



**EUROPEAN NEIGHBOURHOOD AND PARTNERSHIP
INSTRUMENT**

AZERBAIJAN

**COUNTRY STRATEGY PAPER
2007-2013**

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EXECUTIVE SUMMARY

This Country Strategy Paper (CSP) for Azerbaijan covers the period 2007-2013. Assistance to Azerbaijan over that period will be provided principally under the new European Neighbourhood and Partnership Instrument (ENPI) being established to promote the development of an area of prosperity and good neighbourliness between the European Union and the partner countries covered by the European Neighbourhood Policy (ENP).¹

In recent years Azerbaijan has been slowly (although not always coherently) pursuing an “evolutionary” reform strategy to develop democracy and a market economy in the country and to bring Azerbaijan closer to the EU. However, much remains to be done in the coming years.

The principal objective of cooperation between the EU and Azerbaijan is to develop an increasingly close relationship, going beyond past levels of cooperation to gradual economic integration and deeper political cooperation, principally in the framework of the Partnership and Cooperation Agreement and the more recent European Neighbourhood Policy.

EC assistance over the period covered by this strategy will therefore aim at supporting Azerbaijan’s reform agenda on the basis of the policy objectives defined in the Partnership and Cooperation Agreement (PCA) entered into force in June 1999 and the EU-Azerbaijan ENP Action Plan of 14 November 2006.

The National Indicative Programme (NIP) for 2007-2010 translates this into support for three priority areas:

- 1) Democratic development and good governance
- 2) Socio-economic reform (with emphasis on regulatory approximation with the EU *acquis*), fight against poverty and administrative capacity building
- 3) Support for legislative and economic reforms in the transport, energy and environment sectors.

This new Strategy Paper for Azerbaijan has been developed in close consultation with the Azerbaijani authorities and fully reflects national priorities. Member States, other donors and civil society organisations were consulted during the drafting process.

1. THE OBJECTIVES OF EU/EC COOPERATION WITH AZERBAIJAN

1.1. Overall external policy goals of the EU

¹ Regulation 1638/2006 of 26 October 2006.

The EU promotes its values and interests by operating as a global economic and political player, using various instruments, ranging from the Common Foreign and Security Policy (CFSP), assistance and trade, to the external dimension of the EU's internal policies.

In particular, the EU strives to promote prosperity, solidarity, security and sustainable development worldwide.

The EU's development policy as expressed in the European Consensus for Development is driven by the primary objective of poverty reduction, with the complementary aims of promoting good governance and greater respect for human rights in a bid to ensure the stability and security of the countries in the regional context. At the same time, it emphasises the need for a differentiated approach depending on the context and the particular needs of individual states. These objectives also apply to Azerbaijan, and will help to achieve the Millennium Development Goals.

It is of the utmost importance to the EU to define the right "policy mix". This means that, in the light of the EU's strategic external relations objectives, policy coherence needs to be ensured between all available instruments when dealing with Azerbaijan.

1.2. Strategic objectives of EU/EC cooperation with Azerbaijan

Country-specific, regional and global strategic objectives together shape the EU/EC approach to cooperation with Azerbaijan:

A mutually beneficial partnership promoting Azerbaijan's transition

In the Partnership and Cooperation Agreement (PCA) which entered into force on 1 July 1999 the EU and Azerbaijan committed themselves to establishing a partnership which provides for close political and mutually beneficial trade and investment relations together with economic, social, financial, civil scientific, technological and cultural cooperation. The partnership is intended, in particular, to promote Azerbaijan's transition to a fully fledged democracy and market economy.

Implementing the European Neighbourhood Policy (ENP) and the EU-Azerbaijan ENP Action Plan

The objective of the ENP, launched in the context of the 2004 round of enlargement round, is to share the EU's stability, security and prosperity with neighbouring countries, including Azerbaijan, in a way that is distinct from EU membership. The ENP is designed to prevent the emergence of new dividing lines in Europe by offering neighbouring countries closer political, security, economic and cultural ties. It also addresses one of the European Union's strategic objectives set in the European Security Strategy of December 2003, namely to bolster security in the EU neighbourhood. ENP partners expect to gain closer cooperation with the EU, the chance to participate in EU programmes and achieve deeper economic integration with the EU, lending strong

support to their own political and economic reforms. In the case of Azerbaijan, specific objectives are established in the EU-Azerbaijan ENP Action Plan which was jointly endorsed on 14 November 2006.

Security challenges

In the European Security Strategy of 12 December 2003, the EU acknowledged that, as a Union of 25 states with over 450 million people producing a quarter of the world's gross domestic product (GDP), it is inevitably a global player.

One of the key policy implications of the European Security Strategy is the need for the EU to “promote a ring of well governed countries to the East of the European Union and on the borders of the Mediterranean with whom we can enjoy close and cooperative relations”. In addition to this, the Strategy clearly acknowledges the importance of promoting an international order based on effective multilateralism.

The Strategy also identifies the challenges for the EU to ensure security of energy supply. As an oil and gas producer and transit country, Azerbaijan has a pivotal role to play in this, including by opening up of alternative transportation routes for energy resources from the Caspian and Central Asia to Europe. The EU has both direct trade and political interests in fostering regional cooperation in various sectors including energy and transport.

