



Report and Recommendation of the President to the Board of Directors

Project Number: 51059-001
November 2017

Proposed Programmatic Approach and Policy-Based Loan for Subprogram 1 Republic of Azerbaijan: Improving Governance and Public Sector Efficiency Program

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Asian Development Bank

CURRENCY EQUIVALENTS

(as of 6 November 2017)

Currency unit	–	Azerbaijan manat/s (AZN)
AZN1.00	=	\$0.5888
\$1.00	=	AZN1.6985

ABBREVIATIONS

ADB	–	Asian Development Bank
ADIF	–	Azerbaijan Deposit Insurance Fund
GDP	–	gross domestic product
MOF	–	Ministry of Finance
MTEF	–	medium-term expenditure framework
NFES	–	National Fund for Entrepreneurship Support
SMEs	–	small and medium-sized enterprises
SOE	–	state-owned enterprise
SOFAZ	–	State Oil Fund of Azerbaijan

NOTE

In this report, "\$" refers to United States dollars.

Vice-President	Wencai Zhang, Operations 1
Director General	Sean O'Sullivan, Central and West Asia Department (CWRD)
Director	Werner Liepach, Officer-in-Charge, Public Management, Financial Sector and Trade Division, CWRD
Team leader	Tariq Niazi, Principal Public Management Specialist, CWRD
Team members	Annalisa Carlota, Counsel, Office of the General Counsel Marishka Etrata, Associate Project Analyst, CWRD Joao Farinha, Senior Financial Sector Economist, CWRD Hiranya Mukhopadhyay, Principal Public Management Specialist, CWRD Nail Valiyev, Senior Economics Officer, CWRD Maria Celeste Yabut, Senior Operations Assistant, CWRD
Peer reviewer	Claudia Buentjen, Principal Public Management Specialist, Sustainable Development and Climate Change Department

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PROGRAM AT A GLANCE

1. Basic Data		Project Number: 51059-001	
Project Name	Improving Governance and Public Sector Efficiency Program, Subprogram 1	Department /Division	CWRD/CWPF
Country Borrower	Azerbaijan Republic of Azerbaijan	Executing Agency	Ministry of Finance
2. Sector	Subsector(s)	ADB Financing (\$ million)	
✓ Public sector management	Economic affairs management		62.50
	Public expenditure and fiscal management		75.00
	Reforms of state owned enterprises		62.50
Finance	Finance sector development		50.00
		Total	250.00
3. Strategic Agenda	Subcomponents	Climate Change Information	
Inclusive economic growth (IEG)	Pillar 1: Economic opportunities, including jobs, created and expanded	Climate Change impact on the Project	Low
4. Drivers of Change	Components	Gender Equity and Mainstreaming	
Governance and capacity development (GCD)	Anticorruption Institutional development Organizational development Public financial governance	No gender elements (NGE)	✓
Partnerships (PAR)	Implementation International finance institutions (IFI)		
5. Poverty and SDG Targeting		Location Impact	
Geographic Targeting	No	Nation-wide	High
Household Targeting	No		
SDG Targeting	Yes		
SDG Goals	SDG8		
6. Risk Categorization:	Complex		
7. Safeguard Categorization	Environment: C Involuntary Resettlement: C Indigenous Peoples: C		
8. Financing			
Modality and Sources		Amount (\$ million)	
ADB		250.00	
Sovereign Programmatic Approach Policy-Based Lending (Regular Loan):		250.00	
Ordinary capital resources			
Cofinancing		0.00	
None		0.00	
Counterpart		0.00	
None		0.00	
Total		250.00	

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on (i) a proposed programmatic approach for the Improving Governance and Public Sector Efficiency Program, and (ii) a proposed policy-based loan to the Republic of Azerbaijan for subprogram 1 of the Improving Governance and Public Sector Efficiency Program.

2. The proposed program aims to strengthen governance in the public sector and diversification of the economy by enabling enhanced private sector participation through better access to finance and the business environment. The program will introduce rules-based fiscal planning in the government's budget system, improve legal and institutional structures governing state-owned enterprises (SOEs), and help improve the business environment and access to finance for small and medium-sized enterprises (SMEs). The programmatic approach will comprise two subprograms implemented during 2017–2018. Approved transaction technical assistance is assisting with the implementation of the program.¹

II. THE PROGRAM

A. Rationale

3. **Economic context.** After gaining independence in 1991, Azerbaijan registered rapid economic growth averaging 11.0% during 1995–2013. The growth was largely fueled by hydrocarbon activity, which contributed to 90% of the country's exports and around 75% of gross domestic product (GDP) and government income. The crash in the global oil prices from a high of \$110 per barrel in 2014 to \$50 in 2015 caused a major setback to the economy leading to a significant fall in revenues contracting public investments and tightening domestic demand. As a result, the fiscal balance of the central government budget shifted from a surplus of 2.9% of GDP in 2014 to a deficit of 4.8% in 2015. In 2016 the central government budget was balanced; however, without transfers from State Oil Fund of Azerbaijan (SOFAZ), the budget deficit amounted to 13.4% of GDP.² Decline in oil export revenues also led to a negative current account balance. With this backdrop of falling oil prices, the Central Bank of Azerbaijan devalued the manat twice in 2015. On 12 October 2017, the value of the manat in United States dollars represented only 46% of its 2014 year-end value. Since the government has a high proportion of debt denominated in foreign currency, the devaluation deteriorated the country's external debt position, exacerbating inflationary pressures because of a high exchange rate pass-through effect and also created a shortage of credit to the private sector, especially in local currency. The average inflation rate rose from 4.0% in 2015 to 12.4% in 2016. These factors culminated in a negative growth rate of the economy of –3.1% in 2016 compared to 2.8% in 2014.

4. **Development problem.** The twin development of economic growth and social indicators has been a key feature of the Azerbaijan growth story since the 2000s. However, the traditional heavy dependence of the economy on hydrocarbons exposed the country to macroeconomic shocks while limiting the development of the non-oil sector. Excessive reliance on hydrocarbons contributed to appreciation of the real exchange rate of the manat during the oil boom era, thereby undercutting the international competitiveness of the nonresource sector and negatively affecting the export of nonresource goods. This is the core development problem in Azerbaijan, manifested

¹ The program is included in ADB. 2017. *Country Operations Business Plan: Azerbaijan, 2018–2020*. Manila; Attached to ADB. 2016. *Report and Recommendation of the President to the Board of Directors on a Proposed Countercyclical Support Facility Program*. Manila (TA 9259-AZE). This technical assistance is supporting the implementation of the program.

² Ministry of Finance of the Republic of Azerbaijan.

three-dimensionally along fiscal management, public sector management, and nondiversified economic development paradigms. Supported by stakeholder consultations and diagnostic studies, the core issues faced by Azerbaijan are distilled in paras 5-9.

5. **Challenges in fiscal and public debt management.** On the fiscal side, Azerbaijan is experiencing a procyclical budget—a characteristic of a resource-rich country. Until 2014, the government expenditure increased significantly; however, the decline in oil revenue was not followed by a commensurate reduction in expenditure, leading to a large fiscal deficit after 2014. The current government budgetary procedures need to be streamlined to prevent ad hoc spending decisions that result in inefficient allocation of resources not linked to sector priorities and lack focus on long-term, non-oil sustainability. The fiscal policy framework lacks a clearly elaborated and well-established rule to guide the use of oil revenues to finance public spending.³ The current system is closely linked to oil prices and is deficient on long-term measures on reducing the dependence on oil. A significant burden adding to the state budget outlays is financing the pension fund deficit through transfers from the state budget. The transfers to the State Social Protection Fund amounted to \$781 million in 2016, down from \$1.07 billion in 2015. This, coupled with increased debt servicing obligations on foreign-currency-denominated debt, has contracted the available fiscal space. Some key reforms are needed to reduce the burden of social expenditure (such as pensions) and debt servicing on the state budget. These reforms will help increase the available fiscal space and reprioritize expenditure allocations to productive sectors.

