



BLACK SEA TRADE AND DEVELOPMENT BANK

AZERBAIJAN

Country Strategy

2011-2014

THESSALONIKI
JUNE, 2011

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Table 1: Basic Macroeconomic Indicators at a Glance for AZERBAIJAN

Key Long Term Foreign Currency Sovereign Risk Rating at 31 May, 2011:

Moody's: Ba1 | S&P: BB+ | Fitch: BBB-

		2007	2008	2009	2010	Proj. 2011	Proj. 2012
1	Population (Million)	8.7	8.8	8.9	9.0	9.1	9.2
2	Avg Exch. Rate (Manat/ US\$)	0.86	0.82	0.80	0.80	0.79	0.78
3	Inflation (CPI Avg.)	16.7%	20.8%	1.5%	5.7%	7.0%	5.0%
4	Average monthly wages (US\$)	251.8	274.4	298.0	325.0		
5	GDP (Manat million)	28,360.5	40,137.2	35,601.5	41,574.7	44,788.8	44,956.1
6	GDP US\$ million	33,049.4	48,851.3	44,297.0	51,800.0	55,986.0	56,195.1
7	GDP per capita (US\$)	3,841.7	5,603.3	5,018.2	5,797.8	6,186.5	6,129.3
8	Real GDP growth, %	25.0%	10.8%	9.3%	5.0%	3.8%	5.0%
9	Official Unemployment (end of period) %	0.9%	0.9%	0.9%	0.9%	1.0%	1.0%
10	Industrial Production Growth, %	24.0%	6.0%	8.6%	2.6%	1.3%	4.3%
11	Agricultural Production Growth %	4.0%	6.1%	3.5%	-2.2%	4.8%	4.5%
12	Domestic Credit Growth %	98.5%	33.7%	22.8%	17.3%	8.0%	10.0%
13	Domestic Credit/ GDP	17.2%	16.2%	22.5%	22.6%	21.5%	21.0%
14	Foreign Direct Investment - \$US million	4,526.0	3,982.6	2,899.1	3,351.0	750.0	1,350.0
15	FDI/ GDP	13.7%	8.2%	6.5%	6.5%	1.3%	2.0%
16	Consolidated Budget Balance/ GDP, %	2.3%	18.9%	6.6%	14.3%	20.1%	18.4%
17	Total External Debt- US\$ million	3,436.0	4,072.0	3,439.8	3,258.6	3,045.6	3,000.2
18	Total External Debt/ GDP	10.4%	8.3%	7.8%	6.3%	5.1%	4.4%
19	Public External Debt/GDP	7.0%	5.6%	5.2%	4.4%	3.7%	3.3%
20	Private External Debt/ GDP	3.4%	2.7%	2.5%	1.9%	1.5%	1.1%
21	Exports- \$US million (Goods)	21,269.3	30,586.3	21,096.8	26,476.0	27,770.9	29,159.4
22	Imports- \$US million (Goods)	6,045.0	7,574.7	6,513.9	6,745.6	6,575.0	6,970.0
23	Trade Balance \$US mn (Goods)	15,224.3	23,011.6	14,582.9	19,730.4	21,195.9	22,189.4
24	Trade Balance/ GDP	46.1%	47.1%	32.9%	39.3%	35.5%	32.6%
25	Current Account Balance \$US mn	9,018.9	16,453.5	10,177.8	15,262.1	16,745.2	17,602.6
26	Current Acct. Bal./ GDP	27.3%	33.7%	23.0%	29.5%	28.1%	25.8%
27	Forex Reserves (end period- exc gold) US\$ m	4,273.1	6,467.2	5,363.8	6,409.0	6,950.0	7,506.0

Sources: Central Bank of Azerbaijan Republic, IFS –IMF April 2011, IMF Article IV Consultation, Report No. 10/113 May 2010, EIU Country Data- Azerbaijan April 2011.

I. Recent Economic Developments and Outlook

a. Real Sector

Azerbaijan has enjoyed exceptionally high and sustained rates of real GDP growth since 1998. Between 1998-2008, annual real GDP growth averaged 15.2%, including a ‘surreal’ three year period from 2005-2007 in which annual growth exceeded 25% each year, peaking at 34.5% in 2006. Azerbaijan withstood the global financial crisis- and subsequent economic downturn, achieving positive growth of 9.3% in 2009, the highest rate in Eastern Europe and in marked contrast to the rest of the Black Sea region, which experienced an overall contraction of -6.3% in 2009.