The EU/EC, finally, also aims at stabilising the whole Southern Caucasus region by supporting the peaceful settlement of the Nagorno-Karabakh conflict between Armenia and Azerbaijan. Should a peace deal be struck and actively implemented within the lifespan of the present CSP, several basic assumptions of the strategy might change quite radically and, consequently, the EC's approach to assistance should be updated.

Development policy objectives

The EU's development policy is driven by the overriding objective of poverty reduction with the complementary aims of promoting good governance and respect for human rights.² At the same time it emphasises the need for a differentiated approach according to contexts and needs.

Azerbaijan used to be classified as a transition country in the OECD Development Assistance Committee's (DAC) list of aid recipients. With a GNI per capita of US\$ 940 (2004, Atlas method)³ and falling into the category of lower-middle income countries it was recently (December 2005) included in the new single list of Official Development Assistance (ODA) recipients.

² The key principles of the EU's development policy are set out in a recent Communication from the Commission to the Council and the European Parliament which will form the basis for a Joint Declaration by the three institutions.

³ Note that PPP-adjusted GNI per capita (Atlas method) is US\$ 6 250 for 2004. Note also that these figures do not include the informal economy, which plays an important role in Azerbaijan.

2. AN OUTLINE OF THE POLICY AGENDA OF AZERBAIJAN

2.1. General aspects

Azerbaijan is pursuing an “evolutionary” reform strategy to develop democracy and a market economy in the country and to bring Azerbaijan closer to the EU. However, much remains to be done in the near term and the country’s efforts to move forward will have to be more sustained and consistent.

The Azerbaijani leadership has clearly stated that it is firmly committed to using the EU-Azerbaijan ENP Action Plan, jointly endorsed by Azerbaijan and the EU on 14 November 2006, as a key tool to promote its reform objectives. On this basis, the current policy objectives of Azerbaijan can be summarised as follows:

2.2. Internal policy

Consolidating democracy, protection of human rights and fundamental freedoms: Azerbaijan has clearly committed itself to strengthening the stability and effectiveness of institutions guaranteeing democracy, protection of human rights, media and fundamental freedoms, as a basis for more general consolidation of the rule of law.

Consolidating the judiciary: The government has declared its intention to carry out further judicial and legal reform in order to guarantee the independence of the judiciary, strengthen its administrative capacity and ensure the impartiality and effectiveness of prosecution.

Promoting balanced economic growth and the fight against poverty: The government places much emphasis on the need to further develop the country’s energy sector and to use part of the expected oil and gas revenues to ensure balanced socio-economic development, supporting the non-oil sector of the economy and the development of regions outside Baku.

Effective fight against crime and corruption: The government has declared the fight against corruption a top priority. The programme calls for a competitive market climate that reduces special privileges and opportunities of state capture by large financial industrial groups.

Public sector reform: The government has declared its intention to promote comprehensive public sector reform, including both administrative reform and the regulatory reforms needed to improve public governance.

Improving the investment climate: Actively addressing the broad range of issues affecting the investment climate with a view to strengthening investors' confidence is a key component of the government's approach to further economic growth.

2.3 Cooperation for the peaceful settlement of the Nagorno-Karabakh conflict

The EC will continue its current strong commitment to supporting a peaceful settlement of the Nagorno-Karabakh conflict.

This involves, amongst other activities, continuing support for civil society and the promotion of democratic values and respect for human rights throughout Azerbaijan.

If the Nagorno-Karabakh conflict is settled within the timeframe of the present CSP, the EC will provide further specific assistance to help consolidate the settlement, including the reconstruction and rehabilitation of conflict areas, the return to conflict areas of Azerbaijani IDPs and refugees and the elimination of the excessive accumulation of conventional weapons such as SALW (small arms and light weapons) and ERW (explosive remnants of war, including landmines).

Under the appropriate financial instrument, the EC could also provide support for confidence-building initiatives in the South Caucasus region.

2.4. External policy

EU approximation: Deepening its relations with the EU is one of the top priorities of the Azerbaijani government; in order to support these efforts, an intergovernmental committee was created last year by Presidential Decree. Azerbaijan intends to pursue its policy of integration with the EU through the implementation of the PCA and the ENP Action Plan. Enhanced energy relations between the EU and Azerbaijan will play an important role in this context.

Cooperation with Russia: Azerbaijan recognises that good bilateral relations with Russia are important, and that Russia is a key neighbour with strong political, economic and social interests in Azerbaijan. Russia also remains an influential player as regards the protracted conflicts in the Southern Caucasus, including the one with Armenia over Nagorno-Karabakh. Energy cooperation with the Russian Federation is and will remain in the near future another important feature in the short term of the relations between the two countries. Finally, it has to be considered that around 2 of the 8 million inhabitants of Azerbaijan live and work in the Russian Federation.

Cooperation with Turkey: Mainly for historical and cultural reasons, Azerbaijan has very close ties with Turkey, the first country to recognise Azerbaijani independence in 1991. In the short and medium term, the state of the relations between Azerbaijan and Turkey will

be shaped by several factors, among them the European aspirations of Turkey and the opening of the Baku-Tbilisi-Ceyhan and the Baku-Tbilisi-Erzurum pipelines.