6. Because of manat depreciation and increase in the fiscal deficit stemming from the fall in oil revenues and absence of fiscal consolidation, the stock of public debt has grown substantially. The nominal gross debt as a share of GDP increased from 11% in 2014 to 28% in 2015 and further to 38% in 2016. Since over 70% of Azerbaijan's public debt is denominated in foreign currencies, debt sustainability needs to be closely monitored. Future borrowings, exchange rate volatility, and debt of SOEs may put added pressure on debt ratios. The public debt management system in Azerbaijan lacks a medium-term strategic framework or a standardized information technology platform for recording debt transactions. This leads to challenges such as lack of coordination between the cash management system and debt management system of the government, manual collection and reporting of debt indicators, and inadequate dissemination of information on debt, giving rise to issues of transparency and data integrity.

7. **Challenges in the business environment.** Challenges in the business environment include lack of economic diversification, inadequate development of the private sector, inefficiencies in SOEs, decline in banking system solvency, and limited access to finance for businesses. A primary way to reduce dependency on oil revenues is to diversify the economy, which in turn hinges upon development of a vibrant, non-oil private sector. The economic activities are being primarily led by the public sector with very limited role for the private sector. Though Azerbaijan was a leader in terms of growth up until 2014 among the Caucasus and Central Asia Regional Economic Cooperation countries, it lags behind most countries in the region in terms of ease of doing business. Azerbaijan was ranked 65th among 190 countries in 2017 and is one of the lowest ranked countries in the Commonwealth of Independent States.⁴ Access to finance has been one of the major factors leading to constrained growth of the private sector, especially for SMEs. Data from the 2017–2018 Global Competitive Index ranks Azerbaijan low in terms of ease

³ A fiscal rule is a framework comprising macroeconomic and budget parameters for implementation of budget policy which ensures medium- and long-term macroeconomic stability and financial and debt disciplines.

⁴ World Bank. 2017. *Doing Business 2017: Equal Opportunity for All. Economy Profile 2017: Azerbaijan*. Washington, DC.

of access to finance among the major regional countries.⁵ The promotion of SMEs is a major component of private sector development. However, the sector has not seen much growth because of a variety of issues such as regulatory bottlenecks, an unfriendly tax environment, nonavailability of affordable finance, a weak entrepreneur base, and limited access to finance.⁶ This in turn has also inhibited the growth of non-oil exports. As a measure to improve access to finance for enterprises, the National Fund for Entrepreneurship Support (NFES) was constituted under the Ministry of Economy. Authorized lending institutions, including banks and nonbank financial institutions, can issue loans on preferential terms according to the criteria framed by the supervisory board of the NFES for financing investment projects that are in the priority areas for socioeconomic development of Azerbaijan. However, the recent economic recession has adversely affected the performance of the fund, resulting in a decline in the number of enterprises that are supported by the fund and consequently reducing the employment generated.

8. A significant portion of the economic activities within the country is generated by 14 largest SOEs playing a key role in all important sectors of the economy. The SOEs are active in the oil and gas, power generation, water supply, railway, air passenger, and cargo areas. For example, State Oil Company of Azerbaijan, along with consortium of international oil companies is engaged in hydrocarbon extraction that contributes 50% of the country's GDP and over 90% of its exports. Many SOEs, however, receive budget subsidies and are saddled with inefficiencies, and many are incurring losses. They face binding issues relating to ownership, management, transparency, accountability, financial sustainability, and societal value creation. Corporate governance is another area of concern which has affected the performance and image of SOEs in Azerbaijan. Although the presidential decree of October 2016 recommends improving the efficiency of SOEs, a well-designed corporate governance rules framework is yet to be put in place.

9. The banking system came under severe stress in the aftermath of the economic downturn in Azerbaijan as 11 banks lost their license in 2016. This led to a loss of public confidence in the banking subsector. The share of deposits in domestic currency in the total deposits of the banks sharply declined from 50.1% in 2014 to 24.7% in 2016.⁷ The Azerbaijan Deposit Insurance Fund (ADIF) was established to insure people's deposits and maintain confidence in the banking system. The ADIF disbursed \$90 million in 2015 and \$348 million in 2016 as compensation to depositors for failing banks. However, such heavy disbursements have depleted the asset base of the ADIF, and this needs to be replenished for the fund to continue providing depositor compensation. Considering that the ADIF is already under severe financial strain, it is important that the premiums are priced properly. The 2017 amendments to the Law of the Republic of Azerbaijan on Banks clarify the role of the ADIF in liquidation of banks. However, there is a need to institute risk-based pricing of deposit insurance premiums for banks and build in safeguards for moral hazards. As mentioned earlier, access to finance is one of the key inhibiting factors limiting the growth of the private business sector in Azerbaijan. Suitable credit enhancement instruments for providing financial assistance to businesses can improve availability of finance for the private sector. The weakening of the banking subsector because of high dollarization of deposits has also led to limited availability of credit to the private sector.

10. **Government's reform agenda.** To ensure sustainable growth, the government is looking at ways to diversify the economy while consolidating budgetary expenditure and boosting non-oil

⁵ World Economic Forum. 2017. *The Global Competitiveness Report 2017–2018*. <http://www3.weforum.org/docs/GCR2017-2018/05FullReport/TheGlobalCompetitivenessReport2017%E2%80%93932018.pdf>. Azerbaijan ranks 57 as compared to Georgia at 52.

⁶ State Statistical Committee of the Republic of Azerbaijan. <http://www.stat.gov.az>

⁷ Central Bank of Azerbaijan. 2016. *Statistic Bulletin No. 12 (202)*. https://www.cbar.az/assets/4267/STATISTIK_BULLETEN_2016_DEKABR.pdf

revenues. The priority structural reforms contained in the Strategic Roadmap of National Economy include strengthening public institutions, facilitating access to finance, and efficient public financial management.⁸ The series of reform initiatives include fiscal measures such as enforcing a stricter fiscal rule on the use of oil revenues and the development of medium-term expenditure frameworks (MTEFs) for key spending ministries. The rule will help to ensure intergenerational equity, reduce procyclicality, and achieve fiscal consolidation given shrinking fiscal space. The government has also embarked on structural reforms addressing the financial management issues and institutional inefficiencies in SOEs. It has also instituted measures to streamline the existing processes for improving indicators on the ease of doing business. To strengthen the banking subsector, the government is increasing the capital base of the ADIF and removing bottlenecks for resolution of insolvent banks. The government is setting up a credit guarantee fund to ease the access to credit by SMEs with reduced collateral. The proposed program will bolster private non-oil economic activity, increase fiscal space, and help Azerbaijan's transition to a diversified economy.⁹

11. **Programmatic approach.** The structural reforms require a long-term time horizon to implement and attain the intended outcomes effectively. For example, introduction of an MTEF requires sufficient preparatory and implementation time. A programmatic approach facilitates chronological sequencing of reforms across a multiyear time horizon through explicit framing of required policy actions and objectives. The proposed modality also plays a leveraging and catalyzing role in coordinating technical assistance provided by development partners. The Asian Development Bank (ADB) is coordinating closely with the International Monetary Fund in identifying and sequencing the policy actions.

