013/Election observation, Presidential election in Azerbaijan: joint statement by PACE and EP delegations.

¹⁰ OSCE/ODIHR EOM 2010 Parliamentary Elections, Final Report, p.2.

¹¹ International Election Observation Mission, Republic of Azerbaijan – Presidential Election, 9 October 2013, Statement of Preliminary Findings and Conclusions, p.2

Scale and independence of civil society

The CSO sector in Azerbaijan is active with about 3,000 NGOs registered and functioning. The majority of the CSOs remain dependent on funding from international donors, including grants provided by foreign embassies.

During the latest 2013 Universal Periodic Review (UPR) civil society groups raised concerns about the difficult environment for activists in the country. In February 2013 parliament approved amendments to the laws governing national and international CSOs, including amendments to the Law on NGOs, the Law on Grants, and the Code of Administrative Offences. The changes require CSOs to disclose the identity of their benefactors. Of concern to the CSO community are amendments requiring a formal agreement with donors for all contribution over AZN200, limiting the possibility of cash contribution by donors who wish to remain anonymous. Registration procedures for local and international NGOs remain cumbersome.¹²

Independent pluralistic media that operates without censorship

Freedom of the press and freedom of expression are enshrined in the Constitution and are guaranteed by the law. The law specifically prohibits press censorship.

Since Azerbaijan gained independence, its media has been transformed from a state-run system into a variety of new media outlets, both private and state-owned. New media laws and registration procedures have been adopted.

Despite the broad range of media operating in the country, the government uses means to control media content. According to the OSCE Representative on Freedom of Media and other representatives of international community, the overall media environment does not comply with international standards for independent pluralistic media¹³. The government has been encouraged to end the use of criminal defamation and release the journalists and bloggers who were deprived of their liberty as a result of expressing their views.¹⁴

Multiple channels of civil and political participation

The government is required by law to provide citizens with information regarding policies and subjects that affect them. However in practice official websites are poor in content, with information not always delivered in a timely fashion.

Freedom to form political parties and existence of organised opposition

Azerbaijan has more than fifty registered political parties, the ruling Yeni Azerbaijan Partiyasi (YAP) continues to dominate the legislature and the overall political system.

¹² ENP Country Progress Report 2012 – Azerbaijan, Brussels, 20 March 2013, Memo, European Commission, p5.

¹³ Regular Report to the Permanent Council, 13 June 2013, OSCE, The Representative on Freedom of the Media Dunja Mijatovic, p4-6

¹⁴ Enhancing freedom of expression in Azerbaijan, Joint Statement on media freedom by European Commission, Council of Europe and Organisation for Security and Cooperation in Europe (OSCE), Brussels, 9 November 2012.

In April 2012, the Milli Mejlis (parliament) passed amendments to the Law on Political Parties, clarifying rules on political party financing and setting new rules for the disclosure of private contributions. The new law was generally approved by the Council of Europe's Venice Commission.

The political opposition exists and is organised but seems unable to present a strong challenge to the president. This was evident in the last presidential election in October 2013.

Rule of Law and Access to Justice

Supremacy of the law

The Constitution is the supreme law of the country and is accepted by all political forces. The right to a fair trial is envisaged in the legislature, although the strong position of the prosecutor and the shortcomings in the judiciary continue to affect this right.

Independence of the judiciary

Some progress has been made in the establishment of the legislative framework in some areas crucial for the functioning of democratic institutions in compliance with European standards. In particular, the establishment of the Judicial Legal Council was acknowledged as an important step in the country's judicial reform. The newly adopted legal acts introduced revised procedures for recruiting judges as well as amendments to the law on combatting corruption and to the criminal code with regard to the criminalisation of corruption.

Despite these achievements, the lack of judicial independence has been widely reported as a serious problem, making access to a fair trial difficult. The executive branch of power continues to exert influence on the judiciary.

Government and citizens equally subject to the law

The Constitution guarantees the equality of all citizens before the law. Impunity remains a problem, with the authorities not always taking steps to prosecute officials alleged to have committed human rights abuses.

Effective policies and institutions to prevent corruption

Fighting corruption remains a key challenge, as acknowledged by the authorities. It affects the whole society and has a detrimental impact on the economic diversification and development of entrepreneurship in the country. According to Transparency International's latest (2013) Corruption Perception Index (CPI), Azerbaijan is ranked 127th out of 177 countries.

The authorities adopted an anti-corruption Action Plan for 2012-2015. The plan and other initiatives and tools created by the government to curb corruption in the country, has yet to yield results. In a resource-rich country like Azerbaijan, revenue reporting is vital in combating corruption. In this respect, the country scores well. Azerbaijan

has been designated as Extractive Industries Transparency Initiative (EITI) compliant country in 2009 with re-validation due within 5 years.

Despite these measures, however, corruption remains a crucial challenge and it is essential to improve enforcement procedures to ensure that anti-corruption legislation works in practice. In its latest Third Round Evaluation Report, published in January 2013, the Group of States against Corruption (GRECO) noted that Azerbaijan implemented seven of its 17 recommendations, leaving significant room for improvement for implementing the recommendations made by the group.¹⁵

Civil and Political Rights

Freedom of speech, information, religion, conscience, movement, association, assembly, and private property

A member of the UN, the Council of Europe and the OSCE, Azerbaijan has developed a strong legal basis for the protection of civil and political rights by ratifying the core international treaties in this area and the fundamental conventions of the International Labour Organisation (ILO). However, according to specialised local and international observers, the implementation of these commitments is poor.

The last assessment of the track record of Azerbaijan in the area of human rights has been conducted within the framework of the United Nations Universal Periodic Review (UPR) in April 2013. The final report on the outcome of the review was adopted in July 2013. According to the UPR's official statistics, the top three recommendations for Azerbaijan's 2009 UPR review were the rights of the child, freedom of the press, and women's rights. Statistics are not yet available for the latest review but key recommendations included: the rights of the child and women's rights; improvement of the environment of civil society organisations; implementation of legal reforms, and guarantees of the freedom of expression.¹⁶

Freedom of speech and freedom of assembly are being quoted frequently as areas which require special attention. While the government approved a number of peaceful protests last year, it limited the approved demonstrations to locations far from the centre of Baku. There were reports about applications for political protests been denied, and unsanctioned protests forcefully dispersed. The authorities have been encouraged to find a compromise solution to allow protest action in some areas of Baku's city centre, complying with security requirements and mutually acceptable for both the organisers and the authorities.¹⁷

The latest legislative changes have the potential of limiting the constitutionally-guaranteed freedom of expression. In June 2013 the Articles 147 and 148 of the Criminal Code were amended to expand the definition of slander and insult. The

¹⁵ Compliance Report on Azerbaijan, Third Evaluation Round, Group of States against Corruption (GRECO), 8 January 2013, p 17

¹⁶ United Nations, Universal Periodic Review (UPR), Draft Report of the Working Group on the Universal Periodic Review (Azerbaijan), 5 July 2013

¹⁷ Parliamentary Assembly of the Council of Europe, Resolution 1917 (2013), The Honouring of Obligations and Commitments by Azerbaijan, p 4.

amended law made it possible to invoke criminal liability against online activists who post defamatory views on the Internet.

The law contravenes Azerbaijan's commitments and obligations related to decriminalisation of defamation. Azerbaijan's human rights National Action Plan, approved in 2011, envisaged the decriminalisation of libel, and in 2012 the authorities requested the Council of Europe's Venice Commission to assist in drafting a new law on protection against defamation.