The growth has been closely correlated to levels of oil and gas production in Azerbaijan, as well as the global prices for these commodities. This is a reflection of the central role of energy production in the Azerbaijani economy, and the degree to which it has become the driver of growth in the economy. As energy development projects initiated in the 1990s came ‘online’ during the previous decade, they contributed to an ever increasing degree to the output growth of the economy. Revenues from energy also buoyed non-energy economic growth, in particular in the construction sector. Together with growth in other areas such as retailing, this resulted in growth in the services sector at or above 10% every year up to 2010. By way of contrast, non-oil industry has grown on the back of government efforts to promote diversification, but at far more moderate rates. It has also been more vulnerable to prevailing global economic conditions. In 2009, it contracted by nearly 14% in the aftermath of the 2008 global financial crisis, experiencing a downturn typical of those observed around most of the Black Sea region. Agriculture has grown at a decent but much more moderate rate of around 4% per annum, but has diminished in overall contribution to the economy because its growth has been slower than that in the other sectors.

Estimates for GDP growth in 2010 show a slowdown to 5.0%, slightly above the Black Sea regional average of 4.0%. However, this ‘convergence’ is the result of a divergence in direction. Most of the Black Sea recovered from the sharp downturn of 2009 and improved performance, partly due to recovery from the downturn of the year before, but also the more general improvement in global conditions. In Azerbaijan, the outcome was mainly due to a marked slowdown in production in the dominant oil sector. The agricultural sector also experienced a weak year, and construction slowed, whereas other services grew steadily and non-energy related industrial production showed recovery after the sharp contraction in 2009.

Although some geographical imbalances for income distribution remain, income inequality is more moderate than in other former ‘transition’ countries, and large increases in wage levels and targeted social protection programs have helped to reduce poverty substantially. Official poverty rates have declined extremely rapidly as a result of the economic boom, dropping from over 60% in the 1990s and around 50% in 2001, to 11% for 2009. Other social indicators have shown similar improvements: life expectancy, school enrollment and immunization rates have risen, while infant mortality declined¹. GDP per capita in nominal terms rose eighteen-fold in the fifteen years 1995-2010, from US\$ 316 per capita, to an estimated US\$ 5,800. As a result, Azerbaijan has moved from low income country status to middle income status, and since April 2010 Azerbaijan has no longer been eligible for receipt of concessional lending from the World Bank’s International Development Association (IDA) facility.

¹ World Bank Azerbaijan Country Partnership Strategy FY 2011-2014 (October 2010).

b. Public Sector and Fiscal Policy

Azerbaijan's overall fiscal balance has been strongly positive for a number of years, a factor due in large part to transfers from the State Oil Fund of Azerbaijan (SOFAZ), an offshore fund into which revenues from oil exports are deposited, in part as a way to sterilize revenues and to keep them from generating inflationary pressures in the domestic economy.

The Government has increased expenditures substantially in recent years, with large portions of the increases going to public sector wages, expenditure on social programs aiming to reduce poverty, and public investment projects. Between 2005 and 2008, government expenditure rose each year respectively by 40%, 81%, 60.5% and 77%. With the onset of the economic crisis and the slowdown in the increase of oil receipts in 2009, investment expenditure was cut sharply by 16.9%, as non-priority spending was deferred. By way of contrast, current expenditures grew by 5.5% in 2009 and 13.8% in 2010, as the government continued increasing socially related expenditures in order to mitigate some of the negative consequences from the slowdown in oil receipts. This relative tightening, combined with transfers from SOFAZ resulted in the overall fiscal surplus declining from +19% in 2008 to +6.6% in 2009, before recovering to around +14.3% in 2010.

Encouragingly, non-oil revenues grew at a higher rate than expenditures in 2010, although there are still questions about underlying trends concerning non-oil balances. In the years through 2008, non-oil revenues grew at a rate well below that of expenditure growth, and the growing budget surpluses were largely due to increased oil revenues. This has raised concerns about the ever increasing dependence on oil revenues for continued budgetary health, and the degree to which fiscal policy is sustainable, particularly since oil revenues are expected to grow at slower rates in coming years. Currently, over 50% of state revenues come from transfers from SOFAZ, and these oil revenues are the reason behind the fiscal surpluses.

While the current picture is healthy, in order to ensure sustainability in the future, the Government needs to (i) seek ways to diversify and broaden sources of revenue, (ii) improve expenditure efficiency by increasing budget transparency, (iii) undertake pension and civil service reforms, further improving the targeting of public services and social safety nets, and (iv) instill greater financial discipline in a number of state owned enterprises