Cooperation with Iran: The division of the Azeri people between Iran and Azerbaijan has periodically led to tensions between the two countries. Both groups share the same language and are mainly Shiite Muslims. The notion of Azerbaijani reunification, or "one Azerbaijan", which was popular in the 1940s, and re-emerged under Heydar Aliyev's leadership of Soviet Azerbaijan, was raised again after independence by the Popular Front government. This ideology was potent enough to poison Iran-Azerbaijan relations. Iran continues to monitor nationalist sentiment carefully in its Azerbaijan province. Azerbaijan claims to have mastered the issue of import of Islamic fundamentalism from Iran.

Regional role: Good relations with Georgia are equally important for Azerbaijan's access to (mainly oil and gas) international markets. Further deepening and intensification of regional cooperation in the Southern Caucasus is hindered by the conflict in Nagorno-Karabakh. Azerbaijan is clearly committed to playing a constructive role in the wider region, including by cooperating in the framework of GUAM, in the Black Sea Economic Cooperation (BSEC) organisation, the Commonwealth of Independent States (CIS), the OSCE, the Council of Europe and the Organisation of the Islamic Conference (OIC). Azerbaijan is also a member of the United Nations, the International Monetary Fund, the World Bank and the European Bank for Reconstruction and Development.

Promoting trade: Trade policy issues are an important part of the government economic strategy. The peculiar structure of the country's exports (oil products and chemicals account for 94% of Azerbaijan's exports to the EU) make it important and urgent for Azerbaijan to diversify its economy and improve trade-related regulations and administrative practices. In this respect, the slow progress on WTO accession, despite the fact that this is a stated priority for the government, is a source of concern.

NATO accession: Azerbaijan has not begun to negotiate a Membership Action Plan, which would be essential for accession to NATO, but the leadership does have ambitions to join NATO. Azerbaijan joined NATO's Partnership for Peace process in 1994 and is determined to further its cooperation with the Alliance through implementation of the Prague initiatives (Partnership Action Plan against Terrorism and Individual Partnership Action Plan) and to contribute further to security and stability in the whole Euro-Atlantic area.

3. THE POLITICAL, ECONOMIC AND SOCIAL SITUATION⁴

3.1 Analysis of the political situation

General aspects

⁴ See Annex 3 for a detailed description of the environmental situation in Azerbaijan (Country Environment Profile).

Azerbaijan's political and security situation is heavily influenced by its geographic position, squeezed as it is between the Russian Federation and Iran, the availability of sizeable energy resources and the protracted conflict with Armenia over Nagorno-Karabakh.

Much of Azerbaijan's future overall progress will depend on the successful peaceful settlement of this protracted conflict, which has so far held back Azerbaijan's internal development in the social, institutional, political and economic sectors, and limited the country's involvement in regional cooperation activities.

Internal situation

The last parliamentary elections, held on 6 November 2005, remarkably consolidated President Ilham Aliyev's grip on power. The elections were harshly criticised by most international observers (including OSCE/ODIHR, Council of Europe, European Parliament and Nato Parliamentary Assembly), who indicated that, despite some improvements compared to the past, a number of steps still have to be taken to fulfil Azerbaijan's international commitments to political and institutional reforms.

Even before the elections, the purges which took place in October 2005, while allegedly aimed at addressing the severe problem of corruption in governmental circles, had further reinforced President Aliyev's control over the State administration; it is difficult to see how he can fail to be re-elected in the 2008 Presidential elections, also given the fact that the opposition has so far failed to present itself as a credible alternative and remains weak and fragmented.

The reform process in the political and institutional sphere has been proceeding very slowly and not always in a coherent way; the distribution of powers is still heavily biased towards the President of the Republic and neither the Parliament nor the judiciary appear to be sufficiently strong to counterbalance the predominance of the executive power. This institutional system appears well suited to a country which, since its independence, has always had mild authoritarian regimes based on a complex mix of political allegiance, clan solidarity and economic interests. Further progress towards democratisation of the country and an improved protection of human rights, fundamental freedoms (including freedom of assembly) and independent media, including printed press, radio, television and the Internet, as well as the further growth of civil society, appear absolutely indispensable to ensure a truly pluralistic and democratic development of the country. To this end Azerbaijan will have, in parallel with the implementation of the PCA and the ENP Action Plan, to pursue its cooperation with international organisations such as the Council of Europe and the OSCE to fulfil the international obligations it subscribed to when joining these bodies.

The Azerbaijani government, State institutions and political parties will soon have to face the challenge of managing the expected huge inflow of revenues from oil and gas production and transit to the benefit of the overall modernisation of the country. A major overhaul of the public administration, stepping up the fight against corruption and

placing an increased emphasis on the transparent and accountable management of these financial resources will be key to ensuring the sustained and sustainable development of Azerbaijan.