However, instead of going in the direction of introducing civil remedies in cases of alleged slander and insult, the law expanded the scope of criminal liability for defamation. The EU, Council of Europe and the OSCE have expressed disappointment and serious concerns at the promulgation of the latest changes.¹⁸

Most religious groups were able to worship publicly without government interference. Despite accepting UPR recommendations regarding freedom of religion, tightened regulations on religious activity have been introduced by requiring religious communities to re-register and by increasing fines for unauthorised activities.¹⁹

Private property is generally respected in Azerbaijan but hurdles to the sale, registration and use of property such as land and housing remain. State officials frequently interfere with legal processes related to the property rights. There were reports with regard to irregularities during expropriation and reconstruction procedures in Baku. The authorities have been urged to provide adequate compensation and bring to justice those who have broken the law²⁰.

Political inclusiveness for women, ethnic and other minorities

The law prohibits discrimination based on race, gender, disability, language, or social status. However, there are reports suggesting that the law is not enforced systematically.

The share of female candidates increased in 2010 compared to the last parliamentary elections as did the number of women elected (from 14 in the outgoing parliament to 20). However, the number of women in law enforcement, including police, remained very low.

Issues related to national minorities did not appear to be a significant factor in the elections. Members of national minorities are represented among candidates of all main political parties. The authorities have been encouraged to create a national consultative organ, comprising representatives of the minorities in order to better take into account their specific needs.

¹⁸ Council of Europe Commissioner for Human Rights and OSCE media freedom representatives concerned at further restrictions to free expression in Azerbaijan, Press Release, 6 June 2013.

¹⁹ United Nations, Universal Periodic Review (UPR), Summary prepared by the Office of the High Commissioner for Human Rights, Working Group on UPR, 29 January 2013, p6.

²⁰ Parliamentary Assembly of the Council of Europe, Resolution 1917 (2013), The Honouring of Obligations and Commitments by Azerbaijan, p2.

Freedom from harassment, intimidation and torture

Azerbaijan is a signatory of the UN Convention against Torture and Other Cruel, Inhuman, or Degrading Treatment or Punishment. The Constitution and the Criminal Code prohibit such practices and provide for penalties of up to ten years imprisonment. In May 2012 parliament passed legislation implementing the constitutional provisions and providing for the ethical treatment of detainees. However, human rights monitors continue to report instances of torture and abuse of persons in custody.²¹

²¹ Parliamentary Assembly of the Council of Europe, Resolution 1917 (2013), The Honouring of Obligations and Commitments by Azerbaijan, p 4; Office of the High Commissioner for Human Rights, Report compiled in accordance with paragraph 5 of the Annex to Human Rights Council Resolution 16/21, UN Working Group on the Universal Periodic Review, 11 February 2013, p.6.

ANNEX 2 – ASSESSMENT OF TRANSITION CHALLENGES

Azerbaijan: Sector transition indicators

Sectors	Market structure	Market-supporting institutions
Corporate sectors		
Agribusiness	Medium	Medium
General industry	Large	Large
Real estate	Large	Large
Telecommunications	Large	Large
Energy		
Natural resources	Large	Medium
Sustainable energy	Large	Large
Electric power	Large	Large
Infrastructure		
Water and wastewater	Large	Large
Urban transport	Large	Large
Roads	Medium	Medium
Railways	Medium	Large
Financial sectors		
Banking	Large	Large
Insurance and financial services	Large	Medium
MSME finance	Large	Large
Private equity	Large	Large
Capital markets	Large	Large

Agribusiness

Market structure: *Medium*

Market institutions: *Medium*

Key challenges: (i) improve production, transport and storage infrastructure along the value chain to increase productivity in farming and processing; (ii) easing of bureaucratic burden on international trade to increase competitiveness of the sector.

With substantial progress made in Azerbaijan's accession to the WTO the government has somewhat advanced price liberalisation, trade controls and decreasing price support and subsidies to the agricultural sector. However, exports and imports are bureaucratically cumbersome and expensive in comparison to other countries in the region and monopolistic behaviour for certain commodity imports persists. Privatisation has been virtually completed for smaller processors but some larger enterprises remain state controlled or largely unreformed and the overall business environment remains challenging. Productivity in most of the agricultural commodities remains comparatively low and further skills transfer is needed to upgrade farming techniques. Only a very small number of enterprises have implemented international quality and hygiene standards. In the dairy and meat sector small-scale (subsistence) production dominates and productivity lies well below potential. Infrastructure in terms of production assets (equipment and irrigation), transport and processing are underdeveloped. Lending to the agricultural sector has improved in recent years, but remains low with limited tailored financial products or access for working capital financing.

Manufacturing and Services

Market structure: *Large*

Market institutions: *Large*

Key challenges: (i) concerted efforts should be made to tackle corruption, the main barrier to the development of manufacturing and services sector; and (ii) strengthen competition through further streamlining of licenses and permits as well as improving the capacity and powers of the competition authority.

To date, the Manufacturing and Services sector only marginally benefited from the spill-over effects from the natural resources sector, with the development of construction materials, chemicals and other sectors with high transportation costs. Overall, enterprises still operate with obsolete equipment resulting in poor productivity and environmental and quality standards. While the institutional set-up for facilitating new entry has improved in recent years, such as business registration, significant challenges remain in the enforcement of competition policy and improving corporate governance and business standards. Corruption hinders financial transparency, which in turn stifles the growth of enterprises and derails potential attempts by the government to introduce measures to diversify the economy.

Real estate

Market structure: *Large*

Market institutions: *Large*

Key challenges: (i) ensuring the protection of property rights; (ii) developing modern legal and regulatory framework for real estate; (iii) increasing focus on modern construction techniques and technologies, including energy efficiency and sustainability; and (iv) increasing supply of modern commercial property.

The property market is at early stages of development, including the introduction of new products and financing methods. There are a few modern office developments associated with the oil related investments in Baku but foreign institutional investors' interest in the country is still limited. The mortgage market remains underdeveloped. The regulatory framework for property development is weak and the abuse of property rights remains widespread. However, some progress has been made with regard to property registration through the introduction of a one-stop shop and the assignment of sole responsibility for all property registrations in the country to one single agency, the State Registry of Real Estate. Obtaining permits is still cumbersome as it requires 28 procedures and requires over 200 days (according to the World Bank Doing Business 2013). Gaps in terms of the development of modern primary and secondary legislation supporting the sustainability of real estate (energy efficiency, impact on environment) are still large. Public awareness of the sustainability issues is also low.

ICT

Market structure: *Large*

Market institutions: *Large*

Key challenges: (i) continuing to develop the telecommunications infrastructure (broadband internet); (ii) developing the regulatory framework (e.g. establishing an

independent regulator and implementing competitive safeguards); (iii) privatising the fixed line incumbent Aztelekom.

Although there have been plans to proceed with reforms, the telecom sector continues to be dominated by the Ministry of Communications and Information Technologies (MCIT), whose triple role as a regulator (through a regulatory department within the Ministry), policy-maker and key shareholder in most telecommunications enterprises (including the fixed-line incumbent Aztelekom) has had a negative impact on the performance of the sector. The regulatory framework is generally under-developed.