c. Monetary and Financial Sector

As with other energy producing states, Azerbaijan has been more focused upon maintaining exchange rate stability vis a vis the US dollar rather than targeting domestic inflation, in the conduct of its monetary policy. The Central Bank of Azerbaijan (CBA) has over the years followed a policy of pegging the manat to the US dollar since a significant share of Azerbaijan's trade is denominated in dollars, and this has helped to keep the volatility of capital flows under control. Despite sharply rising inflows of foreign exchange, between 2000-2008 the manat only gradually appreciated against the dollar, by approximately 20%. Given the decline in the dollar versus the euro and other reserve currencies, this means that the manat also depreciated against these, despite the rise in foreign exchange inflows. Due to increased inflationary pressures, this exchange rate policy was modified in March 2008 with the adoption of a euro-dollar basket peg. Nevertheless, the dollar appears to have remained the main point of reference, especially during the turbulence caused by the global crisis. Facing strong depreciation pressures in early 2009, the CBA intervened successfully to defend the manat and kept it fairly steady versus the dollar. This came at the cost of a US\$ one billion decline in reserve levels, but it resulted in reduced dollarization and contributed to the successful support and stabilization of the financial system which would have been impacted negatively by significant

devaluation. Over the years, confidence in the manat has grown as evidenced by the fact that in 2001 85% of bank deposits were held in foreign currency, while at end 2010 this figure had fallen to 53%.

A consequence of the emphasis on exchange rate stability vis a vis the dollar, together with the oil boom and rising foreign exchange inflows was a steady rise in inflation levels over the course of the past decade, from low single digits from 2000-2003 to 16.7% for 2007 and a peak level of 20.8% in 2008. High energy and commodity prices, a credit boom, and above all an expansionary fiscal policy by the government with significant increases in wage, infrastructure and social sector expenditures contributed to the steady rise in prices. Indeed, a beneficial side-effect for Azerbaijan of the global financial crisis was that the slowdown put brakes on an economy displaying several symptoms of overheating. The decline in international commodity prices reduced inflationary pressures and resulted in a dramatic fall in inflation to only 1.5% for 2009. In 2010, moderate inflationary pressures reappeared resulting in an increase in the average price level on the order of 5.7%. Principal causes for this rise were the negative impact of a regional drought which resulted in rising food prices, and the recovery in commodity prices which had dropped sharply after the global financial crisis and the US and European economic downturn in 2009.

One policy issue for the medium term is the possibility that the Government might consider a shift in emphasis from the exchange rate to using monetary policy to target inflation, and as a consequence to move to a flexible exchange rate. This is a policy measure encouraged by the IMF, which also advocates boosting CBA independence to support further such a shift. It would also need to be supplemented by reforms to expand and deepen secondary markets for government securities, so as to improve the effectiveness of the transmission of monetary policy.

Banking Sector & Capital Markets

The banking sector and payments system are regulated by the Central Bank of Azerbaijan (CBA), formerly known as the National Bank of Azerbaijan until it was renamed in 2009. As at end 2010, there were 148 financial organizations with a licence for banking, of which 47 operated as regulated banks. Of these, one bank is state owned, the International Bank of Azerbaijan, which accounts for nearly 50% of total banking system assets, while the rest are private. There are 23 banks which have foreign capital, and out of these seven are majority foreign owned. One new bank received a banking license during 2010, while two were in the process of liquidation. At the end of 2010, 40 of the banks possessed capital of over 10 million manat. The CBA has stated that a long term objective for the financial sector is to reduce the number of banks to 15-20, and to this end the CBA is working on a strategy for consolidation and optimization. Raising capital requirements has been a key tool for achieving this consolidation, as the CBA has encouraged small banks to merge, become non-bank credit organisations, or else face liquidation. Via consolidation, CBA would be able to supervise the sector more effectively, and the banking sector would consist of fewer, but financially-stronger and healthier banks, thus resulting in greater competition and growth.

Despite high double digit credit growth in Azerbaijan during the period prior to the global financial crisis, the levels of financial intermediation and banking sector development remain modest, compared to the overall needs of the economy. As at end 2010, domestic credit was approximately 22.6% of GDP. This represents a doubling as a share of the economy relative to 2004-05, and against a background of extremely high overall economic growth it underscores the rapidity of the expansion, but it comes off of a very low starting base.

The financial sector was largely unaffected by the global crisis due to its limited exposure to global capital markets. Non-performing loans doubled in 2009, but still are less than 4% of total. However, the sector did suffer a temporary crisis of confidence that necessitated intervention by the

CBA to provide liquidity support, reducing the re-financing rate by a total of 13 percentage points after the outbreak of crisis, a measure which was further facilitated by the precipitous decline in inflation. This was supplemented by other measures such as government guaranteed credits, an increase in deposit insurance coverage in June 2009 with a quintupling of the deposit limit, and profit tax exemptions for banks and insurance companies which used those profits for recapitalization. With the crisis now past, the government is seeking to unwind some of these measures- re-financing rates were raised slightly in November 2010 in a signal to the market to this effect, as well as to tighten up in view of the rise in inflation observed during 2010.