12. **Development partner coordination.** Development partners in Azerbaijan have investment projects mainly in transport, energy, water supply, and the finance sector. The World Bank supports strengthening the business environment, and facilitates agriculture lending capacity. The European Bank for Reconstruction and Development is supporting the private sector through equity investments in financial institutions, direct lending, financial intermediation, and capacity building in business administration. Funded by the Swiss Cooperation Agency, the International Finance Corporation also supports financial institutions via investments and advisory services. The European Union provides technical advice in the areas of public financial management and governance. The World Bank will also provide technical assistance on some public financial management areas in 2018. The International Monetary Fund provides technical support on development of new fiscal rules and advises government on macroeconomic policy and the exchange rate regime. Under this program, the ADB is complementing implementation of a fiscal rule being developed by the International Monetary Fund and is consolidating the medium-term horizon of budget planning conceptualized by the World Bank.

13. **Lessons.** The program takes into account lessons from ADB's programmatic engagement in many other developing member countries in the areas of public financial management, financial sector development, and SOE reforms, and lessons from the recent and specific policy dialogue in the Azerbaijan context. The policy dialogue has highlighted the importance of supporting the planned or initiated reform processes with technical assistance, which is instrumental in building a strong base for the reforms to move to the next level. Policy reforms must be accompanied by strong government ownership, which is demonstrated by the government's clear reform priorities and willingness to engage in a multiyear programmatic engagement framework with ADB. In

⁸ Decree of the President of the Republic of Azerbaijan on approval of the Roadmap on National Economy and Main Sectors of the Economy dated 9 December 2016.

⁹ ADB. 2014. *Country Partnership Strategy: Azerbaijan, 2014–2018*. Manila

addition, setting realistic policy actions is critical to ensuring that the reform program can be carried out effectively while building simultaneous capacities. International lessons for the successful development of public financial management, financially sustainable SOEs, and finance sector development emphasize several crucial factors: (i) sound sequencing and realism in reform objectives; (ii) clear connection to local circumstances; and (iii) sound, modern, reliable, and efficient institutional infrastructure. The program incorporates these lessons.

14. **ADB's value addition.** In 2016, ADB provided a short-term countercyclical support facility to mitigate the adverse impact of the economic recession. As highlighted in the facility's development policy letter, the government also sought ADB's assistance to support structural reforms in the medium term related to macroeconomic and fiscal management, improving public sector efficiency and accountability, and promoting SME development.¹⁰ ADB adds significant value to the programmatic approach by (i) identifying critical policy actions based on preparatory works carried out during the preparation of the facility; (ii) improving the targeting of reform-related expenditures and their partial financing; (iii) enhancing coordination with development partners in the design and execution of the programmatic approach; (iv) providing technical assistance to sustain the reform initiatives, especially in the areas related to rule-based budgeting, corporate governance improvements in SOEs, and implementing international financial reporting standards;¹¹ and (v) consolidating policy reforms in the finance sector. ADB also gives a strong impetus to the government's ongoing debt management reforms by providing affordable least-cost solutions critical to sustaining these reform initiatives.

B. Impact and Outcome

15. The program impact will be sustainable and broad-based economic growth facilitated. The outcome will be allocative efficiency of public and private resources improved. Subprogram 1 has 17 policy actions and subprogram 2 has 22 policy actions. All subprogram 1 policy actions have been completed.

C. Outputs

16. **Output 1: Rule-based fiscal planning introduced.** The objective of this output is to promote discipline in fiscal policy making over the medium-term horizon to put Azerbaijan on a path of fiscal consolidation. This will be achieved by improving multiyear budget formulation and forecasting, increasing fiscal space by rationalizing public expenditures, and improving management of public debt and fiscal risks. Anchoring consolidation in credible multiyear frameworks is instrumental to maintaining macroeconomic stability and ultimately achieving sustainable and inclusive growth. Under the program, the government has formulated fiscal rules to serve as the basis of the national budget formulation. An important advantage of a rule-based fiscal framework is greater focus on medium-term budgetary forecasts, which in turn ensures better targeting of sector priorities. The government has initiated preparation of an MTEF on a pilot basis for one large-spending ministry, which will then be scaled up. The MTEFs play an important role in improving budget and expenditure management processes for better utilization and prioritization of existing fiscal resources in line with government priorities. The MTEFs for the line departments, in conjunction with a top-down, medium-term fiscal framework, are a prerequisite for effective implementation of expenditure rationalization.

¹⁰ ADB. 2016. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to the Republic of Azerbaijan for the Countercyclical Support Facility*. Manila.

¹¹ While this program promotes corporate and financial governance standards across SOEs of different sectors, the proposed Railways Sector Development Program represents a sector focused package of sector, financial, governance, tariff and corporate reforms in railways.

17. Several laws have been amended under subprogram 1 to improve public financial management. The amended law on labor pensions will reduce the quantum of deficit financing required for meeting pension fund liabilities, as the government currently allocates a significant amount from the state budget to meet the deficit in the pension fund every year. This in turn will create the fiscal room to prioritize the expenditure allocations to productive sectors. Other legal and policy interventions have been undertaken with the aim of streamlining and restructuring (i) management of the State Guarantee Fund, (ii) borrowings by SOEs, and (iii) management of single treasury account residual funds. Subprogram 1 has also prepared a medium-term debt management strategy including an information-technology-based debt management system to manage debt at a sustainable level. This will provide a key element of a rule-based fiscal framework by having ceilings on fiscal deficit, debt, and the interest service obligations on debts. To implement the debt management strategy, the government will undertake institutional reorganization of the Public Debt Management Agency and has deliberated on the design of a debt management system for improving recording and dissemination of information on debt, and finalized the same.

18. **Output 2. State-owned enterprises restructured and private sector participation in economic activities strengthened.** Financially sustainable and effective SOEs are critical prerequisites for improved public service delivery and reduced fiscal transfers from the government budget. The actions under this output aim to strengthen corporate governance of SOEs, standardize financial practices, and allow space for private sector participation in economic activities. Under subprogram 1, the government has formulated an action plan to improve the transparency and financial reporting practices of SOEs. The action plan outlines the activities to be undertaken and underpins the role of various agencies responsible for implementing the action plan, along with specific time frames required for undertaking each activity. A commission has also been constituted which will closely monitor and report to the government the financial performance of the SOEs, especially in the areas of financial planning and utilization of funds. To ensure greater adherence to international practices in the functioning of the SOEs, the government has drafted comprehensive corporate governance rules that will guide the selection of directors, internal audit, accounting, and financial reporting procedures for all SOEs. Additionally, the government is amending the existing accounting laws to strengthen accounting practices in SOEs by mandating implementation of international financial reporting standards. To diversify the economy of Azerbaijan and reduce the dependence on oil, the government has formulated and approved strategic plans for the national economy and the key sectors. These plans articulate the key goals and actions to achieve those goals over short-, medium-, and long-term horizons. The policy actions under subprogram 1 also facilitate formulation of guidelines for public-private partnerships to improve transparency and address limitations of public financial resources in strengthening economic activities and creating new jobs.

19. **Output 3. Enhanced access to finance and business environment improved.** The interventions under this output aim to diversify the economy and reduce reliance on oil exports through enhanced participation of the private sector in economic activities by increasing access to finance and improving the business environment for the private sector. Improving access to finance, especially for SMEs in local currency, is the key to achieving the broader objective of diversification of the economy. Under subprogram 1, the government has prepared a detailed action plan highlighting key intervention areas for improving the overall business environment in the country. Based on the action plan, as a credit enhancement measure the government has set up a credit guarantee fund for SMEs with measures to manage risks related to moral hazards generally associated with the operation of credit guarantee funds (e.g., setting up a seven-member supervisory board with nongovernment participation and working groups made up of

eminent persons from the public and private sectors). Credit bureaus play a vital role in reducing the risk in the financial sector by maintaining a repository of borrowers and their risk profiles based on their credit history. Under the program the government has passed the enabling legislation that will help to establish the legal framework for setting up a credit bureau and defining its activities.