The fixed segment is dominated by two state-owned incumbents Aztelekom and Baktelekom (in the capital city Baku). Even though a number of companies hold licenses for fixed telephony, competition is very limited. The mobile market is better developed (with 3 major mobile operators, Azercell, Bakcell and Azerfon), but still lags behind the region. Mobile phone and broadband internet penetration levels have been increasing significantly, although they remain at relatively low levels. Azercell was fully privatised in February 2008, and a CDMA license (450MHz frequency) was issued to Catel in February 2006, which however mainly provides fixed wireless services. Internet services development has been hindered by the lack of local loop development and legislation that would determine the legal status of Internet-related businesses.

Natural Resources

Market structure: *Large*

Market institutions: *Medium*

Key challenges: (i) achieve commercialisation and restructuring of SOCAR, the State's oil and gas company; (ii) further liberalise the oil and gas downstream sector and encourage the entry of new participants into the market; and (iii) establish an independent energy regulator.

The country is abundant in natural resources. Oil and gas receipts are estimated to account for over 70 per cent of Azerbaijan's exports and nearly 50 per cent of budget revenues. The main government vehicle, SOCAR, currently accounts for almost half of domestic oil production, in partnership with international oil companies (IOCs), and dominates gas production (ca. 30 per cent of total production in 2011). SOCAR remains a fully integrated company with many non-core assets; its restructuring and commercialisation are slow to materialise and are a key challenge for the future. In 2012, SOCAR expanded its dominant position as gas supplier and distributor in Georgia following the acquisition of the Georgian subsidiary of Itera. BP entered Azerbaijan in 1992, and is now the country's largest foreign investor and the second largest crude producer after SOCAR.

Greater diversification of export routes was achieved following construction of the Baku-Tbilisi-Ceyhan (BTC) oil pipeline and the development of Shah Deniz field and associated South Caucasus gas pipeline, which were inaugurated in 2006. Furthermore, Azerbaijan is party of other transport projects which pursue similar goals: for instance, SOCAR is involved in long-distance LNG transport from Georgia, and in trans-Caspian interconnection projects with neighbour countries Kazakhstan and Iran. In November 2012, the Azeri parliament ratified inter-government

agreement with Turkey for the construction of Trans-Anatolian gas pipeline (TANAP) that will carry Caspian gas from Turkey's eastern border with Georgia to its western border with Europe. In June 2013, the Shah Deniz consortium announced that it had selected the Trans-Adriatic Pipeline (TAP) project over Nabucco West for its gas supply to Europe. Supply terms for the Caspian gas sales have been agreed with a number of companies from Greece and Italy.

In order to reduce government subsidies and improve energy efficiency, some adjustments in domestic oil and gas prices towards world market prices have been made. However, an independent regulator has not been established yet. Legislation seems appropriate. Most fields exploited under Production Sharing Agreements (PSAs). The EITI Board designated Azerbaijan as EITI compliant on 16 February 2009 and must be re-validated within five years. The split of PSA revenue streams between the government and SOCAR have been clarified, and the State Oil Fund operates in a transparent manner. Revenues are fully integrated into the State Budget.

Sustainable Energy

Market structure: *Large*

Market institutions: *Large*

Key challenges: (i) introduce cost reflective tariffs for end consumers; (ii) develop the legal framework for energy efficiency and renewable energy projects; and (iii) strengthen institutional capacity for supporting renewable energy projects.

The country continues to be one of the most energy intensive in the region. Energy tariffs are very low, do not include environmental costs and do not encourage energy efficient behaviour. While some decrees were adopted by the Cabinet of Ministers and the President in 2004 ("Action plan for Energy Efficiency and Reduction of losses in Energy Sector enterprises", and a presidential decree on "State programme on usage of alternative energy sources"), no energy efficiency law or policies are in place. A state agency for alternative and renewable energy sources which aims to support and issue licences for RE generation has been set up recently. Azerenerji has signed one of the first CDM projects in the country under an EBRD financed project signed in 2006.

Power

Market structure: *Large*

Market institutions: *Large*

Key challenges: (i) increase the corporatisation of the state-owned entity; (ii) establish an independent regulator; and (iii) introduce cost reflective tariffs for end consumers.

The power sector continues to be dominated by the state-owned monopoly electricity utility, Azerenerji. The government continues to fund the capital investments of the utility while all tariffs remain regulated with no plans for liberalisation. Privatisation, although explored and reversed for the Baku distribution network, is not an explicit objective of the government. However, the company is pursuing ambitious plans for corporatisation. The first stage in this direction - implementation of IFRS standards - has been completed. Further progress in this direction is represented by the company securing an international credit rating from S&P in 2012. These plans should

ultimately facilitate unbundling within the company and significantly improve business processes. There is still no independent regulator. The state Tariff Council tripled electricity tariffs for all users at the beginning of 2007, which helped to improve financial performance, but there have been no significant tariff increases since then. New investment is targeting an upgrade of the distribution network so as to reduce losses and improve collection rates. Works are nearing completion for the Energy Bridge project aimed at strengthening the interconnection capacity between Azerbaijan, Georgia and Turkey; once completed the project will allow for the power exchange between Azerbaijan and Turkey through Georgia. Since the end of 2011 greater emphasis has been placed on the development of renewable energy through the state agency for renewables. However, this support follows the model of principally utilising public funds and opportunities for private investors are limited.

Water and wastewater

Market structure: *Large*

Market institutions: *Large*

Key challenges: (i) institutional and regulatory capacity building; (ii) improved contractual arrangements and predictability; (iii) effective tariff reforms; and (iv) restructuring of water utilities to improve efficiency and sustainability.

Water and wastewater services are yet to be decentralised, as the central government continues to play a key role in operations and investment decisions. The national company Azersu supplies water to 65% of the population, with 10% provided by small private operators and 25% by households themselves. Failure to implement tariff reforms, weak management and poor governance have translated into very poor financial performance of Azersu. Despite government instructions to state-owned enterprises to settle transactions in cash, collection rates remain low, in particular for residential population. Moreover, the Presidential decree in 2011 wrote off all the debts of the population for water and sewerage services accumulated until February 1st, 2011, and act that may weaken the payment discipline going forward. Water meters have been installed in the large cities and meter-based billing has been recently introduced.

Urban Transport

Market structure: *Large*

Market institutions: *Large*

The challenges in the sector include: (i) decentralisation of some core regulatory aspects, including responsibility of tariff setting and service provision organisation, along with (ii) strengthening of institutional and legal capacity for the municipalities to regulate and monitor public transport service provision.

The urban transport in Azerbaijan is represented mainly by a large number of private bus operators. There is a municipal Metro company in Baku as well. Substantial control and influence in the sector rest with the central government. The urban transport operators are licensed and regulated by the departments of the Ministry of Transport of Azerbaijan. In accordance with the decree of the Ministry of Transport in 2007, the medium and small size buses have been gradually replaced by the large size buses. Baku Metro stand alone is unprofitable mainly due to low tariffs, and relies

heavily on direct transfers from the government. Although the metro fare was increased by one third in 2011, it still remains at a low level. In 2012 the government increased the grant provided to Baku Metro by 28 per cent to cover high company's losses. The tariffs for transport are set at national level by the Tariff Council of the Republic of Azerbaijan. In 2013 the government adopted a new decision regarding tariffs for passengers' transportation services on bus routes which aimed at grouping of bus routes and linking fares to the length of a route.

Ministry of Transport has developed and traffic management system in Baku, which was launched in December 2011. Integrated with the service of Ministry of Internal Affairs, the system is aimed at improving of public transport services, optimisation of traffic routes and traffic control. The system provides for the introduction of single payment cards in public transport, which is currently in the testing phase.