One effect of the global crisis on the Azerbaijani financial system was that new lending temporarily froze in late 2008 and early 2009, before picking up again in the second part of 2009. As a result there was a slowdown in the growth of domestic credit to 23% for 2009 and 17% for 2010, a reflection of the overall slowdown in the economy.

In 2000, the Baku Stock Exchange (BSE) was established as the main stock exchange in Azerbaijan, in the form of a closed joint stock company with 19 shareholders, including the Istanbul Stock Exchange. BSE is regulated by the State Committee for Securities of Azerbaijan Republic and BSE carries out trading and settlement (clearing) operations for corporate securities. Trading, depository and clearing operations on primary and secondary markets of public securities (T-bills of the Ministry of Finance and Notes of the Central Bank) are carried out at BSE. Two companies listed shares on the BSE as at end 2010. BSE's activity is limited, and it does not at present play a major role in attracting or mobilizing financial resources for investment in the economy.

d. External Sector

Debt

Along with most other CIS countries, Azerbaijan accepted Russia's 'Zero Option' offer, renouncing its share of Soviet external assets in favor of Russia, and in return inheriting no Soviet era debt. Azerbaijan has largely avoided the trap of external borrowing at high interests which plagued other transition states in the 1990s. As a result, gross external debt- private as well as public sector borrowing- have been limited. At end 2010, private sector external debt stood at approximately 1.9%. Government external debt has consistently been less than 20% of GDP, and at end 2010, it stood at approximately 4.4%. Overall public debt (external and domestic) at end 2010 was around 14% of GDP. Since Azerbaijan is able to cover its financing needs thanks to energy receipts, the principal reasons for undertaking external borrowing are (i) to implement high priority development projects with the assistance of international financial institutions, and (ii) to help deepen the Azerbaijani financial sector by setting benchmarks for Azerbaijani companies seeking to access international capital markets and to promote development of portions of the domestic financial sector, such as secondary markets, pension schemes, and insurance.

Azerbaijan's has one investment grade (Fitch: BBB-) and two sub-investment grade (Moody's: Ba1, Standard and Poor's: BB+) from the three major credit rating agencies. All have a positive rating outlook, implying an upgrade is likely, but given its exceptionally low levels of both external and overall public debt, Azerbaijan possesses the lowest debt levels of any sovereign rated in this range.

Trade and the Current Account

Since 2005, Azerbaijan has consistently experienced very large trade surpluses ranging between 25-47% of GDP. In the decade between 2000-2010, exports increased fourteen-fold in

dollar terms, from US\$ 1.9 billion to US\$ 26.5 billion. At the same time, imports increased about four times, from US\$1.5 billion to US\$6.7 billion. The initiation of key oil and gas projects accounts overwhelmingly for the increase in export revenues, and they have come to represent over 95% of export earnings.

During 2010, Italy, followed by France and Russia, were Azerbaijan's largest trading partners. Italy absorbed nearly a quarter of Azerbaijani exports, emerging as the main buyer of oil and gas following the signing of a number of bilateral trade agreements in 2008. Trade with other member countries of the Black Sea Economic Cooperation (BSEC) has also grown over the course of the last decade, but at rates well below those of overall trade growth. Between 2000-09 (the latest year for which country by country full annual data are available), Azerbaijan's overall external trade grew eight times, while trade within BSEC grew five and one half times. However, this hides the fact that imports from other BSEC countries (+481%) grew more rapidly than overall imports (+323%), as it was exports beyond the Black Sea region that account for most of the increase in the trade volume. Among BSEC members, Azerbaijan's most important export destinations were Russia, followed by Georgia. In recent years, exports to Ukraine, Greece, Bulgaria and Romania have grown substantially, albeit from a very low base for each of these. Exports to Turkey peaked in 2007 at over US\$ 1 billion, and have subsequently declined to around US\$ 100 million. Exports to other BSEC countries are low. On the import side, Azerbaijan's main regional partners are Russia, Turkey and Ukraine, with Georgia a distant fourth and the rest at very low levels.

Azerbaijan is not a member of the World Trade Organization, but is in negotiations to join. After a number of slow years, the pace of discussions has picked up recently, although issues still remain with respect to a number of customs matters relating to legislation, regulations for valuation, and tariff policies.

As a result of the large positive trade balance, Azerbaijan's current account surplus has also been sizeable. Even during the 'downturn' of 2009, when energy prices dropped sharply and as a result export earnings declined, the surplus was +23.0% of GDP. For 2010 it came in around +29.5%.

Foreign Direct Investment

Over the years, levels of foreign direct investment (FDI) into Azerbaijan have fluctuated considerably, peaking at 54.3% of GDP in 2003 and 54.1% of GDP in 2004, as various projects in the oil and gas sectors reached the peak of their preparation. Following completion of these projects FDI levels fell, and for 2009 and 2010 Azerbaijan attracted FDI around 6.5% of GDP in each year.