Justice, Security and Freedom affairs will also require special attention. The situation of refugees and internally displaced persons (IDPs) remains problematic. According to the UNHCR, there are around 1 million refugees and IDPs in the South Caucasus region (some 580,000 IDPs in Azerbaijan alone). Azerbaijan shares borders with seven countries, with a total length of 3371 km, including 713 km of sea border. The modernisation of the State Border Service is an urgent priority aimed to countering drug smuggling, trafficking in human beings and illegal migration, principally from Afghanistan, Iran, Iraq and Pakistan.

Azerbaijan is the only Muslim republic in the former Soviet Union where the Shiite branch of Islam is dominant. The Shiites form a majority in the southern oblasts bordering Iran, in central Azerbaijan and in Baku. Sunnis predominate in northern and western Azerbaijan. Another interesting feature of Azerbaijan is that the Caucasus Spiritual Board of Muslims, headed by Sheikh Ul' Islam Pashe-zade, exerts an influence on both Shiites and Sunnis. Traditionally, the head of this spiritual board is a Shiite and his deputy a Sunni. Interestingly, unlike in most Muslim countries, Shiites and Sunnis often worship in the same mosque. Azerbaijan has managed so far to keep at bay Islamic fundamentalism, principally thanks to the traditional secular orientation of the State (following the Turkish "Atatürk" model and drawing on the Soviet legacy). Should the Azerbaijani ruling class not manage to implement the necessary socio-economic reforms, in particular those aimed at fighting the still widespread poverty, Islamic radicalism could become a more concrete danger, but only in a medium to long-term perspective.

External situation

Since independence, Azerbaijani foreign policy has followed a "multi-vector" and balanced approach in its relations with the EU, Turkey, Iran and other Caspian Sea neighbours, the Russian Federation and the US.

The Azerbaijani foreign policy agenda is dominated by the ongoing conflict with Armenia over Nagorno-Karabakh. A breakthrough was expected at the last meetings between President Aliyev and his Armenian counterpart Kocharian, which took place in Rambouillet, near Paris, in February and in Bucharest at the beginning of June 2006. No deal was struck on those occasions and this triggered some disappointment in the international community, which felt that both countries should have made more of an election-free year. However, the talks between the two sides continue, at different levels.

The **Russian Federation** plays a major role in Azeri foreign policy and, more broadly, in the Southern Caucasus, including in the regional disputes such as the demarcation of the Caspian Sea and the Nagorno-Karabakh conflict. Moreover, about a quarter of Azeri nationals work and live in Russia and Russian gas is still needed *inter alia* for heating and

domestic consumption. Continuing a solid tradition of good relations with Russia is therefore an imperative of Azerbaijan's foreign policy.

Azerbaijan has also developed strong relations with the **United States**. The recent visit of President Ilham Aliyev to the US (end of April 2006) can be seen as confirmation of the increasing importance Azerbaijan has for Washington as a strategic ally in the region, both as an energy producer (or transit country) and for its proximity to Iran.

Relations between Azerbaijan and the **European Union** and its Member States are also an important part of Azerbaijani external relations, due to Baku's explicit intention to pursue a policy of "*further integration into Euro-Atlantic structures*". The inclusion of Azerbaijan in the EU Neighbourhood Policy (June 2004) was enthusiastically greeted by the Azerbaijanis as a first acknowledgment of the progress made by the country since its independence.

Good neighbourly relations continue to mark Azerbaijan's interaction with **Georgia**, whose territory has become increasingly important to Baku for the delivery of oil – and gas in the near future – to Western markets, and the same applies to **Turkey**. In this case, however, hydrocarbons transit is to be considered in the wider framework of traditionally good relations, developed on the basis of common "Turkic brotherhood".

It will also be important to monitor the energy-driven developments in the coming years of Azerbaijan's relations with neighbours such as **Kazakhstan** (and, maybe in a more distant perspective, **Turkmenistan**), which could take up Baku's offer of using its infrastructure for oil and gas delivery to Europe and the US.

Finally, the Azerbaijani government is trying to maintain good relations with **Iran**, in spite of the periodic tensions triggered by the Teheran leadership on the world scene. The presence of several million ethnic Azeris in Iran, the recurring fears of Islamic fundamentalist infiltrations from the south, cooperation on energy and the need for Iranian support in the Nagorno-Karabakh conflict make it essential for Azerbaijan to seek a pragmatic *modus vivendi* with Iran. This is a strategy likely to be further pursued in Azerbaijani foreign policy under the current circumstances.

Prospects

The expected economic boost due to hydrocarbons production and transit, plus the possible settlement of the conflict with Armenia over Nagorno-Karabakh, can provide Azerbaijan with a unique opportunity to address its present problems and lay the foundations for its successful development in a wide range of sectors in the coming years. Achieving this objective will require hard work, consensus-building and sustained implementation of reforms, with the assistance of the EU and other donors, as appropriate.

3.2 Analysis of the economic situation and trade structure

The Azerbaijani economy declined dramatically after independence, as the country's GDP contracted by almost 60 percent from 1990 to 1995. Economic output began to recover in the mid-1990s, principally thanks to the renewed interest of foreign companies in the exploitation of its gas and oil reserves and the subsequent signing of several production-sharing agreements (PSAs). Oil production under the first of these PSAs, with the Azerbaijan International Operating Company, began in November 1997, triggering an overall economic recovery which, however, has so far been slowed down by, among other things, the lack of radical reforms, the backwardness of the State administration and widespread corruption.