Roads

Market structure: *Medium*

Market institutions: *Medium*

Key challenges: (i) unbundling road maintenance units and corporatise them; (ii) introduction of competition in road construction and maintenance; (iii) more private sector participation in the sector; and (iv) road user charge reform and its allocation to the road maintenance and construction.

In roads, the road agency (known as Azerroadservice) was transformed into an open joint stock company in February 2007 (100 per cent state-owned). During the period 1994-2000, the road sector was financed through a Road Fund based on "earmarked" charges on road users, including revenues from fuel excise, annual vehicle inspection and taxes on vehicle sales, transit and a turnover tax. The Road Fund was abolished in 2000, after which all the sector revenues were channelled through the central budget. However, the Road Fund was subsequently reinstated in 2007. It is known as the Special Budget Fund on Roads, and is administered by the Ministry of Transport. There have been efforts to separate the road maintenance units (initially under the same company) and establish tight contractual arrangements within the company, but progress has been slow. A service level agreement was signed between the road agency and the ministry of transport. More efforts are needed to implement the road reform strategy.

Railways

Market structure: *Medium*

Market institutions: *Large*

Key challenges: (i) initiate institutional separation; (ii) increase financial transparency and independency from the government; (iii) establishment of the financial sustainability in passenger and infrastructure businesses (including tariff reform and introduction of PSO mechanism); and (iv) introduction of competition in railway businesses.

The core railway businesses (infrastructure, passenger, freight, etc.) are operated by the same entity. Little progress has been made in terms of competition and privatisation. The Azerbaijani State Railway Company, Azerbaijan Devlet Demir Yolu (ADDY), continues to operate as a fully integrated state monopoly. Freight

tariffs were liberalised while passenger tariffs remain determined by the government. One of the biggest financial problems was the practice of barter transactions among state entities (i.e. state owned companies did not pay for services in cash), which was banned in 2006. ADDY prepared its first five year business plan in 2000. IAS/ IFRS accounts have been prepared since 2002.

Banking

Market structure: *Large*

Market institutions: *Large*

Key challenges: (i) privatize state-owned banks and extend competition in the sector. (ii) grow private sector financial intermediation (iii) expand local currency products

The Azerbaijani banking system remains state-influenced, 45 per cent dollarized, and highly dependent on non-deposit funding. Levels of financial intermediation remain low, despite strong credit growth. There is scope for further institutional development, competition, product innovation, and growth in private sector intermediation.

As of end-2012, the Azeri banking system has 43 banks, of which the top 5 hold 59 per cent of assets, and only 6 are foreign-owned²² (these hold less than 12 per cent of assets). The remaining state-owned bank, International Bank of Azerbaijan, continues to dominate the market with a market share of 35 per cent of assets. However, taking into account state-affiliated owners, around 70 per cent of banking assets are with state-connected banks.

IBA has experienced deteriorating asset quality. In Q1 2012, IBA was supported by capital injections of AZN50 million (Tier 1 capital) from the Ministry of Finance and AZN150 million (Tier 2 capital) subordinated loan from the Central Bank. This brought total capital to 10.8 per cent, still below the regulatory minimum of 12 per cent. Privatization plans have been put on hold following the sub-debt injection.

Azerbaijan Deposit Insurance Fund was introduced in 2007; its resolution method is restricted to forced liquidation. The number of banks declined in 2012 as Royal Bank was declared bankrupt in July 2012 and liquidated. Local depositors were paid by Azerbaijan Deposit Insurance Fund.

Assets/GDP recovered after declining in 2011, but deposits remain low, and are costly at rates of 10 per cent and higher. Financial intermediation is consequently limited and dependent on non-deposit funding. 45 per cent of deposits are denominated in foreign currency, the result in part of macroeconomic policies focused on a managed exchange rate that leaves local currency holding subject to unpriced event risk. Progress towards greater exchange rate flexibility and moving to an interest rate based monetary policy framework has been limited.

Banking supervision has improved over the past decade and is evolving. The Law on Banks and Banking Activity and the Law on the Central Bank of Azerbaijan – both drafted with the assistance of the IMF – were passed in 2004 and 2005 respectively.

²² 22 banks have foreign capital; however only 6 have over 50% foreign capital.

As the sector develops, the central bank continues to tighten prudential rules. CBA established a macro-prudential department to identify potential systematic threats. CBA has introduced macro-prudential regulations including a leverage ratio and an increase in the reserve requirement on foreign exchange deposits. In September 2012, the minimum capital requirement was increased to AZN 50 million from AZN 10 million, effective from January 1, 2014. The Azerbaijani Association of Risk Professionals was established in 2009 with the central bank's support.

Insurance and other financial services

Market structure: *Large*

Market institutions: *Medium*

Key challenges: (i) reduce role of government in insurance sector (ii) further develop insurance industry product range and skills (ii) expand the availability of leasing and mortgages

Azerbaijan's insurance sector remains very small, with premiums of 0.6 per cent of GDP, up from 0.46 per cent per cent in 2012 as total premiums rose from AZR 213 million to AZR 343 million (61 per cent increase). The majority remains non-life (89 per cent), with only 3 companies offering life insurance. The rapid growth in insurance in 2012 was due to a new law on compulsory vehicle and real estate liability insurance, which became effective in Sep 2011. Strong growth continued into the first half of 2013, at a rate of 17 per cent for the half year.

There are 28 competing companies, most of which are small, with the top three representing 38 per cent of the market. State-owned companies comprise only 14 per cent of the market; state-associated companies (those owned by the state, ministers, and related parties) comprise 77 per cent. The sector has attracted one foreign strategic: in the fall of 2010 AXA bought a controlling stake in a local insurer from EBRD (30 per cent) and the main shareholder (21 per cent). AXA market share is 5 per cent. In early 2013 the limit on foreign ownership in combined capital of local insurers was lifted from 10 to 30 per cent, which may potentially open market to foreign players

Insurance legislation and regulation are in place and have been enforced, as witnessed by the revocation of licences from companies that did not meet the minimum required standards. However, they still lag international best practice.

There are no private pension funds operating in the country and the leasing sector is still at early stages of development, both with respect to market penetration and regulatory framework. The leasing portfolio as a percentage of GDP is low at 0.4 per cent (end-2011 latest data). Mortgage penetration remains very low, and at 0.4 per cent of GDP is the lowest ratio in the region.

Micro, Small and Medium-sized enterprises

Market structure: *Large*

Market institutions: *Large*

Key challenges: (i) expanding the availability of financial instruments for SMEs by banks as well as other financial institutions e.g. through improvements in legal

framework for leasing and product development; (ii) improving corporate governance, lessening administrative procedures and regulation to facilitate development of availability of equity capital; and (iii) developing the legal and regulatory framework through the creation of a central collateral registry and of a private bureau, and enforcement of creditor rights.

The low total domestic credit to private sector amounting to only 21.1 per cent of GDP in end-2012 significantly restricts access to finance for SMEs. However, lending to SMEs as a percentage of total bank lending has increased, and at the end of 2012 the figure was estimated at around 30. Over the past years regional disparities in access to finance for SMEs have been reduced, with rapid increases in the share of SME loan portfolio available in regions outside the capital, for both large and small banks (20 per cent of portfolio for large banks, and between 20 and 30 per cent for small and medium banks at the end of 2012). However, challenges remain in building critical mass in the MSME loan portfolio, and improving the skills of loan officers. Development of micro-finance is another key component in promoting MSMEs in Azerbaijan. The business climate in non-oil sectors is poor and particularly MSMEs suffer from bureaucratic hurdles as well as high levels of corruption. The legal framework has improved in particular in terms of cadastre real estate and land registration and coverage of the public credit information system, even though the coverage remains low at 16 per cent of population. The implementation of a flexible definition of collateral, a registration system for movable assets and the enforcement of creditors' rights will contribute to the improvement of access to finance for MSMEs.