In contrast to the energy sector, where Azerbaijan has successfully attracted large investments, and will continue to do so for as long as prospects for development of new oil and gas fields are favorable, it has proven considerably more difficult to attract investments in other sectors of the economy.

Aware of this, Azerbaijan has taken measures to improve its business environment, and to improve the legal framework for foreign investment. For 2008 Azerbaijan was recognized as a top reformer by the World Bank's *Doing Business 2009* report, for measures such as the establishment of a one stop shop to facilitate business registration, and improvements in the protection of investor rights and property registration. Partly as a result of this, Azerbaijan enjoys a very positive five year score for improvements in the ease of doing business for 2011, relative to 2006. In the *Doing Business 2011* report, Azerbaijan ranked 54th overall out of 183 countries surveyed. Azerbaijan fares very well in areas such as starting up a business, registering property, protecting investors, and reasonably well in areas such as enforcement of contracts and obtaining access to credit. Its score concerning closing

a business is in the middle while it fares relatively poorly in areas such as dealing with construction permits, and difficulty and cost of paying taxes. Its largest challenge remains the area of international trade practices, where it scored near the bottom as a result of a series of identified problem areas including excessive document requirements, burdensome customs procedures, lengthy periods of time required to complete transactions, and high transaction costs. The report credits Azerbaijan as a top reformer in 2010 as well, stating that “Azerbaijan improved access to credit by establishing an online platform allowing financial institutions to provide information to, and retrieve it from, the public credit registry. A revision of Azerbaijan’s tax code lowered several tax rates, including the profit tax rate, and simplified the process of paying corporate income tax and value added tax.”

Another indicator of country risk and business environment in which Azerbaijan is rated is *Euromoney* magazine’s country risk index, in which Azerbaijan’s score has risen (improved) substantially over the years, coming in 46.6 (out of a perfect score of 100) in September 2010, which ranks slightly below the average for the BSEC region of 52.6 and below the EU average of 79.1. Significantly, the government is a signatory since 2003 to the Extractive Industries Transparency Initiative (EITI), publishing regular reports that disclose revenues from the oil and gas industry.

e. Forecast for 2011-12

Following a run of annual real GDP growth rates that have ranged from high to extraordinary, the overriding objective for Azerbaijan in coming years is to diversify the economy so that non-oil and gas based economic growth proves sustainable. In the absence of such diversification, the economy will be particularly sensitive to fluctuations in energy prices since new production from energy projects is not projected for a number of years, and thus the volume of output from current projects will remain more or less stable.

The Government’s “*State Program on Poverty Reduction and Economic Development 2003- 2005*” (SPPRED) and its follow-up “*State Program on Poverty Reduction and Sustainable Development 2006-15*” (SPPRSD) represent the formally stated development program of Azerbaijan. Stated goals include maintaining macroeconomic stability, improving conditions for income generating opportunities, improving the quality and access to basic health and education services, expanding and improving infrastructure, and strengthening the social protection system. Oil and gas will continue to play a central role for economic growth but they are to be complemented with new ‘engines’ of growth. To this end, the government hopes to improve infrastructure in order to take advantage of the country’s geographical position and to develop transit-related services. Additional priority areas include developing high value-added food processing industries and other light manufacturing, the tourist sector, and improving productivity and efficiency in the agricultural sector. To meet these targets, the Government has embarked on an ambitious program to expand transport, energy, and water infrastructure, while it also aims to improve further the business environment via structural reforms as well as legal and regulatory reforms and upgrades.

For 2011, real annual GDP growth in Azerbaijan is expected to slow a bit to 3.8% before recovering to 5.0% in 2012, with projections for years beyond in more or less the same 4-5% range. However, these projections are subject to high degrees of uncertainty, since changes in the price of oil and gas could push the rate higher (if global prices rise), or lower. Non-energy GDP is expected to grow faster in 2001 and 2012, but its impact on overall economic growth is lower. Nevertheless, for the forecasting period government and external debt should remain very low, while the current account should post surpluses in excess of 25% of GDP as a result of the strongly positive trade balance. The overall fiscal balance will also remain positive on the back of transfers to the budget

from SOFAZ. Inflation rates are likely to remain in mid to high single digits, although they too are sensitive to changes in energy prices and global food prices.

II. Overview of Current BSTDB Portfolio

As of 31 December, 2010, the active BSTDB portfolio in Azerbaijan amounted to 14 operations approved by the Board of Directors (BoD), involving an investment of € 64.2 million (US\$ 85.1m). Out of this total amount, 14 operations were signed for € 63.9 million (US\$ 84.6m) and the outstanding disbursements were at € 37.7 million (US\$ 50.0m). Azerbaijan ranks seventh as a destination for operations by BSTDB, in terms of BoD approved operations, with 5.6% of the total portfolio, sixth in terms of signed operations, with 6.3% of the total portfolio, and seventh in amounts outstanding, with 5.7% of the total portfolio.