20. Based on the action plan to improve the ranking in the ease of doing business indicators, the government is implementing reforms based on the World Bank's ease of doing business parameters. Because of the recent downturn in Azerbaijan and the fact that banks are struggling to honor deposits of customers, confidence in the banking system has been seriously shaken. The ADIF has restored the situation to a degree by compensating depositors. Keeping the ADIF in a financially sound position is critical to ensuring public confidence in the banking subsector. The policy actions under subprogram 1 will strengthen deposit insurance by recapitalizing the ADIF's depleting asset base and developing a model for a risk-based pricing methodology to price premiums to be charged from banks. This framework will keep the ADIF operationally sustainable and in turn provide impetus to local currency deposits in banks. The increased liquidity in the banking system will lead to enhanced credit availability for SMEs. As a supporting measure, the NFES has been providing subsidized credit to entrepreneurs through extension of low-cost loans to authorized financial institutions for onlending to entrepreneurs, and capping the spread that can be charged by the authorized lending institutions from the borrowers. There has been significant economic activity and jobs generated through the NFES intervention.

D. Development Financing Needs

21. The government has requested ADB to provide policy-based lending under a programmatic approach in order to support its continuing structural reform agenda. The overall program is \$500 million, and it will comprise two subprograms. The government has requested a regular loan of \$250 million from ADB's ordinary capital resources to help finance subprogram 1. Subprogram 2 is also expected to be \$250 million. The loan will have a 15-year term, including a grace period of 3 years, an annual interest rate determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility, a commitment charge of 0.15% per year, and such other terms and conditions set forth in the draft loan agreement.

22. The amount of the loan reflects the government's development financing needs and the strength and development impact of the proposed policy reforms over the two subprograms. Based on detailed discussions with the government officials, the following costs of reforms under the overall program were identified: (i) support the ADIF for meeting the obligations of banks toward depositors, (ii) support the NFES to help in SME development, and (iii) make the Credit Guarantee Fund operational. The subprogram 1 loan will be disbursed in a single tranche and the closing date will be 31 March 2018. The loan size is justified considering the key development expenditures during the program period (Table 1).

Table 1: Key Reform Costs (2017–2018)
(\$ million)

Item	Amount
One-time budgetary support to ADIF	320.0
Budgetary support to NFES over 2017 and 2018	180.0
Budgetary support for operationalization of Credit Guarantee Fund	200.0
Total	700.0

ADIF = Azerbaijan Deposit Insurance Fund, NFES = National Fund for Entrepreneurship Support.
Source: Asian Development Bank staff estimates.

23. Table 2 summarizes the total financing requirements if the official repayment of foreign currency debt principals is included. The estimated 2017 deficit is \$1.2 billion. The proposed loan will help the government partly cover these financing needs while targeting specific reform expenditure items. Given the rigidity in nondiscretionary recurrent expenditures (salary, pensions, and interest payments), the impact of a hard budget constraint on development financing has been found to be negative. It will be difficult for the government to incur additional costs to carry out critical reforms unless these are partly financed by the government's development partners. This is for two reasons: Firstly, there is continued significance of oil transfers in maintaining fiscal sustainability, as transfers from SOFAZ continue to be above 40% of state budget revenues since 2009. Given that a sharp increase in oil prices in the near future appears improbable, transfers to support the state budget are not expected to jump substantially. Secondly, the fiscal consolidation in the medium term can be achieved largely through spending cuts with a strong focus on the quality of public spending. Given the distress which the economy is currently in, delays in government spending on some of these crucial reforms could be counterproductive from a longer term macroeconomic perspective.

Table 2: Fiscal Financing Needs
(\$ billion)

Item	2016	2017p	2018f	2019f
Central government overall deficit	0.142	0.790	1.067	1.030
Debt repayment ^a	0.394	0.449	0.514	0.537
Total financing needed	0.536	1.239	1.581	1.567

^a Official repayments of foreign currency debt principal.

p= provisional, f=forecast

Source: Official figures for 2016, and Asian Development Bank staff estimates for 2017–2019, using different sources.

E. Implementation Arrangements

24. The Ministry of Finance (MOF) is the executing agency. The Central Bank of Azerbaijan, Financial Market Supervisory Authority, Ministry of Economy, and MOF are implementing agencies. Both the MOF and Central Bank of Azerbaijan have a well-established track record in implementing reform programs with ADB, the World Bank, and the International Monetary Fund. The implementation period for subprogram 1 is October 2016 to November 2017. The implementation period for subprogram 2 is expected to be December 2017 to December 2018. The proceeds of the policy-based loan will be disbursed in accordance with ADB's *Loan Disbursement Handbook* (2015, as amended from time to time).

III. DUE DILIGENCE

A. Economic and Financial

25. The beneficiaries of subprogram 1 are the citizens of Azerbaijan, who will directly benefit from improved delivery of services and enhanced employment opportunities. The proposed program will have a favorable impact on growth and job creation, both directly and indirectly. The introduction of rule-based fiscal planning under subprogram 1 facilitates targeted public investments in social and economic infrastructure, which in turn will result in improved health and education services and economic opportunities. Moreover, additional public investment will stimulate private sector investment and productive activities. SOE reforms under subprogram 1 will also have a beneficial effect on national finances. This will originate primarily from three sources: nondebt capital receipts (disinvestment income), reduced fiscal transfers, and higher

dividend income. In addition, the government will reduce its contingent liabilities once pensions and related retirement liabilities are allocated and funded more efficiently and transparently.¹²

B. Governance

26. The government placed combating corruption high on its agenda in 2011, announcing a no-tolerance policy. Efforts to combat corruption since 2005 had resulted in important improvements, which were acknowledged by regional anticorruption bodies by 2012,¹³ and Azerbaijan continued to make progress in preventing corruption in several sectors.¹⁴ This contributed to marked improvements in public perceptions of governance. The findings of a survey undertaken by the European Bank for Reconstruction and Development across several transition economies in 2016 show a positive public perception; 59% of respondents think that there was less corruption in 2016 than in the 4 years before the survey.¹⁵ Initiatives such as the National Action Plan for 2016–2018 on the Promotion of Open Government paved the way for measures like ASAN Xidmet.¹⁶ While punitive actions against certain senior officials suggest that the government wants to signal a tough approach on corruption, such efforts need to be sustained. A desk review of potential risks and vulnerabilities in the public financial management systems was also undertaken. The review identified vulnerabilities that could impact the program. While budget comprehensiveness and transparency as well as predictability and control in budget execution have improved in recent years in Azerbaijan, weaknesses remain in external and internal audit. This is especially the case in line ministries, and has been taken up in the public financial management action plan adopted by the MOF. The new law on public procurement is expected to facilitate the required changes in the public procurement system for more transparent and efficient processes. While improvement of fiscal management is a key reform under the attached technical assistance, development of the integrated financial system is envisaged in subprogram 2 to help expenditure tracking. There is also an increasing focus on implementation of international financial reporting standards in SOEs to improve transparency and accountability.

27. The Government of Azerbaijan has made important progress in strengthening country systems for transparency and accountability in the extractive industries. Following the withdrawal of Azerbaijan from the Extractive Industries Transparency Initiative in March 2017, the president issued a decree in April 2017 that resulted in the establishment of the high-level Extractive Industries Transparency Commission, with SOFAZ managing its secretariat. The committee assumed its activities in April 2017 and agreed on a stakeholder engagement process that also involves civil society organizations in extractive industry transparency-related tasks such as commenting on transparency reports. ADB's planned support for beneficial ownership plan implementation will help sustain this progress and the momentum generated by the leadership of SOFAZ on extractive industry transparency. ADB's Anticorruption Policy (1998, as amended to date) was explained to and discussed with the government and the MOF.