Private equity

Market structure: *Large*

Market institutions: *Large*

Key challenge: improve business environment and corporate governance frameworks to be more attractive for inward private equity investment by regional funds and the eventual establishment of sustainable locally based private equity funds

A commercial private equity sector is yet to develop and to date the country has not attracted significant interest of international private equity funds. Only three regional fund managers have been identified to include Azerbaijan in their scope two of which have included Azerbaijan as part of their wider regional scope rather than a targeted country. These cover growth capital and distressed assets; other strategies such as mezzanine, venture and small capital, infrastructure, and buyouts remain absent from the market. Active capital and capital available for investment stood at an estimated 0.02 per cent and 0.02 per cent of GDP, respectively, in 2012

The business environment is challenging, there are limited investment opportunities and poor exit prospects. In addition, the institutional framework remains a challenge for Azerbaijan's private equity market development, as there is no local institutional investor base and the country shows very low conformity with OECD Principles of Corporate Governance.

Capital markets

Market structure: *Large*

Market institutions: *Large*

Key challenges: (i) broaden the listed market with additional corporate issues (ii) improve implementation and enforcement of existing market rules and compliance with IOSCO principles

Azerbaijan's money market shows infrastructure developed to a certain extent, including the formal availability of central bank repos and reverse repos, and interbank repos. However, there is little activity.

Development of equity and debt markets in Azerbaijan remains nascent. As of June 2013, the value of outstanding government bonds was USD 274 million. The Baku Stock Exchange continues its efforts to bring more corporates to the market and there are listed equities and corporate bonds (including mortgage bonds issued by the Azerbaijan Mortgage Fund). An offering of the latter was fully placed at 100.8167% in June 2012. The total value of outstanding corporate bonds increased from 1.5% of GDP in 2011 to 2.88% in July 2013, however there is little secondary market activity.

Only two companies were reported to be listed on the Baku Stock Exchange, and the total securities traded in 2012 represented 3.96% of GDP. In the first 5 months of trading in 2012, 98% of the total AZN 4.76 billion in trade turnover was in government securities, with the remainder in corporate shares and bonds.

International risk practices were explored and applied during 2011 and with the adoption of the State Program for Securities Market Development for 2011-2020, reforms are being directed towards simplification of the registration mechanism of securities, support of large state enterprises raising capital from the stock market and the promotion of listing in the Azerbaijan stock exchange, among others. The country showed low compliance with IOSCO principles. The institutional framework of the market remains insufficient, showing low quality and relatively weak effectiveness in implementing existing rules and limiting improper practices.

ANNEX 3 – LEGAL TRANSITION

This annex contains analytical information on a few legal sectors directly relevant to the EBRD new country strategy for Azerbaijan. It is based on assessments conducted by the Bank's Legal Transition Programme in recent years. Legislation on corporate governance will play a crucial role in promoting market-driven diversification, while the laws and institutions pertaining to secured transactions, insolvency, contract enforcement and energy efficiency are relevant to the Bank's plans to develop a sustainable financial sector to support private sector development. Finally, the legislation relating to public-private partnerships (PPPs) is important in the context of IFI cooperation in the road development sector.

Corporate Governance

Azerbaijan has undertaken substantial legal and regulatory change that has led to a number of improvements in the corporate governance framework. The framework however could be further improved, especially with regards to disclosure and the role of supervisory boards. Further, shareholders and investors continue to report problems in accessing company information. While all companies are required to produce audited financial statements that include balance sheet and income statement, many do not seem to do so. The Azerbaijani Corporate Governance Standards are voluntary and do not provide much impact on the practices by companies. However, they offer good guidance to those companies willing to improve their structure.

Authorities should consider strengthening the capacity of authorities (i.e., courts, State Committee for Securities and Central Bank of Azerbaijan) for the monitoring and implementation of sound corporate governance practices, especially by public interest companies. A tightening of the implementation of the Azerbaijani Corporate Governance Standards should be coupled with appropriate and qualified resources able to monitor disclosure and practices. In general, disclosure practices should be enhanced. The legal framework would benefit of improvement, especially in relation to:

- Clarifying the strategic and oversight role of the supervisory board;
- Considering requiring boards of large companies and systemically important banks to include qualified independent directors;
- Assessing the current structure of the audit commission and consider introducing an audit committee, exclusively comprised of independent and qualified supervisory board members;
- Clarifying the applicability of pre-emptive rights in open joint stock companies and avoiding the possibility for joint stock companies to delegate the increase of capital to the board.

Secured Transactions

Security rights over movable and immovable assets in Azerbaijan are primarily governed by the Civil Code, which entered into force on 1 September 2001, and the Mortgage Law of 2005. The 1998 Pledge Law was repealed at the end of 2006 and its progressive features, such as the possibility to take a mortgage over the whole or part

of a business' enterprise and the possibility for the chargeholder in case of default of the chargor to take possession of the charged assets, have now disappeared.

The Civil Code makes a fundamental distinction between pledges and mortgages. According to the Code pledges can be of various kinds: the charged assets can (but need not) be given in possession to the creditor, and can cover intangible assets (e.g. account receivables). Pledges are mostly not registered. Mortgages must be registered in the relevant official registry. For movable assets, this refers to existing asset-based registries, such as motor vehicles registry, ship registry, etc.

Improving the enforcement of secured creditors' rights, removing ambiguities and limitations of the present secured transaction system (especially for pledge over movable property) and creating legal underpinning that could facilitate credit bureau operations would contribute to enhancement of the access to finance in Azerbaijan.

IFC is currently partnering with USAID and the Central Bank to work on a draft secured transaction law. A conference was organised in Baku on 4 December 2012 to raise awareness of the current work and the importance of the secured transactions reform among the potential users and beneficiaries.

Insolvency

Law on insolvency and bankruptcy of 1997 (the Bankruptcy Law) only applies to the insolvency of non-bank companies and private entrepreneurs; the insolvency of banks is regulated by the law on banks of 2004. The EBRD's 2009 insolvency sector assessment concluded that the Bankruptcy Law did not meet international standards of insolvency law and that the legislation was problematic in many areas.

Azerbaijan's Bankruptcy Law would benefit from whole-scale revision. While the liquidation provisions appear to be relatively adequate, the law offers limited scope for reorganisation in bankruptcy. It contains an out of court bankruptcy option for exceptional cases, but this does not appear to function properly and may not in any event be appropriate for cases involving a number of creditors where court supervision would be beneficial. The role of the key players within the law, particularly the insolvency administrator, would also benefit from examination and improvement.

Contract Enforcement

The EBRD 2012 Judicial Decisions Assessment found that the quality of court judgments in commercial law matters in Azerbaijan was very uneven. The case law is often inconsistent; similar cases give rise to different outcomes. The country's commercial legal framework is still developing, and gaps, such as in the areas of company operations and shareholder rights, contribute to the inconsistency. Issuance of guidance by the Supreme Court on various legal matters is a factor promoting more uniform application of commercial law. Judges' lack of experience with commercial law and practice is believed to be a major factor affecting the quality of judgments. Judicial training is provided by the Training Section of the Judicial Legal Council. Continuing professional training is voluntary and courses are given based on judges' wishes; initial training for newly appointed judges is more extensive and has recently

become mandatory. Speed of justice is another area of concern, with postponement of proceedings a common practice and judges' very large caseload adversely affecting the quality and speed of proceedings.