The Bank has made concerted efforts to identify suitable operations for financing in Azerbaijan, and it has been one of the main beneficiaries of the increased emphasis placed on finding operations in small shareholder countries. Relative to the Bank's active portfolio at the end of 2006, Board approvals increased by 161%, signings by 159%, and amounts outstanding by 75%.

Table 2: Active BSTDB Portfolio as at end December 2010

All Figures in Euros Million	BoD Approval Date	Approved Amount	Signed Amount	Amount Outstanding
AccessBank (former MFBA) Equity	14-Oct-01/ 9-Oct-06/ Feb-08	3.4	3.5	3.4
International Bank of Azerbaijan	14-Jul-01 / 15-Nov-02	4.9	4.9	3.2
Unibank	1-Oct-05	2.3	2.3	2.3
Respublica Bank	10-Jun-06	2.3	2.3	2.3
AccessBank (former MFBA) SME II	16-Jun-07	3.0	3.0	1.7
Respublica Bank II	16-Jun-07	2.3	2.3	2.3
ADA Almali Retail Chain	16-Jun-07	6.8	6.8	-
Demir Bank (former Technika Bank II	29-Sep-07	7.5	7.5	3.4
Unibank II	1-Dec-07	6.0	6.0	3.3
Bank Standard	1-Dec-07	3.8	3.8	2.2
Bank Standard	1-Feb-08	6.0	6.0	-
Kapital Bank II	4-Apr-08	9.1	9.1	7.5
Azer-Turk Bank	25-Sep-09	3.0	3.0	2.9
Bridge Plaza Baku	26-Feb-10	3.8	3.4	3.4
Total		64.2	63.9	37.7

III. Review of Country Strategy 2007-2010

The current evaluation was performed by the Bank's Evaluation Office as per the respective Evaluation Policy. It reveals the performance of the Bank's 2007-2010 Country Strategy for Azerbaijan. Its goal is to provide accountability to the Board of Directors and Board of Governors as

well as facilitate the decision-making by the Bank's Management and Boards on the eventual update of the country strategies.

The evaluation of the respective country strategy compares the stated targets with results as of end of 2010, and provides a country-oriented analytical picture.

Performance of Azerbaijan Country Strategy 2007-2010

The 2007-2010 country strategy for Azerbaijan was approved by the Board of Directors in early 2007, reflecting an in-depth independent evaluation of the implementation of the BSTDB's earlier strategies, conducted by the Evaluation Office in late 2006. The country strategy was aligned with the objectives of the Bank's Business Plan 2007-2010 and was therefore evaluated in its overall context.

Overall, the implementation of the Country Strategy is Excellent, which is consistent with the Business Plan implementation. The implementation of the Strategy exceeded the volume targets at 130-150% and achieved a good, albeit financial sector oriented sector coverage, as shown in the table in Annex I.

IV. BSTDB Operational Priorities for 2011 - 2014

The Bank's role and priorities are defined (i) in accordance with the priorities and targets laid out in its *Medium-term Strategy and Business Plan 2011-2014* and (ii) country needs and objectives, as well as (iii) available resources, strategies and policies of BSTDB. In this respect, BSTDB will seek viable opportunities and will continue closely monitoring the developments in the Azerbaijan economy in order to stand prepared to support bankable projects. In addition the Bank shall seek co-financing opportunities with IFIs, public sector institutions and private partners.

BSTDB will focus in the next four years on providing support for the implementation of the Government program and priorities, while responding to market demand. The Bank will consider undertaking activities and providing services as may advance its purpose, paying special attention to activities promoting export of goods and services, and development of infrastructure, including energy efficiency. In addition, through selected intermediaries, the Bank would attempt to expand its financing programs in favor of SMEs.

Based on the 2011- 2014 BSTDB Business Plan, the Bank would expect to approve on average two new operations per annum during this period, for approximately € 18-26 million per year. Over the four year period, this implies around eight approved operations for approximately € 88 million. With the Bank committing to raising the level of commitments (signed operations) to approved operations to over 85%, the Bank expects signings for 2011-2014 to be on the order of seven operations for € 78 million (a range of € 16-23 million per annum).

These indicative targets are based on the Base Case Scenario of the MTSBP, and given appropriate circumstances and sufficient operational opportunities the Bank would make efforts to exceed this level. In case of higher regional economic growth rates, increased demand for Bank funding, and an improved situation in financial markets, a phased increase in the average number and size of operations would allow the Bank to move towards achieving the targets envisaged under the High Case Scenario. Moreover, at the Mid-Term Review, depending upon performance and prospects, the above targets may be revised upwards².