¹² Economic and Financial Analysis (accessible from the list of linked documents in Appendix 2).

¹³ As part of technical assistance support, a governance risk assessment was conducted along the implementation guidelines of ADB's Second Governance and Anticorruption Action Plan, and this was published in 2012.

¹⁴ Organisation for Economic Co-operation and Development. 2016. *Anti-Corruption Reforms in Azerbaijan*. Report adopted at the Anti-Corruption Network for Eastern Europe and Central Asia meeting. Paris. 16 September.

¹⁵ European Bank for Reconstruction and Development. 2016. *Country Assessment for Azerbaijan*. <http://litsonline.ebrd.com/countries/azerbaijan/>

¹⁶ ASAN Xidmet, a government-operated network of 11 mobile and permanent service points intended to streamline public service delivery, is being expanded to cover three new regions. The State Agency for Public Service and Social Innovations reports 98% user satisfaction. In May 2016, the State Customs Committee launched a pilot project for electronic declaration of goods and transport aimed at streamlining procedures and improving transparency.

C. Poverty and Social

28. Azerbaijan's poverty ratio was low at 4.9% in 2015. However, recent recession has adversely affected Azerbaijan's labor market with many layoffs in both the public and private sectors. The number of unemployed rose by 2.5% in 2015 and 14.5% in 2016, after falling by an average of 2.0% annually during 2010–2014. The impact of the ongoing recession on the poverty ratio is expected to be negative, albeit in the short term. The proposed program aims to improve long-term financing in local currency to SMEs, enhance fiscal space to better respond to external shocks that affect employment, and improve the efficiency of public sector resource allocation to improve service delivery. These initiatives are expected to have a direct impact on employment creation and poverty reduction. The promotion and protection of gender equality is one of the nine strategic goals of the government's poverty reduction and development program, and gender issues are prioritized in education, health, the labor market, and in programs for internally displaced persons and the refugee population. Addressing poverty- and gender-specific problems becomes more challenging, especially in a situation where government is unable to provide adequate funds for investment in economic and social infrastructure. The program's special emphasis on better expenditure targeting with the help of MTEFs, especially in health and education, is geared toward protecting poor people and vulnerable groups.

D. Safeguards

29. In compliance with ADB's Safeguard Policy Statement (2009), the program is classified category C for impacts on the environment, involuntary resettlement, and indigenous peoples.

E. Risks and Mitigating Measures

30. The major risks to the program are discussed in the risk assessment and management plan, together with mitigation factors and measures. Table 3 presents the risks that are either substantial or high (premitigation levels), and that are, to an important extent, out of control of the program. The overall assessment for the risk level of the program is *moderate* (premitigation levels). Fiduciary arrangements for budget support are acceptable, and the strengthening of public financial management is one of the key objectives of the program. While no significant risks of mismanagement of resources at the executing level are expected, relevant issues identified in the assessments are also targeted in the proposed loan and the ongoing technical assistance. This will provide, by default, close levels of engagement and monitoring that provide at this stage an important degree of fiduciary comfort.¹⁷

Table 3: Summary of Risks and Mitigating Measures

Risk Description	Rating	Mitigation Measures	Responsibility
Reform Sustainability			
Leadership and political will to complete the reforms weakens because of vested interests	S	Government of Azerbaijan has been announcing and implementing reforms since mid-2015, and the implementing agencies of the proposed program (i.e., CBA, FMSA, MOE, and MOF) were strongly engaged in discussions with ADB and ADB TA experts over the most challenging reform needs under their respective mandates. This leadership and political will may weaken in the face of resistance by vested interests (e.g. resistance to change inside SOEs) or with turnover of key officials that upon being trained might	MOF and ADB

¹⁷ Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

Risk Description	Rating	Mitigation Measures	Responsibility
		not be retained. ADB's engagement will have to remain institutionally anchored at the MOF level, as both the natural and formal coordinator of the current reform drive, and political economy challenges identified upfront.	

ADB = Asian Development Bank, CBA = Central Bank of Azerbaijan, FMSA = Financial Market Supervisory Authority, MOE = Ministry of Economy, MOF = Ministry of Finance, TA = technical assistance.
Source: ADB staff.

IV. ASSURANCES

31. The government and the MOF have assured ADB that implementation of the program shall conform to all applicable ADB policies including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement as described in detail in the loan documents.

V. RECOMMENDATION

32. I am satisfied that the proposed programmatic approach and policy-based loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve

- (i) the programmatic approach for the Improving Governance and Public Sector Efficiency Program; and
- (ii) the loan of \$250,000,000 to the Republic of Azerbaijan for subprogram 1 of the Improving Governance and Public Sector Efficiency Program, from ADB's ordinary capital resources, in regular terms, with interest to be determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility; for a term of 15 years, including a grace period of 3 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft loan agreement presented to the Board.

Takehiko Nakao
President

14 November 2017

DESIGN AND MONITORING FRAMEWORK

Impact the Program is Aligned with Sustainable and broad-based economic growth facilitated (Source: Azerbaijan 2020: Look into the Future Concept of Development) ^a			
Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting	Risks
Outcome Allocative efficiency of public and private resources improved	By 2019: a. Local currency bank credit increased by at least 20% (2016 Baseline: AZN8 billion) b. Fiscal outlays to SOEs are reduced by at least 0.2 percentage points (2016 Baseline: 1.1% of GDP)	Annual report of the CBA budget documents	Continued commitment of the government toward reform momentum is not sustained.
Output 1 Rule-based fiscal planning introduced	By 2017 unless mentioned otherwise: 1a. Government amended the public financial management legal framework, including the Law on the Public Budget, incorporating clear fiscal rule guidelines in budget making from 2019 onwards (2016 Baseline: Not amended) 1b. Government developed MTEF for one large-spending ministry by 2018 (subprogram 2; 2017 Baseline: Not prepared) 1c. Parliament amended the law on labor pension to simplify the rules for budgetary allocations (2016 Baseline: Not amended) 1d. Government approved a medium-term debt management strategy (2016 Baseline: Not approved) 1e. Government adopted legislative amendments for (i) the guidelines for utilizing the State Guarantee Fund, (ii) regulating the borrowings of SOEs by imposing an upper limit, and (iii) managing the single treasury account residual fund (2016 Baseline: Not adopted)	1a.–e. Annual report of the MOF; budget documents	Trained staff are not retained in the relevant departments during the entire period of the program, affecting successful completion of various policy actions.
Output 2 SOEs restructured and private sector participation in economic activities strengthened	2a. (i) President approved the overall direction of SOE restructuring and privatization, and (ii) government approved action plan on increasing transparency and efficiency in the management of the large SOEs including financial practices. (2016 Baseline: Not approved by the president) 2b. Government (i) established a commission to monitor income and expenditure budgets of 20 large SOEs, (ii) amended the rules related to budget preparation and submission, (iii) approved a comprehensive CGR framework (covering selection of directors, internal audit, accounting, and	2a.–d. Annual report of the MOE; annual report of the MOF	Resistance to change inside SOEs derails reform processes.