Enforcement of court judgments remains a key challenge for the country's judicial sector, as is the case in other countries in the region. Recent measures to improve the situation include introduction of specific timeframes for enforcement procedures as well as increased penalties for defendants for failure to comply with court judgments. The effects of these improvements on the enforcement system are yet to be seen. A key factor of the inefficient enforcement system appears to be the lack of motivation on part of bailiffs who are public officials.

The country has made progress in developing a modern functioning judicial system, particularly in terms of physical infrastructure, however much remains to be done. One key priority is to bolster the impartiality of the judiciary, particularly in relation to matters where the state is a party or has a substantial interest. In this connection, greater access to court decisions and case materials would be a useful measure. Another is to strengthen the training curriculum, with a greater focus on commercial and administrative laws areas. Enhancing capacity of enforcement agents is another recommended area for reform efforts, with a particular focus on setting up appropriate incentives for agents to carry out the enforcement process in an efficient manner. Introduction of private agents, possibly along with public officials, should be considered.

Energy Efficiency

The State Programme for the Development of Fuel and Energy Sector for 2005–2015 is the centrepiece of the country's policy framework in the energy efficiency (EE) sector, targeting the reduction of losses and prevention of theft and inefficient use of energy in order to cover the electric power and natural gas demands. It is stated that full payment of the cost of electricity and natural gas consumed is one of the factors that would ensure efficient use of these resources.

In the energy efficiency sector, the government should make a stable policy commitment to decrease energy intensity in the economy and introduce sufficient incentives for efficient use of energy resources. The government should look at developing a legal and regulatory framework enabling effective implementation of the EE measures across the sector reflective of internationally proven practices. Project implementation mechanisms, including setting up proper incentives for investors and financing institutions, should be carefully considered. Appropriate institutional capacity has to be strengthened and educational programmes for market players and households have to be rolled out.

Concessions/PPPs

Azerbaijan does not have any specific Law dealing with PPPs or concessions. The Civil Code and the Law on Protection of Foreign Investments do recognise concessions yet neither of the two refer to the modern understanding of PPP/Concession. The Law on Protection of Foreign Investments contains only one article related to concessions. However this law is limited to concessions in the

natural resources sector and is restricted in its application to foreign investors. Furthermore, concessions are understood as permits or licenses, refer to administrative procedures largely in mining and have nothing to do with the common understanding of modern concessions of public works or services. Sector-specific laws and other acts that cover privatisation do not regulate concessions either. The 2001 Law on State Purchase sets the basis for public procurement, organisation and rules for public procurement procedures as well as selection of the contractor and complaints procedures. Yet, this law is silent on PPP.

The 1996 Regulations dealing with the transfer of state enterprises (objects) into management on a contractual basis regulate the transfer of the right of use of certain public enterprises (infrastructure), based on management contracts, as a preparation for future privatisation. Such contracts are awarded on a competitive basis.

Current laws still seem to focus on production sharing agreements as a form of foreign investment, are discriminating to domestic investors, are in fact out of date and do not any longer serve the needs of the dynamically growing economy of the republic.

To sum up, Azerbaijan remains one of the very few countries in the EBRD region that still has no legal framework for PPP or modern day concessions.

ANNEX 4 – SMALL BUSINESS SUPPORT

The Bank supports economic transition through its Small Business Support operations which are aimed at achieving enterprise change in viable micro, small and medium enterprises (MSMEs) and contributing to the development of a sustainable infrastructure of local business advisory services. SBS operations comprise two complementary programmes, the Enterprise Growth Programme (EGP), formerly the TurnAround Management Programme, and Business Advisory Services (BAS).

Previous SBS experience in Azerbaijan

Since inception in 1998, €2.68 million of funding have been provided by donors for the implementation of **EGP in Azerbaijan**. This has been supplemented by € 39 thousand in enterprise cost-share. The largest donors of EGP operations have been EBRD Shareholders Special Fund and EU. EGP has carried out 42 projects, 12 of which are still in progress and 8 were cancelled. Projects aimed at improvement of sales and marketing systems as well as organisation and management have been the most common type among all projects. These projects were implemented across various industry sectors, with the top three being agribusiness, ICT and construction. To date, 26 projects have been evaluated upon completion with 50 per cent rated as “highly successful” and the rest as “successful”. 59 per cent of assisted enterprises reported increases in turnover, 82 per cent reported increases in pre-tax profit, and 58 per cent reported increases in employment. 59 per cent of assisted enterprises reported productivity growth after the EGP assistance, and 78 per cent reported improvement in profit margin. EGP assists medium-sized enterprises averaging 375 employees.

Since its inception in 2003, **BAS Azerbaijan** has received a total of €5 million in donor funding. This has been supplemented by €2.7 million in enterprise client contributions. As of the end of May 2013 BAS has undertaken a total of 712 projects with MSMEs, engaging 116 consultants. BAS assists small enterprises and more than 84 per cent of the projects are with enterprises with less than 50 employees. Projects aimed at improvement of market performance, quality management and management effectiveness have been the most common type among all projects carried out in Azerbaijan. The industry spread of enterprises assisted has been wide, with agribusiness, wholesale and retail distribution and construction being among the most common sectors. 619 projects in Azerbaijan have been evaluated, of which 74 per cent were rated successful or highly successful. 77 per cent of BAS assisted enterprises have reported an increase in turnover, and 63 per cent an increase in their workforce. BAS thereby contributed to the creation of more than 2,200 jobs. In addition, 10 per cent of BAS client companies have received financing in an average amount of about €1 million. In addition to projects, BAS carried out market development activities (MDAs) geared towards increasing the demand for consultancy services (via visibility and dissemination events) as well as improvement of quality of consultancy services (via training programmes for local consultants) resulting in the fact that 68 per cent of assisted enterprises continue using consultants at their own cost.

In terms of cross-cutting issues, BAS has focused on gender issues and on facilitating rural development. More than 32 per cent of the projects were located outside of Baku. In 2011, BAS also started implementing the recently introduced ETC

Accounting Improvement Programme (AIP) with the objective of raising enterprise financial management practices and standards in view of potential EBRD investments in the ETC countries and 5 projects have been implemented to date. BAS has also implemented a specific Women in Business Programme funded by CIDA and targeted at helping female entrepreneurs boosting their businesses through advisory services and training .

MSME and Consulting sector in Azerbaijan

The MSME sector and business environment

During the last decade the economy of Azerbaijan has grown rapidly and MSME sector has also expanded. Most of economic growth has been due to the oil and gas sector and non-oil sector has become the main driver of the economy only recently.

The MSME sector is still largely underdeveloped in Azerbaijan. In 2011 there were 364,581 registered individual entrepreneurs and 60,223 registered small enterprises, but only around 50 per cent of individual entrepreneurs and slightly over 60 per cent of small firms were estimated to be active²³. While the number of MSMEs is exceeding 80 per cent of the total number of legal entities operating in Azerbaijan, their share in total value added and employment is still very small. According to the official figures, small enterprises contribute less than 2 per cent to GDP and employ only 6 per cent of country's workforce, well below other transition economies²⁴. The majority of MSMEs are involved in low-value added activities, like trade, agriculture, construction and services, and around half of registered entities are located in Baku.