Principally due to the positive impact of oil and gas on the domestic economy, Azerbaijani GDP has shown very high growth rates in recent years: around 10% on an annual basis in the period 2000-2004, 24% in 2005 and even more is estimated for 2006. The oil and gas sector, accounting for about 42% of GDP, has been the key contributor to the acceleration lasting recent years. At the same time the ratio of public debt to GDP has been brought down, from 20.1% in 2002-03 to around 17% in 2004. Per capita GDP (in current USD) should reach 1 902 USD in 2006 (IMF estimate) compared to just 759 USD in 2002. Finally, when considering the situation of the Azerbaijani economy, mention should also be made of the important role played by immigrants' remittances. As mentioned in § 2.4, it is estimated that some 2 million Azerbaijani citizens reside and work abroad, mainly in the Russian Federation.

The macroeconomic outlook of Azerbaijan appears undoubtedly positive, at least in the short and medium term. The main challenge for the Azerbaijani government will be to make this trend sustainable, in particular by means of economic diversification through the development of the non-oil sector and the improvement of socio-economic conditions in the poorest regions of the country. Tackling these problems successfully will make a decisive contribution towards poverty eradication (some 40 percent of the population still lives below the official poverty line⁵); the government will have to speed up its social and economic reforms, as it is estimated that oil extraction could start decreasing in 2010 and dry up (or return to modest production levels) by 2025. This could be partially compensated by exploiting Azerbaijan's geographic location and infrastructure for oil and gas transit, particularly from Central Asia towards Western markets, but, in that case too, sizeable investments, political commitment and reforms will be required if Azerbaijan's economic growth path is to be sustainable. A positive step towards Azerbaijan's effective and transparent management of hydrocarbon resources has been the country's participation in the Extractive Industry Transparency Initiative (EITI)⁶.

⁵ In the first State Programme for Poverty Reduction and Economic Development (SPPRED) the absolute poverty line is set at 120 000 (old) Azerbaijani Manat per person per month, equivalent to some 26 USD or 20.27 EUR at current exchange rates.

⁶ The Extractive Industry Transparency Initiative was announced by UK Prime Minister Tony Blair at the World Summit on Sustainable Development in Johannesburg, September 2002. Its aim is to increase

Azerbaijan has been the first country to report on EITI implementation and an important player in encouraging other countries to take part in the process.

Another challenge to be addressed by Azerbaijan is the severe environmental damage inherited from Soviet times, when the country was a focal point of the chemical and extractive industry in the whole Federation. The Absheron Peninsula, where Baku lies, is often seen as one of the most polluted zones in the world; deforestation, erosion of agricultural lands, pollution of the Caspian Sea and inland waters, and poor waste management are the most prominent environmental threats, to be tackled as a matter of urgency.

The investment climate, particularly in the non-oil sector, still has to be improved, being governed as it is by unclear laws and regulations and uneven or arbitrary enforcement. Principally due to capital inflows in the hydrocarbons sector, foreign direct investment (FDI) in Azerbaijan is estimated at some US\$ 433 per capita, compared with typical estimates in the range of US\$ 2000-4000 per capita in the new Central European EU Member States.

The enlarged EU remains Azerbaijan's most important commercial partner, accounting for 46.2% of its external trade in 2004. However, Azerbaijan's trade structure is unbalanced. Hydrocarbons and chemical products account for around 94% of Azerbaijani exports to the EU, while the share of other products remains practically negligible. Export diversification is crucial if exports are to become a reliable source of future economic growth in Azerbaijan. It would also protect the Azerbaijani economy better against external shocks resulting from movements on international energy markets.

As at mid-2006, Azerbaijan is still in the process of WTO accession, which is still likely to take some time. The Azerbaijani government should pursue WTO accession more vigorously.

3.3 Analysis of social developments

Azerbaijan is ranked 101st in the 2005 Human Development Report, with a Human Development Index (HDI) of 0.729. It is in the *Medium Human Development* category, last among the countries of Eastern European and the South Caucasus.

Azerbaijan has made some progress in reducing income poverty, but the problem still remains. Poverty incidence dropped from 46.7% in 2002 to 44.7% in 2003, and analysis

transparency over payments by companies to governments and government-linked entities, as well as transparency over revenues by those host country governments. This will help to ensure that natural resources and the wealth they generate are governed well. EITI is supported by a strong and varied coalition from industry, governments, donors, international financial institutions, institutional investors and NGOs. Nigeria, Azerbaijan and Ghana are the first three countries to have adopted the EITI principles and actions. 22 countries are committed to implementing the initiative.

of the data concerning 2004 and 2005 seem to suggest that the decline continued in those years. However, despite this relative improvement, the overall percentage of Azerbaijani population living in poverty is still above 40%. These data indicate that, despite the steady two-digit growth of the Azerbaijani GDP in recent years, poverty is not decreasing as speedily as might be expected, pointing to increasing inequalities among the Azerbaijani population. In addition to this, there is significant income disparity among regions. The income level in Baku is 30 percent higher than in the region of Nakhichevan, which has the lowest income, even though in the capital city has the highest percentage of persons living in extreme poverty, which probably reflects the difficulty of absorbing internal migrations.