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting	Risks
	<p>financial reporting for all SOEs), and (iv) issued a circular to make this mandatory for the large 20 SOEs. (2016 Baseline: Not in place).</p> <p>2c. Government amended the Law of Accounting for the implementation of IFRS in SOEs (2016 Baseline: Not amended)</p> <p>2d. 50% of SOEs submitted compliance report of implementing CGR by 2018 (Subprogram 2; 2017 Baseline: CGR not implemented)</p>		
<p>Output 3 Enhanced access to finance and improved business environment</p>	<p>3a. Government approved action plan for facilitating effective business environment in Azerbaijan including setting up of the Credit Guarantee Fund for SMEs (2016 Baseline: Not approved).</p> <p>3b. Government passed the Law of Azerbaijan Republic on Credit Bureaus to establish the legal basis of creation and activities of credit bureaus (2016 Baseline: Law not in place).</p> <p>3c. ADIF recapitalized (2016 Baseline: Not in place).</p> <p>3d. ADIF and FMSA established risk-based pricing methodology for deposit insurance by 2018 (Subprogram 2; 2017 Baseline: Risk-based pricing methodology has not been prepared).</p>	<p>3a.–d. Annual report of the CBA; annual report of the FMSA</p>	

Key Activities with Milestones

Not applicable

Inputs

ADB: \$250 million for subprogram 1 (loan)

\$250 million for subprogram 2 (loan)^b

Assumptions for Partner Financing

Not applicable

ADB = Asian Development Bank, ADIF= Azerbaijan Deposit Insurance Fund, CBA = Central Bank of Azerbaijan, CGR = corporate governance rules, FMSA = Financial Market Supervisory Authority, GDP = gross domestic product, IFRS = international financial reporting system, MOE = Ministry of Economy, MOF = Ministry of Finance, MTEF = medium-term expenditure framework, SMEs = small and medium-sized enterprises, SOE = state-owned enterprise.

^a Office of the President of Azerbaijan. 2012. *Azerbaijan 2020: Look Into the Future Concept of Development*. http://www.president.az/files/future_en.pdf.

^b Amount is indicative and subject to further discussion between the government and ADB.

Source: Asian Development Bank.

LIST OF LINKED DOCUMENTS

<http://www.adb.org/Documents/RRPs/?id=51059-001-3>

1. Loan Agreement
2. Sector Assessment (Summary): Public Sector Management and Finance
3. Contribution to the ADB Results Framework
4. Development Coordination
5. Country Economic Indicators
6. International Monetary Fund Assessment Letter
7. Summary Poverty Reduction and Social Strategy
8. Risk Assessment and Risk Management Plan
9. List of Ineligible Items

Supplementary Documents

10. Economic and Financial Analysis
11. Programmatic Approach Concept Paper

DEVELOPMENT POLICY LETTER


**MINISTRY of FINANCE
REPUBLIC of AZERBAIJAN**

135, Samad Vurghun str., Baku, AZ 1022
E-mail: office@maliyye.gov.az

Phone: (+994 12) 404 46 99
Fax: (+994 12) 404 47 20

8 November 2017

№ DA-02/03-1090-5631

**To: Mr. Takehiko Nakao
President
Asian Development Bank**

Subject: Development Policy Letter

Dear President Nakao,

Let me begin by thanking the Asian Development Bank for its strong and continued support to the Republic of Azerbaijan's development efforts. Let me reiterate that the Government of Azerbaijan is implementing a concerted set of efforts to revive economic growth and make it more broad-based and inclusive going forward.

In 2016, the economy of Azerbaijan contracted by 3.1%, while the non-oil sector contracted by 4.5% after continuous robust growth. This decline stems from a lower hydrocarbon output, contraction of public investments and a tightened domestic demand. Inflation accelerated to 12.4% beyond a single-digit target of the CBAR, from 4.0% in 2015, reflecting continuing effect on prices of the sharp currency depreciation during 2015. The current account deficit estimate has widened to 3.6% of GDP in 2016, up from 0.4% of GDP in 2015. Exports declined by 20% because of lower oil prices and output. Imports declined by 7.5% mainly because of devaluation impact, but also due to lower imports of cars, tobacco, and pharmaceuticals. GDP is expected to grow slightly in 2017. The oil sector is still the key factor affecting the growth and accounts to about 34% of GDP.

In response to these recessionary conditions, the government also reacted with the intention of preparing and undertaking structural reforms to strengthen financial sector stability, enhance the business environment, broaden privatization, and improve the efficiency of state administration. A comprehensive approach to structural reforms is needed in Azerbaijan to foster broad-based private sector-led growth in the non-oil economy. Specific initiatives to improve the business environment and

enhance financial sector stability need to be elaborated and implemented, and we are taking a wide range of steps in that direction.

In December 2016, the President approved the Strategic Roadmap on National Economy and Main Sectors of the Economy (The Roadmap) to respond to macroeconomic and financial challenges, and to re-double its efforts to diversify the economy. Main components include: (i) oil and gas, (ii) agricultural production, (iii) production of consumer goods at SME level, (iv) heavy industry and machinery, (v) tourism, (vi) logistics and trade, (vii) technical and vocational education, (viii) social housing, (ix) financial services, (x) communication and information technologies, and (xi) utilities sector (electricity, water, and gas). The Government has adopted sub-roadmaps for each of the subcomponent. Strategic Road Map on National Economic Perspectives covers short, medium and long-term horizon and comprises economic development concept and action plan for 2016-2020, long-term outlook by 2025 and target outlook for the period after 2025. It covers not only economic objectives and principles, but also global trends for each area, 360 degree diagnostics of the economy and SWOT analysis of current situation, actions to be undertaken, required investments and key performance indicators as well.

We are taking significant measures to diversify the economy and to build a strong export-oriented non-oil sector. We have, for example, established an export promotion web-site to create unified database of goods produced in Azerbaijan. The purpose of this initiative is providing information about products of Azerbaijani origin and becoming the beneficial platform for their sales in foreign and domestic markets. The website is integrated with the most popular electronic trading platforms that makes the local products available to potential buyers from different parts of the world. Leading global and local transport and logistics companies are integrated into the website. It offers fast and secure payments via VISA, Master Card and American Express cards payment systems. In April 2016, The Government has also established an investment promotion facility. This institution provides entrepreneurs with concessions and subsidies while investing and doing business for 7 years. Concessions include: i) 50% discount on income and profit tax; ii) exemption from land or property tax; and iii) full exemption from customs duty and VAT on machinery and equipment imported under the project. 158 investment promotion facility was provided to 169 entrepreneurs. This is expected to attract AZN 1.6 bln. investment and generate 11,000 employment.

In June 2017, the President of the Republic of Azerbaijan approved the Action Plan on "Improving the Expediency of Business Environment" in Azerbaijan to improve the country's position in international rankings. The action plan covers the following areas: the development of financial markets and the availability of loans; effective governance and macroeconomic monitoring; labour market; physical infrastructure; the execution of contracts, dispute resolution, closure and bankruptcy of the enterprise, the judicial system and rule of law; corporate governance, investments and investors' interest protection; foreign trade and trade tariffs; human capital; efficiency of commodity markets and competition; technology and innovations; tax and accountability; border trade; healthcare system; connectivity to the power supply network; construction permit and property registration processes; and transparency and combating corruption.

The prospects of private sector development will remain incomplete unless we have an efficient financial sector to provide easy and cost-effective access to finance. We are taking important measures

to stabilize financial sector and also to enhance financial intermediation. The government announced the plans to privatize the state-owned bank which shares about 25% of total banking sector. The Central Bank of Azerbaijan has also taken important steps to improve provisioning and accurately classifying the non-performing loans, which has increased for the past 2 years. To streamline responsible lending, the Government approved a law on credit bureau, which will collect, maintain, analyse and provide information on the credit histories of legal entities and individuals, prepare software to build credit histories, advise on how to build and use a credit history, conduct statistical research, assess the solvency and performance discipline of debt obligations by legal entities and subjects, and assign credit ratings. In September 2016, the Government has formed ABAD (Easy Support to Family Business) agency to support rural private family businesses to produce, brand, promote their produce and deliver them to end user. In 2016 the Government has also initiated self-employment program on a pilot basis. This program as well as other active labor market measures with adequate financial provision shall be extended by implementation of the new unemployment insurance system effective from the next year. These initiatives target social and economic development of rural areas, involve local people in such development, achieve higher employment in such regions and enable competitive private businesses.