² Under no circumstances would targets be revised downwards unless the lower case scenario of the 2011-2014 BSTDB Business Plan were to be followed.

Areas for BSTDB Financing:

The Bank will focus on small and medium scale projects in the non-oil sector with development and cooperation impact. BSTDB will focus on the economic development of Azerbaijan, by providing financing for bankable operations in the country, with special emphasis in transportation, agriculture and agribusiness, manufacturing and development of micro, small and medium-sized enterprises.

BSTDB Trade Finance and Financial Sector Strategy for Azerbaijan

BSTDB's Trade Finance and Financial Sector Strategy have been created in order to develop a network of financial intermediaries, through which to deliver trade finance, SME finance and mortgage products.

Since BSTDB began operations, the following products have been introduced through selected financial intermediaries in Azerbaijan for the purpose of trade finance, mortgage finance and SME development:

- Combined Trade Finance (export/import) product;
- Medium-term Multiple Buyer products;
- Medium –Term Micro and SME Finance product;
- Medium –Term Mortgage product.

By developing a network of financial intermediaries in Azerbaijan, BSTDB intends to support Azerbaijan's emerging private financial sector. BSTDB considers support for this sector an important strategic priority and will devote efforts to upgrade its presence.

The Bank already works with a number of financial intermediaries in Azerbaijan providing trade finance products and micro, small and medium enterprise (MSME) medium term lending. Such activities will continue to represent a priority for the Bank, since the financial sector is rapidly developing, and the small size of non-oil sector firms often renders conducting direct operations with these enterprises as uneconomical (due to scale) or too difficult (due to informational difficulties and complexity of reaching out to small firms). The Bank remains committed to a pro-active strategy of working with Azerbaijani commercial banks and as the needs of Azerbaijani banks and SMEs evolve, the Bank will adapt in order to meet the changing needs as effectively as possible.

Projects (i) financing trade, particularly for promoting imports of capital goods and manufacturing equipment from other BSEC countries, and (ii) supporting the development of micro, small and medium-sized enterprises were successfully implemented by the Bank in previous years. Considering the emergence the non-oil private sector is, it is expected that BSTDB's trade finance facilities will also help to support export oriented companies in coming years.

For ongoing operations, the Bank is likely to increase the amount of existing trade finance facilities and renew and/or increase Micro and SME loan facilities where performance is good and prospects are favorable. In addition, the Bank will seek to increase the number of financial intermediaries, while it will seek to change any if their performance is unsatisfactory.

The Bank hopes to find suitable partners to support the development of leasing, as well. The Bank intends to use the leasing product not only for financing capital expenditure of SMEs but also for other companies as an effective financing tool for the promotion of regional trade. Medium-term credit lines opened to leasing companies for trade related purposes will enable them to offer their customers finance for capital expenditures on imports from other countries in the region.

The Bank will also consider the option to take equity participations in selected financial institutions and funds, and will also seek to develop quasi-equity products, such as subordinated loans. In view of Government efforts to establish a private bank together with IFIs (i) to support the agriculture sector and enhance food security and (ii) to develop SMEs in the non-oil sector through established state funds, BSTDB will consider providing support in the form of financing and/ or technical assistance to promising and 'bankable' ventures.

Moreover, the Bank will maintain regular contact with complementary international financial institutions (IFIs) such as EBRD, IFC, EIB, DEG and KFW to seek ways to coordinate activities and share experiences, given the opportunities which exist for joint involvement.

Energy, Power, and Infrastructure

Azerbaijan has huge hydrocarbon energy reserves, and achieving increases in the exports of oil and gas requires substantial financial resources for new investment and maintenance of existing transportation links, including oil and gas pipelines. The Bank will consider projects which intend to reduce the energy dependency of Azerbaijan on imports and to increase the supply of energy resources through transport networks with strong environmental and other positive externalities. The Bank also expects that there may exist bankable business opportunities to provide financing for 'downstream' operations, particularly for the expansion of retail networks, the building of storage facilities, and the construction of new and/or modernization of existing petrochemical facilities to improve product quality and environmental acceptability.

The Bank will focus on projects that envisage modernization and expansion of conventional energy infrastructure in order to facilitate power generation, transmission and distribution inside and outside Azerbaijan. Alternative energy sources such as hydro-power, wind and solar are enhancing the potential in this field, while also helping to address a number of environmental issues. Hence, BSTDB will seek to support economically viable projects in the renewable energy sector.

Azerbaijan has a need for further development and improvement of its infrastructure including municipal and urban infrastructure. The Bank will focus on projects supporting efficient waste management and rehabilitation of the water sewage and water supply networks.