The slow reduction of poverty is matched by equally slow growth in official employment: according to the State Statistical Committee, employed persons numbered 3 613 000 in 1995 and 3 764 200 in 2004, an increase of 151 200, compared to an overall population growth of some 600,000 over the same period. As a result, the employment-to-population ratio in Azerbaijan was only 48% in 2004, even lower than in “transition economies” (53.5% in 2003). However, only 1.46% of the economically active population of Azerbaijan was officially unemployed in 2004; the sizeable informal economy can help to explain the wide gap between the relatively small number of officially employed labourers and the almost negligible figure concerning official unemployment. Lastly, the labour market too reflects the imbalance between the oil and non-oil sectors of the economy: only 2% of the officially employed workforce is employed in the oil sector. This last point is possibly the most important one: the low labour intensity of the energy sector, especially once the investment phase is over, is rather problematic in socio-economic terms. In the absence of a diversified economy which could absorb surplus labour capacity, huge transfers and social benefits will have to be built into the social safety net, in order to stop the poverty gap from widening on the one hand, and to keep domestic consumer demand at acceptable levels on the other.

A National Employment Strategy for 2006-2013 was signed by the President in October 2005 and includes a National Action Plan on Employment (NAPE), developed in cooperation with ILO and focusing in particular on vocational education and training, development of small and medium-sized enterprises (SMEs) and social protection.

Azerbaijan’s population has been constantly growing since independence, from 7,200,000 in 1991 to 8,350,000 inhabitants in 2005, despite a sharp decline in the birth rate over the same period (26.6 births for 1 000 in 1991, 16.1 in 2004); life expectancy was 69.6 for the male population in 2004 (66.3 in 1991) and 75.2 for females (74.8 in 1991).

Maternal mortality, which was very low in Soviet times (10.5 per 100,000 live births in 1991), reached its peak in the mid-1990s (44.1 in 1996) but is gradually decreasing again (34 in 2004) and remains about seven times the EU average (5/100,000). Access to essential health facilities, particularly for the poorest part of the population, remains a cause for concern.

The country faces a malaria threat, generally of the benign *vivax* form. Sporadic cases have even been reported in the Baku suburbs. Diphtheria occurs predominantly in towns, but increasingly also in rural areas. Shortages of vaccine, antibiotics and diphtheria antitoxins contribute to the spread of this disease. Hepatitis B is considered to be endemic in Azerbaijan, with between 4% and 7% of the population affected. Tuberculosis also constitutes a serious problem. The incidence of communicable diseases is increasing. Nevertheless, as in other Southern Caucasus countries, life expectancy is relatively high. Access to clean drinking water poses a health-related challenge, both in rural areas, especially to persons displaced by the Nagorno-Karabakh conflict, and in the coastal areas of the Caspian Sea, due to pollution linked to oil extraction. HIV/ AIDS is present in Azerbaijan, although not to any alarming degree. Due to its geographical position, on the migratory routes of wild birds, Azerbaijan needs to remain vigilant against possible outbreaks of avian influenza, after the outbreak in February-March 2006 which resulted in some 10 human victims.

While Azerbaijan's soviet-inherited educational system continues to score well on literacy and enrolment indicators with an adult literacy rate of 99% (2004) and a net primary education enrolment rate of 96.8% (2004), those figures conceal increasingly unequal access to education, eroding quality, corruption and low efficiency in the use of resources.

3.4 Analysis of the environmental situation⁷

Azerbaijan faces significant challenges in terms of promoting environmental protection. Key areas include air quality, water quality, waste management, nature protection, coastal and marine pollution and land use (in particular desertification). Furthermore, institutional and administrative capacities require strengthening, in particular as regards implementation and enforcement. Civil society also needs support in order to become a valuable partner for the government in the development and implementation of environmental policy.

4. AN OVERVIEW OF PAST AND ONGOING EC ASSISTANCE

4.1. EC assistance to Azerbaijan 1991-2005

The European Community has provided assistance to Azerbaijan totalling almost €400 million since 1991. This includes assistance under the TACIS programme (including its national and regional components), TACIS Exceptional Assistance Programme (EXAP), food security programme (FSP), post-war rehabilitation activities, support under thematic budget lines such as the European Initiative for Democracy and Human Rights (EIDHR) and humanitarian assistance provided by ECHO.

⁷ A more detailed description of the environmental situation in Azerbaijan can be found in the Country Environment Profile annexed to this CSP (Annex 3)

Under the 2002-2006 **Country Strategy Paper** (CSP) TACIS assistance has focused on two main priority areas: i) support for institutional, legal and administrative reform and ii) support for the private sector and assistance for economic development. During the first four years covered by the CSP (2002-2005) 40.7% of available resources were allocated to the first priority and 36.5% to the second. The remaining 22.8% went to “Small Project Programmes”, including civil society support (IBPP), policy advice, statistics, customs, Managers Training and Tempus programmes. The Tempus programme has provided considerable support to the modernisation and the reform of the higher education system in Azerbaijan. Since 1996, Tempus has funded 14 cooperation projects with EU higher education institutions in the areas of curriculum development, university management and structural reform.