The business environment for MSMEs should be further developed. The sector is facing challenges in terms of sales growth, exports, production quality and business sophistication. The World Bank's Doing Business 2013 report ranks the country 67th out of 185 economies. Azerbaijan scores comparatively high on starting a business and registering a property and some improvements are shown in such categories as paying taxes and resolving insolvency issues. However, dealing with construction permits and trading across borders are identified as the two major bottlenecks in private sector development. The Global Competitiveness report 2012-2013 ranks Azerbaijan 46th out of 144 countries on market efficiency.

Another issue is insufficient access to finance. Most of the MSMEs do not have an access to finance particularly on the early stages. Different financial vehicles that are used to serve MSME sector are very limited in Azerbaijan, and lack of credit bureau holds banks from expanding lending to small enterprises.

The consultancy market

In Azerbaijan, the consultancy sector faces large transition challenges with regard to MSMEs. The industry remains fragmented and the access and quality of services requires further improvement. Demand for consultancy services remains limited

²³ OECD, *et al.* (2012), "SBA country profile: Azerbaijan", in *SME Policy Index: Eastern Partner Countries 2012: Progress in the Implementation of the Small Business Act for Europe*, OECD Publishing

²⁴ State Statistical Committee and Ministry of Economic Development

especially outside of Baku. The number of local consultants appears to be adequate relative to the number of MSMEs, and some second-tier international consultancy companies operate in the country. However, only around 2.8 per cent of local consultants promote their businesses online and the vast majority are concentrated in Baku. Azerbaijan consultants provide services in a number of areas, but most of them are specifically qualified in the area of market analysis and planning, development planning and ICT. In recent years, the number of consultants offering quality management services has also increased. Conversely though, expertise is lacking in the field of computerised manufacturing systems, and there seem to be a lack of qualified consultants in the area of energy efficiency, environmental management and for strategy development. The quality of services has improved in recent years but many providers still lack specialisation, innovation and international market insights. The market remains fragmented and there is no professional management consultant association in place to support and further develop the market.

Infrastructure of SME support

Currently Azerbaijan doesn't have an active strategy or special agency responsible for MSME sector development. Some measures intended to promote sector's growth were included by the government in the State Program on socio-economic development for 2009-2013 and the State Program on Poverty Reduction and Sustainable Development in the Republic of Azerbaijan for 2008-2015. Inside the Ministry of Economic Development, which is formally responsible for the development of small entrepreneurship, three agencies – the Azerbaijan National Fund for Entrepreneurship Support, the Baku Business Training Centre, and the Azerbaijan Export and Investment Promotion Foundation – provide financial, training and consulting, and export support to non-oil business. Other organizations that promote MSME sector development include the Azerbaijan Chamber of Commerce and Industries, the Azerbaijan Investment Company, and the Confederation of Entrepreneurs.

Continuation of SBS in Azerbaijan

The Bank will continue to support SMEs through direct enterprise assistance under SBS operations in order to contribute to the development of a competitive and sustainable private sector in Azerbaijan. SBS operations will focus on activities in priority sectors such as agribusiness, local manufacturing sectors, including furniture and construction materials.

The Bank will facilitate access of the SBS clients to finance through the EBRD and its partner financial institutions. Cross-cutting issues such as regional development, gender equality and energy efficiency will also be addressed.

Under **EGP** operations, the Bank plans to further support the transfer of management skills. EGP will be focusing on providing advice in the areas of organization and management, business planning, sales and marketing, and product development. The Bank will also assist the enterprises improving their organizational and management skills and enhancing their exposure to international best practices.

Under **BAS** operations, the Bank plans to further enable MSMEs to access advisory services by facilitating projects with local consultants. A flexible grant scheme will be applied through annual updates of the Grant Guideline Matrix to prioritise interventions, ensure additionality and avoid duplication of efforts with international donors and governmental organisations. Higher grants are typically allocated for smaller enterprises, for enterprises located outside of major cities and for projects involving services where market demand is less mature.

At the market level, the Bank will promote international best practices in priority sectors through dissemination of successful showcases and trainings. The Bank will promote the use of business advisory services to stimulate demand and enhance the professionalism of the local consultancy sector. The Bank will seek to develop a sustainable MSME support infrastructure through the support and development of local consultants.

In addition, the Bank will continue Accounting Improvement Programme with the objective of raising enterprise financial management and reporting practices and standards to support clients' access to finance through the EBRD and its partner banks, as well as other financial institutions. The Bank will also implement a specific Women in Business programme targeted at helping female entrepreneurs boosting their businesses through training and advisory services with a greater focus on facilitating access to finance.

ANNEX 5 – TECHNICAL COOPERATION

TC COMMITMENTS BY DONOR THROUGH EBRD, 2010-2013 (end-Nov)

Donor	TC Commitments (€)
Austria	50,000
BP	745,435
Early Transition Countries Fund	845,956
EBRD Shareholder Special Fund	1,834,056
EU	6,076,453
Germany	49,000
Japan	274,500
Taipei China	24,328
Grand Total	9,899,728

TC COMMITMENTS BY SECTOR THROUGH EBRD, 2010-2013 (end-Nov)

Sector/Team		TC Commitments (€)
SME Development*	SBS	2,835,361
	Enterprise Support	51,320
Financial Institutions	Financial Institutions	2,667,547
Infrastructure	Transport	3,900,000
	MEI	274,500
Other	Other	171,000
Grand Total		9,899,728

Note: Commitment values based on year end or period end data for each year.

* This sector category encompasses direct assistance to SMEs and indirect assistance through policy dialogue between the EBRD, the authorities and commercial/business associations (e.g. Investment Councils)