We are taking significant measures to strengthen ease of doing business through the one-stop window and the easy service centers—the ASAN Service. ASAN Service is part of a comprehensive set of reforms to modernize public administration and service delivery. It brings together representatives of various government entities and private companies to limit direct interaction of the applicant with public servants. Services in the centers are rendered based on the “single window” approach. ASAN Service widely applies modern technologies and social innovations to increase efficiency and quality of the public service. With its 9 centers and mobile teams ASAN has served more than 10 million applicants by June 2016 since its establishment in 2012.

We are also in the process of simplifying tax and customs procedures and providing tax incentives for new businesses. For example, the residents of the industrial parks are provided with tax incentives and are exempt from customs duties on the equipment they import. Agro-producers are also exempt from profit, VAT, property and other taxes till 2019. This will help increase agricultural productivity, ensure food security and increase employment in the sector. There has also been the introduction of electronic services in the tax administration and customs, such as the production of electronic declarations and the payment of fees electronically, which are important in increasing transparency and reducing bureaucratic hurdles. Also considerable reforms have been realized in the country's social protection system by extensive use of modern technologies and innovations enabling to significantly raise the system's coverage, targeting and efficiency.

Dear President Nakao,

We have identified a few key areas of reform where a multi-year engagement with ADB would increase impact and effectiveness of reforms. With ADB support and the technical assistance that supported the recent policy dialogue, we started to prepare and implement these reforms. Several government teams worked with the ADB team to design the Proposed Improving Governance and Public Sector Efficiency Program, comprising three key and priority areas of reform.

Introduction of Rules-based fiscal planning to improve aggregate fiscal discipline and allocative efficiency of public resources. To promote fiscal discipline over the medium-term horizon, and to put Azerbaijan's public finances on a path to fiscal consolidation, we need to improve multi-year budget formulation and forecasting, increase fiscal space by rationalizing public expenditures, and improve the management of public debt and fiscal risks. To achieve this, the government of Azerbaijan has started to incorporate fiscal rules to serve as the basis of the national budget formulation and put greater focus on medium term budgetary forecasts from 2019 onwards. The government also intends to initiate the preparation of a MTEF on a pilot basis. This approach is to be subsequently scaled up (in Subprogram 2), to gradually introduce budget-making based on the rolling medium-term fiscal framework (MTFF) and rolling MTEF. MTEFs for the line departments, in conjunction with a top-down MTFF, are pre-requisites for effective implementation of the much-needed expenditure rationalization objectives in our public sector. Our government has also initiated a plan to implement an Integrated Financial Management System within MOF.

Also under subprogram 1, and to improve public financial management, amendments were done to the Law on labor pensions to exactly determine state budget's liabilities on pension expenses and on this basis differentiate financial sources of the pension liabilities. Other amendments under Subprogram 1 streamline and restructure (i) the management of the Contingency Fund of publicly guaranteed loans, (ii) the rules governing borrowings by SOEs, and (iii) management of single-treasury account residual funds.

Under subprogram 1 we also prepared and approved a medium-term debt management strategy, including the specifications on an IT-based debt management system. This will provide key pillars for a rules-based fiscal framework. To implement the debt management strategy, we'll undertake in Subprogram 2 an institutional reorganization of our Public Debt Management Agency (PDMA) and operationalize the debt management system for improving the recording and dissemination of information on debt.

Restructuring of SOEs to improve legal and institutional arrangements and strengthen private sector participation in key economic activities. To improve public service delivery and reduce fiscal transfers from the government budget to SOEs in Azerbaijan, substantial reforms need to be undertaken to ensure their financial sustainability. With ADB support and under the program, we aim to strengthen the corporate governance requirements for SOEs and standardize their financial reporting and practices. We also aim to open space for private sector participation in SOE economic activities. Under subprogram 1, the government formulated an action plan to improve the transparency and financial reporting practices of SOEs, outlining the activities to be undertaken and the role of various agencies responsible for implementing the time-bound action plan. We also established a commission to closely monitor and report to the government the financial performance of the SOEs. To ensure greater adherence to international practices in the functioning of the SOEs, the government drafted comprehensive Corporate Governance Rules to guide the selection of directors, internal audit, accounting and financial reporting procedures for all SOEs. These have been submitted for Presidential approval. Additionally, government is carrying out a plan with a set of measures on accounting reforms in SOEs for implementation of national accounting standards as well as International Financial Reporting

Standards (IFRS). Our government has also strengthened the institutional arrangements for preparation, approval and execution of PPPs, and assigned a focal agency to administer PPP processes. Strategic roadmaps for key sectors of the economy were also approved to lay the set of initiatives that is needed to promote the economic diversification of Azerbaijan.

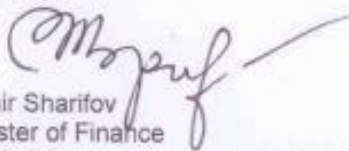
Enhance access to finance and generate a conducive business environment for diversification of the economy. The government of Azerbaijan is committed to improving access to finance, especially for SMEs, in local currency. De-dollarization is the key to achieve the broader objective of diversification of our economy. Under subprogram 1, the government prepared a detailed action plan for this purpose, highlighting key intervention areas for improving the overall business environment in the country. Credit Bureaus play a vital role in enhancing information sharing in the financial sector by maintaining a repository of borrowers and their risk profiles based on their credit history. As a measure to establish the legal framework for setting up credit bureaus, the government passed the supporting legislation to establish the creation of credit bureaus and defining their activities. Due to the recent downturn in Azerbaijan and the banks struggling to honor deposits of customers, the confidence in the banking sector has been seriously shaken. ADIF has restored the situation to a degree, by compensating depositors. Keeping ADIF in a financially sound position is a critical measure to ensure public confidence in the banking sector. To strengthen deposit insurance, the government recapitalized the ADIF, and has put in place an institutional and regulatory framework for providing impetus to local currency deposits in banks. To enhance credit access of SMEs amendments were made to the existing guidelines for the National Fund for Entrepreneurship Support, as well as a decision were taken to establish Credit Guarantee Fund.

We are committed to continue our efforts towards successful implementation of the Roadmap and achieve vibrant and diversified that supports broad-based and inclusive growth. We reiterate our request to ADB for a \$250 million program to enable the government to effectively implement the ongoing and planned reform agenda.

We note that the proposed Program is in line with our priorities outlined in the Roadmap and will contribute significantly to the country development agenda. The program will help the government to maintain macroeconomic stability, improve public sector efficiency, strengthen fiscal management, ensure efficient SOEs and better private sector participation, as well as improve access to finance.