Regional cooperation addressed, in particular, issues relating to closer inter-state cooperation on transport and energy, principally through the TRACECA and INOGATE Programmes. Azerbaijan has played an active part in the work of the High Level Group on the extension of the major trans-European transport corridors to neighbouring countries and regions and also in the EU-Black Sea-Caspian Basin Ministerial Conferences on Transport and Energy in November 2004 in Baku and in the follow-up working groups. Justice and home affairs priorities included further integrating border management, combating organised crime and international terrorism, and improving migration and asylum management.

The EC is also providing support to help Azerbaijan address the problem of Anti-Personnel Landmines (APL). Nearly €3.7 m has been allocated, targeting the **destruction of anti-personnel landmines** and awareness-raising campaigns in Azerbaijan.

The EC also makes an annual contribution to the Science and Technology Centre in Ukraine (STCU) which is an intergovernmental organisation established by a number of donor countries dedicated to the non-proliferation of technologies and expertise relating to weapons of mass destruction. Azerbaijan became the fourth recipient party after Ukraine, Uzbekistan and Georgia when the Governing Board approved its request for accession in December 2002.. Since 1994, the STCU has supported about 945 projects and 13 600 scientists.

4.2. Key lessons learnt for the new programming cycle

The Commission launched an evaluation of the TACIS programme as a whole at the end of 2004.

The main recommendations are as follows:

- Increasing relevance to the context of the partner countries
- Moving to a programme-based approach
- Diversifying the programme approach to improve the response to individual country needs

- Improving the effectiveness and sustainability of sectoral intervention
- Improving project/programme quality assurance tools.

The Commission discussed the report with the member states during the last TACIS meeting in June 2006. A *'fiche contradictories'* has been prepared and will be re-discussed one year hence to see what progress has been made.

A Country Strategy evaluation for Azerbaijan was also finalised in 2003. The main recommendations were integrated into the current 2004-2006 National Indicative Programme but they also remain relevant to this new programming exercise.

The evaluation suggests that overall the **relevance** of the TACIS assistance has been high and it has responded to needs. However, in particular during the first few years, the programme was mainly governed by a “top-down” approach. This was partly a consequence of the need for institution building in the countries in transition and partly due to an insufficient sense of ownership on the part of the national authorities. In the specific case of Azerbaijan this problem seemed less severe than in other TACIS countries. Furthermore, National Indicative Programmes (NIPs) tended to be over-detailed which meant they were not flexible enough at project identification level to respond to evolving needs.

The EC will focus in this new programming exercise on defining strategic priorities and objectives rather than specific activities or delivery mechanisms. National authorities are being involved in this process from the very beginning and have shown a greater level of commitment and ownership as a result of the clearer political framework provided by the ENP. The EU-Azerbaijan Action Plan adopted on 14 November 2006 goes along these lines.

According to the ongoing programme evaluation the TACIS programme features a large number of “**stand-alone” technical assistance projects**, in particular on institutional and administrative reform. These often achieve good results at project level⁸ but have **limited impact at sector and national policy level** due to a lack of continuity and coherent long-term sector planning. A similar conclusion was reached in the 2003 country strategy evaluation and also seems to be emerging from the ongoing thematic evaluation on good governance, where Azerbaijan is one of the countries being analysed in more detail.

In terms of the key priority areas covered by previous TACIS assistance to Azerbaijan the evaluators single out JHA-related projects as being well-coordinated and monitored by the JHA scoreboard system. By contrast, problems are being observed with the impact of projects and sustainability of results in the health sector, mainly due to delays in the implementation of pilot projects and questionable political commitment in this specific area. In the case of economic development the Commission has been most successful when addressing issues relating to an enabling regulatory environment for business and

⁸ This is confirmed by a detailed analysis of project monitoring reports for Azerbaijan over the period 2002-2005 which shows – on a scale of four (A-D) - an overall rating of 2.8 which is well above the median point of 2.5.

investment. This assessment is also confirmed by a recent (October 2005) Evaluation of EC support to Private Sector Development in Third Countries which concluded that "...the EC has a higher comparative advantage in macro- and institutional interventions and a lower one in interventions in financial markets"..

The above sector-specific findings are taken fully into account in defining future priority areas for EC assistance to Azerbaijan. Issues relating to JHA and regulatory reform are at the forefront of the EU-Azerbaijan Action Plan and will remain key areas for EC support in the future. In the areas of good governance and legal and administrative reform future assistance will build on the substantial work carried out to date but aim to increase the impact by making future assistance more integrated and coherent.

4.3. Complementarity and coordination with other donors

Although some donors, including some EU Member States, are scaling down their activities in Azerbaijan, a large number of donor organisations are still active in the country.

The principal ones, in addition to the EC, are the World Bank, EBRD and UNDP, the USA and Canada, and, among EU countries, Germany, Sweden and the United Kingdom.