ANNEX 6 – SELECTED ECONOMIC INDICATORS

	2006	2007	2008	2009	2010	2011	2012	2013 <i>Projection</i>
Output and expenditure								
	<i>(Percentage change in real terms)</i>							
GDP	34.5	25.0	10.8	9.3	5.0	0.1	2.2	3.5
Private consumption	14.5	17	17.4	8.5	10.8	8.4	8.4	
Public consumption	4.7	3.9	4.9	4.6	3.4	3.4	3.1	
Gross fixed capital formation	14.5	6	20.7	-14	2	1	4	
Exports of goods and services	48.3	36.1	7.4	14.3	9.1	2	-4.9	
Imports of goods and services	20.1	20.1	16.5	0.5	12.4	1.5	-3.1	
Industrial gross output	36.6	24.0	6.0	8.6	2.6	-5.0	-2.3	
Labour Market¹								
	<i>(Percentage change)</i>							
Gross average monthly earnings in economy (annual average)	20.6	44.8	27.2	8.6	11.2	9.9	9.4	
Real LCU wage growth	11.4	24.2	5.3	7.2	5.3	1.9	7.6	
	<i>(In per cent of labour force)</i>							
Unemployment rate (end-year)	6.8	6.3	5.9	5.7	5.6	5.4	5.2	
Prices								
	<i>(Percentage change)</i>							
Consumer prices (annual average)	8.3	16.7	20.8	1.5	5.7	7.9	1.1	3.4
Consumer prices (end-year)	11.4	19.6	15.4	0.7	7.9	5.6	-0.3	
Fiscal Indicators								
	<i>(In per cent of GDP)</i>							
General government balance	0.6	2.6	20.3	7.0	14.6	13.3	4.3	-3.0
General government revenues	28.0	28.2	51.1	41.6	46.7	46.1	41.4	
General government expenditure	27.4	25.6	30.8	34.6	32.1	32.8	37.1	
General government debt	10.2	8.6	7.3	12.1	11.4	10.2	11.6	
Monetary and financial sectors								
	<i>(Percentage change)</i>							
Broad money (M2, end-year)	86.8	71.7	44.0	-0.3	24.3	32.1	20.7	
Credit to the private sector (end-year)	84.0	86.4	52.9	8.5	11.9	18.5	20.5	
	<i>(in per cent of total loans)</i>							
Non-performing loans ratio	3.6	2.3	2.1	3.4	5.0	5.1	na	
Interest and exchange rates								
	<i>(In per cent per annum, end-year)</i>							
Local currency deposit rate	11.6	12.2	12.5	12.6	7.7	10.5	9.2	
Foreign currency deposit rate	10.5	12.1	12.2	12.2	11.0	10.4	10.1	
Local currency lending rate	19.5	20.7	20.6	21.4	20.2	18.2	17.1	
Foreign currency lending rate	18.3	19.5	19.1	22.2	19.1	19.2	18.6	
Money market rate / Discount rate/ Policy rate	9.5	13.0	8.0	2.0	3.0	5.3	5.0	
	<i>(Manats per US dollar)</i>							
Exchange rate (end-year)	0.87	0.85	0.80	0.80	0.80	0.79	0.78	
Exchange rate (annual average)	0.89	0.86	0.82	0.80	0.80	0.79	0.79	
External sector								
	<i>(In per cent of GDP)</i>							
Current account	17.7	27.3	33.7	23.0	28.4	26.0	27.7	
Trade balance	36.9	46.1	47.1	32.9	37.3	36.9	41.1	
Merchandise exports	62.0	64.4	62.6	47.6	50.0	52.3	60.4	
Merchandise imports	-25.1	-18.3	-15.5	-14.7	-12.8	-15.4	-19.3	
Foreign direct investment	-6.2	-15.4	-1.1	0.3	0.6	1.4	1.2	
Gross reserves, excluding gold (end-year)	11.9	10.2	12.6	11.7	12.1	15.9	17.0	
External debt stock	28.1	21.3	20.2	20.8	21.3	na	na	
Public external debt	9.4	7.4	6.1	7.7	7.3	7.3	8.3	
Private external debt	18.7	13.6	13.7	12.9	11.1	na	na	
	<i>(In months of imports of goods and services)</i>							
Gross reserves, excluding gold (end-year)	3.7	5.4	6.8	6.5	7.9	7.9	8.0	
Memorandum items								
	<i>(Denominations as indicated)</i>							
Population (end-year, million)	8.7	8.8	8.9	9.0	9.1	9.2	9.4	
GDP (in millions of Manats)	18,746	28,361	40,137	35,602	42,465	52,082	53,995	
Non-oil GDP (in billions of Manats)	8,176	11,702	17,054	18,620	21,364	25,432	28,475	
GDP per capita (in US dollars)	4,471.6	3,841.7	5,603.3	5,018.2	5,922.0	7,285.0	7,490.5	
Share of industry in GDP (in per cent)	57.2	59.5	58.5	49.1	51.7	53.8	50	
Share of agriculture in GDP (in per cent)	6.7	6.4	5.3	5.8	5.3	4.8	4.9	
FDI (In million of US dollars)	-1,305	-5,103	-545	146	329	912	811	
External debt - reserves (in US\$ million)	16.2	11.1	7.6	9.1	9.2	na	na	
External debt/exports of goods and services (in per cent)	14.1	11.3	9.4	15.0	13.6	na	na	
Broad money (M2, end-year in per cent of GDP)	18.3	20.8	21.2	23.8	24.8	26.7	31.1	

¹ Figures do not include emigrant workers abroad.

ANNEX 7 – GENDER EQUALITY

Gender Inequality and Human Development

According to the UNDP 2012 Human Development Index (HDI)²⁵, Azerbaijan is amongst those countries with a high human development index. It is ranked 82nd out of 187 countries, which is around the regional average for Eastern Europe and the Caucasus. The HDI is comprised of three dimensions: health, education and decent standard of living. The country ranks better in terms of the UNDP Gender Inequality Index (GII), at 54th globally. The GII is a composite measure, which captures the loss of achievement, within a country, due to gender inequality, and uses three dimensions to do so: reproductive health, empowerment, and labour market participation.

Labour force participation and gender pay gap

According to the State Statistical Committee of the Republic of Azerbaijan, 61.5 per cent of females aged 15 + and 67.5 per cent of males were economically active in 2011. As far as employment rates are concerned, 48.6 per cent of women and 51.4 per cent of men were employed, and 6.4 per cent of women and 4.5 per cent of men were unemployed.

According to the United Nations Economic Commission for Europe (UNECE), in 2010 women earned 45.2 per cent less than men when average monthly earnings were considered. Azerbaijan is reported to have the second largest gender pay gap amongst the 24 EBRD countries of operation for which data are available, second only to Tajikistan. According to the State Statistical Committee, one of the biggest gender gaps observed are in natural resources, manufacturing and transport sectors.

There are minor gender differences reported with regards to enrolment rates in primary and secondary education in Azerbaijan. According to the State Statistical Committee, in 2011-2012 academic years 46 per cent of females and 54 per cent of males were enrolled in primary education and 47 per cent of females and 53 per cent of males were enrolled in secondary education. Gender parity was achieved in tertiary education (50/50). Of note, however, is that there are gender differences in the fields of study which may be contributing to the occupational segregation in the labour force, as the table shows below.

Economic activity; 2011	Women	Men
Human health and social work activities	72.7	27.3
Education	68.6	31.4
Art, entertainment and recreation	61.9	38.1
Real estate activities	47.1	52.9
Professional, scientific and technical activities	62.5	37.5
Water supply; waste treatment and disposal	48	52
Financial and insurance activities	36.1	63.9

²⁵ According to the HDI, countries fall into four broad human development categories: Very High Human Development, High Human Development, Medium Human Development and Low Human Development

Information and communication	80.3	19.7
Trade; repair of transport means	57.4	42.6
Other service activities	55.7	44.3
Public administration and defence; social security	16.8	83.2
Manufacturing	28.1	71.9
Accommodation and food service activities	36.8	63.2
Administrative and support service activities	63.7	36.3
Agriculture, forestry and fishing	56.3	43.7
Transportation and storage	6.4	93.6
Electricity, gas and steam production, distribution and	14.6	85.4
Mining	21.4	78.6
Construction	15.3	84.7

Source: State Statistical Committee of the Republic of Azerbaijan statistics 2011

According to the World Bank's Women, Business and the Law database, women in Azerbaijan are entitled to 126 days of fully paid and 14 days of unpaid maternity leave and 969 days of partially paid parental leave. The laws mandate equal pay for equal work. Women are also by law protected by non-discrimination practices in hiring on the basis of gender.

Entrepreneurship, access to finance

According to the 2009 Business Environment and Enterprise Performance Survey (BEEPS), 10.8 per cent of the 380 surveyed firms had female participation in the ownership, which is below the regional average for Eastern Europe and Central Asia (36 per cent). 4.7 per cent of the firms had a female top manager, significantly less than the regional average (18.9 per cent), and the proportion of permanent full-time female workers were 30.2 per cent.