We would like to thank ADB for working closely with the Government of Azerbaijan in developing this program. We also appreciate ADB's continued support to the development of country's water supply and sanitation, road and energy infrastructure

Sincerely,



Samir Sharifov
Minister of Finance
Azerbaijan

08.11.2017

POLICY MATRIX

Policy Objectives	Policy Actions Subprogram 1 (by November 2017)	Policy Actions Subprogram 2 Indicative (by November 2018)
Output 1: Rule-based fiscal planning introduced.		
Improve multi-year budget formulation and forecasting	1. MOF strengthens the public financial management legal framework by drafting amendments to the Budget Systems Law incorporating clear fiscal rule guidelines, including for example, expenditure targeting, in budget making from 2019 onwards.	1. Government (i) approves the fiscal rules for budget making, and (ii) develops a Medium-Term Budget Policy document, including a Fiscal Policy Statement with three-years rolling medium-term fiscal framework (MTFF) projections based on the fiscal rule adopted, a Macroeconomic Strategy, a Statement of Fiscal Risks, and National Spending Priorities as part of 2019 budget documentation.
	2. MOF, on behalf of the Government, develops reform proposals on the preparation of medium-term expenditure framework (MTEF) and results-based budgeting including proposal of preparation and implementation of MTEF for one large spending ministry.	2. Government presents the annual budget for 2019 based on the MTFF and the fiscal rules.
		3. Government approves the MTEF for the selected ministry, and initiates the preparation for another two large spending ministries.
		4. Government creates a specialized group in the Ministry of Finance with in-house skills for the regular preparation of MTFF and MTEFs.
		5. Government develops and approves a plan for implementing Integrated Financial Management and Information System (IFMIS).
Increase fiscal space by rationalizing public expenditures	3. Parliament adopts amendments to the Law on labor pensions to exactly determine state budget's liabilities on pension expenses and on this basis differentiate financial sources of the pension liabilities.	6. Ministry of Finance and the Ministry of Labor and Social Protection of Population establish a joint working group to exactly calculate state budget's liabilities on pension expenses.

Policy Objectives	Policy Actions Subprogram 1 (by November 2017)	Policy Actions Subprogram 2 Indicative (by November 2018)
Improve management of public debt and fiscal risks	4. MOF internally approves a medium-term public debt management strategy to serve as a framework for future borrowings incorporating ceilings on level of government debt and submits to the Cabinet of Ministers.	7. Government restructures the Public Debt Management Agency (PDMA) by operationalizing a separate unit for debt recording and reporting in the Debt Management System.
	5. Government adopts legislative amendments to keep public debt and fiscal deficit to manageable levels by: (i) amending guidelines to restrict utilization of the State Guarantee Fund (for state guaranteed debts) only for 'A' rated debt, (ii) framing of guidelines for the borrowings of state owned enterprises by imposing an upper limit, and (iii) amending the legislation on the management of residual funds by transfer to single treasury account towards deficit financing.	8. Based on the debt management strategy, an updated version of the Law on State debt is drafted with a view to consolidate legal framework on public debt management including the authority to borrow and procedures for negotiating and contracting external loans.
	6. MOF approves the design specifications of the Debt Management System to be procured for automating the public debt management processes.	9. Government operationalizes the selected Debt Management System covering loan types, maturity, interest payments, guarantees and other relevant benchmarks.
Output 2: State-owned enterprises restructured and private sector participation in economic activities strengthened.		
Strengthen corporate governance and standardize financial reporting and practices	7. Government (i) mandates the overall direction of SOE restructuring and privatization and (ii) approves an Action Plan on increasing transparency and efficiency in the management of the 20 large SOEs including financial practices.	10. Government implements the action item nos. 1, 3, 5, 6 and 7 of the approved Action Plan for the large SOEs and submits an Action Taken Report on the same.
	8. Government establishes a Commission to monitor income and expenditure budgets of 11 large SOEs, amends the existing rules related to SOE budget preparation and submittal to the government and increases the monitoring of budget execution with a view to improve oversight and transparency in the large SOEs.	11. Commission annually monitors the budget of the selected SOEs and submits regular reports to the government with recommended actions.

Policy Objectives	Policy Actions Subprogram 1 (by November 2017)	Policy Actions Subprogram 2 Indicative (by November 2018)
	9. Government drafts and submits for Cabinet of Ministers approval a comprehensive Corporate Governance Standards/ Rules Framework covering selection of directors, internal audit, accounting and financial reporting for all SOEs; in alignment with the Order of the President No. 2300 dated 05.09.2016.	12. Government approves the Corporate Governance Standards/ Rules and issues a circular to make it mandatory for 20 large SOEs.
		13. 50% of selected SOEs submit compliance report of implementing Corporate Governance Rules.
	10. Government approves a plan for implementation of international and national accounting standards to strengthen financial discipline in 20 large SOEs.	14. Government submits a compliance report on the implementation of international and national accounting standards in at least 20 large SOEs.
Increase commercialization and private sector participation in the economy	11. Government strengthens the institutional arrangement for preparation, execution and approval of PPPs and approved guidelines on the rules of competition among investors for build-operate-transfer (BOT) projects in PPP mode to improve transparency.	15. Government approves a PPP policy incorporating a mechanism to monitor and report on the fiscal risks and liabilities from PPP projects.
	12. Government to approve strategic roadmaps for key sectors such as heavy industries, tourism, agriculture, telecommunication and IT and financial services aimed at economic diversification	16. Government to implement (i) Priority 7.1.3 for heavy industries related to creation of central asset register, (ii) 7.1.1 for Tourism related to setting up of a National Tourism Bureau and (iii) Priority No. 7.2.4 for agriculture related to improving private public cooperation for complex projects under the approved strategic roadmaps for these sectors and submit an Action Taken Report on the same.
Output 3: Enhanced access to finance and improved business environment.		
Improve access to finance for the private sector by intervening through the banking system	13. Government approves an Action Plan for facilitating effective business environment in Azerbaijan including setting up of a Credit Guarantee Fund for SMEs to facilitate credit access with reduced collateral requirements defining the supervisory framework for the fund to make it compliant with corporate governance requirements.	17. Government undertakes amendments to the laws related to (i) encumbrance of movable properties, (ii) Insolvency and Bankruptcy law, and (iii) Mortgage law as required under the Action Plan.

Policy Objectives	Policy Actions Subprogram 1 (by November 2017)	Policy Actions Subprogram 2 Indicative (by November 2018)
		18. Government submits a report on the number of credit guarantees provided for facilitating access to finance for SMEs.
	14. MOF (i) recapitalizes the Azerbaijan Deposit Insurance Fund (ADIF) and (ii) develops a model for a risk-based pricing methodology to price premiums to be charged from banks.	19. ADIF and the FMSA to establish a risk-based pricing methodology to price premiums (on the basis of FMSA's own prudential ratings).
	15. Government passes the Law of Azerbaijan Republic on Credit Bureaus to establish the legal basis of creation and activities of credit bureaus for improving citizen's access to financial services and credit consumer rights.	20. Government operationalizes the Credit Bureau and submits an Implementation Report on the same.
Improve business environment for private sector	16. Government implements at least one significant reform based on the World Bank's Ease of Doing business framework	21. Government to implement at least two more significant reforms based on the World Bank's Ease of Doing business framework
	17. Government provides budget support to the National Fund for Entrepreneurship Support (NFES) to enable low cost loans for entrepreneurs in agriculture, tourism and service sectors leading to creation of at least 4,745 jobs in the program implementation period.	22. Government (i) submits a report on the utilization of NFES by authorized lending institutions showing an increase in utilization over the past three years i.e. 2015-2017 and (ii) undertakes a performance review of NFES and submits a report on the same.

ADIF = Azerbaijan Deposit Insurance Fund, BOT = built-operate-transfer, CBA = Central Bank of Azerbaijan, CGF = Credit Guarantee Fund, FMSA = Financial Markets Supervision Authority, FSB = Financial Stability Board, IFMIS = Integrated Financial Management and Information System, MLSP = Ministry of Labor and Social Protection of Population, MOE = Ministry of Economy, MOF = Ministry of Finance, MSME = micro, small and medium-sized enterprises, MTEF = medium-term expenditure framework, MTEF = medium-term fiscal framework, NFES = National Fund for Entrepreneurship Support, PDMA = Public Debt Management Agency, PPP = Public-Private Partnership, SME = small and medium-sized enterprises, SOE = state-owned enterprises.