In terms of financing instruments, the Bank's energy and infrastructure priorities will primarily focus on medium- to long-term debt financing products to both local and international companies operating in Azerbaijan. Such financing may be used for the purpose of financing corporate development needs, capital expenditures, financing of working capital requirements, re-financing of existing debts, as well as for sound project finance structures.

The Bank will attempt to participate in co-financing projects in the energy and infrastructure sector with other IFIs as an important source of institutional knowledge transfer and to increase the development impact of its financing operations.

The Bank will continue to ensure that all BSTDB operations in Azerbaijan meet sound banking principles and comply with the Bank's Environmental Rules and Procedures.

Manufacturing and agri-business

Regarding general industries, there has been significant progress in recent years. However, Azerbaijan still depends mostly on imports for various industrial goods. The country depends heavily on the local investors for development of non-oil sector, due to low level of FDI. Due to the fast growth of the economy in the last five years, capital accumulation is increasing and consequently local investors are more and more involved in medium and large scale investments in the non-oil

sector. The Bank will attempt to position itself strategically and identify medium-size projects in processing, import substitution, and will also seek complementarities with other IFIs.

Agriculture and Agribusiness

Azerbaijan has vast potential in the agriculture sector. Major agricultural products are grapes, cotton, tobacco followed by citrus fruits, and various sorts of vegetables. Livestock, dairy products, and wine and spirits are also important farm products.

BSTDB will support the agribusiness sector through financing food-processing projects. The Bank will give priority to projects targeting increasing productivity in agriculture via infrastructure modernization, development of distribution channels for agricultural products and establishing financing mechanisms for farmers for their activities.

Construction sector

BSTDB will give priority to projects in transportation, in particular cross-border cooperation with other member countries, which focus on additional road and rail transportation, as well as improvement of port facilities.

The construction sector has evolved rapidly from state controlled to one marked and dominated by a large number of dynamic private architectural, design and building firms. There is still a shortage of acceptable financing (i.e., bank loans and working capital) to support acquisition of the latest Western technologies and building materials, a fact which forces Azerbaijani construction companies to rely on internal sources of capital.

BSTDB will strengthen its cooperation with the Ministry of Economic Development in order to identify opportunities in the projects that are strategically important for the country.

An important area for BSTDB is co-financing of private sector operations with the Public Investment Company (funded from the Oil Fund) which provides equity for the non-oil sector.

ANNEX I: Post Evaluation of 2007-2010 Country Strategy Azerbaijan (approved 04.02.2007)				
2007- 2010 TARGETS			RESULTS (end of 2010)	
General	Sectors	Target operations: Number approved/ number signed; USD approved/ USD signed (million)	Actual operations: Number approved/ number signed; USD approved/ USD signed (million)	Evaluation Summary
<p>Co-financing with IFIs, public sector institutions and private partners.</p> <p>Focus on small and medium scale projects in the non-oil sector with development and cooperation impact.</p>	<p>1. Financial sector/ Micro/ SMEs</p> <ul style="list-style-type: none"> ▪ Development of the financial sector infrastructure. ▪ Leasing and insurance activities; ▪ Micro-finance for rural development. <p>2. Trade Finance</p> <ul style="list-style-type: none"> ▪ Import of capital goods <p>3. Manufacturing</p> <ul style="list-style-type: none"> ▪ Processing, import substitution ▪ Co-finance private sector operations with the Public Investment Company <p>4. Agriculture and Agribusiness</p> <ul style="list-style-type: none"> ▪ Food-processing <p>5. Infrastructure and construction sector</p> <ul style="list-style-type: none"> ▪ Transport with a focus on cross-border cooperation ▪ Construction sector and development of specialized financial services ▪ Focus on large-scale development projects, particularly involving international financial institutions as well as sub-contracted projects for the international oil consortia 	<p>8/7 NA/59</p>	<p>11/11 76/75</p>	<p>1. Volume: Approved number/volume: 138%/157 Signed number/volume: NA/127%</p> <p>2. Sector coverage:</p> <p>2.1. Respublica Bank II (trade finance)</p> <p>2.2. Demir Bank (SME.)</p> <p>2.3. Technika Bank II (bank to bank multipurpose)</p> <p>2.4. Unibank II (SME)</p> <p>2.5. Access Bank SME II (SME, FI)</p> <p>2.6. Bank Standard (trade finance)</p> <p>2.7. Azer-Turk Bank (SME)</p> <p>2.8. ADA Almali Retail Chain (removed, manufacturing)</p> <p>2.9. Bridge Plaza Baku (services / real estate)</p> <p>2.10. Kapital Bank II (mortgage finance)</p> <p>3. Performance: Excellent: Targets substantially exceeded, adequate sector coverage, although focused on financial intermediaries.</p>