Donors' activities are focusing in particular on issues relating to governance, economic reform and development, and social reform and protection. In particular, the World Bank and EBRD are also active in the field of infrastructure development.⁹

The EC is currently active, to varying degrees, in all the abovementioned areas. The continued (and increased) level of financial assistance to Azerbaijan is mainly justified by the country's inclusion in the European Neighbourhood Policy, and the need to help implement the ambitious EU-Azerbaijan ENP Action Plan throughout its duration. Under this new strategy EC assistance will continue to focus strongly on governance-related issues and the regulatory aspects of economic reform. Support for infrastructure development in close collaboration with the EIB, EBRD and other IFIs will be further increased. In the area of social reform the EC will focus on structural changes in social sectors and their approximation with EU standards. As a major contributor to the Global Fund to fight AIDS, Tuberculosis and Malaria the EC will continue to support the fight against HIV/AIDS in Azerbaijan.

While formal government-led donor coordination is weak in Azerbaijan, mainly due to limited national capacity, the Commission attends regular coordination meetings with other donors, including on this future strategy. In addition, frequent informal contacts are maintained, mostly on sector-specific issues.

Such coordination efforts need to be further intensified over the period covered by this strategy as the EC – *inter alia* in the context of the commitments made in Paris in March

⁹ See Annex 4 for a more detailed analysis of donors' activities.

2005 on Aid Effectiveness and Harmonisation - will increasingly aim to provide assistance on the basis of sector-wide programme support, including pool funding and budgetary support as appropriate.

The added value of EC assistance stems clearly from: (1) the level and ambition of the political objectives to be achieved through EC funding, as enshrined in the Partnership and Cooperation Agreement and in the ENP Action Plan; (2) the possibility of the EC operating in several sectors at the same time (unlike most other donors), with beneficial cross-fertilisation between economic, social and political initiatives supported by the EC; (3) the experience accumulated by the EC in Azerbaijan since the country's independence.

4.4. Consistency of EC cooperation policy with other core policies of the EU (“policy mix”)

Relations with Azerbaijan are affected by a number of other Community policies, which is why it is so important to choose the right “policy mix”. This concerns, in particular, Common Foreign and Security Policy (CFSP), border management and migration, trade, energy, transport and transboundary environmental threats. Education, vocational training and information and communication technology issues are also highly relevant.

5. THE EC RESPONSE STRATEGY

5.1. Principal objective

The principal objective of cooperation between the EU and Azerbaijan at this stage is to develop an increasingly close relationship, going beyond past levels of economic and political cooperation and including cooperation on energy, foreign and security policy.

EC assistance over the period covered by this strategy will therefore aim to support Azerbaijan's ambitious reform agenda (as outlined in the PCA and the ENP Action Plan) to root democracy and the market economy firmly in the country, and to ensure that Azerbaijan manages its oil and gas revenues efficiently and transparently to the benefit of the whole country. EC assistance will also aim to further enhance EU-Azerbaijan cooperation in specific sectors, such as energy and transport. In all these sectors, the EU has the leverage necessary to make a tangible contribution to the reform process.

Gender will be mainstreamed as far as possible, as a cross-cutting issue, into the design of programmes relating to all the key issues mentioned in this document.

5.2. EC assistance priorities

EC assistance priorities have been identified primarily on the basis of the policy objectives defined in the jointly agreed EU-Azerbaijan ENP Action Plan (the ten

priorities in the first part of the document)¹⁰ but, for the purposes of this Strategy Paper, these are presented under the chapter headings of the Action Plan.¹¹

These assistance priorities apply to all assistance instruments and programmes which will or might be available for Azerbaijan.

Political dialogue and reform

EC assistance in this area will focus on strengthening democracy and good governance, the rule of law, human rights and fundamental freedoms, including freedom of press and assembly. This also covers fighting against crime and corruption and fostering the development of civil society, including in the social and economic sphere.

In terms of enhanced cooperation on foreign and security policy, particular attention will be paid to issues relating to WMD non-proliferation and disarmament, including conventional disarmament and landmines, and to conflict prevention and crisis management with a particular focus on Azerbaijan's role in settling the protracted conflict with Armenia over Nagorno-Karabakh.

Economic and social reform, poverty reduction and sustainable development

Assistance will be offered to enable further progress on the establishment of a fully functioning and balanced market economy and to ensure that oil and gas revenues are managed in an accountable and transparent way; this will include support for diversification of the economy, and will be to the benefit of the whole country. Adequate support should be also given to making further progress on the gradual approximation of laws and regulations with those of the EU and effective implementation thereof and also improving the investment climate (especially in the non-oil sector) by ensuring transparency, predictability and simplification of procedures. Furthermore, assistance will be provided with the aim of consolidating social reform and response to infectious and other health threats, fighting against corruption and encouraging approximation with EU

¹⁰ These are: 1) Contribute to a peaceful solution of the Nagorno-Karabakh conflict, 2) Strengthen democracy in the country, including through fair and transparent electoral process, in line with international requirements, 3) Strengthen the protection of human rights and of fundamental freedoms and the rule of law, in compliance with international commitments of Azerbaijan (PCA, CoE, OSCE, UN), 4) Improve the business and investment climate, particularly by strengthening the fight against corruption, 5) Improve functioning of customs, 6) Support balanced and sustained economic development, with a particular focus on diversification of economic activities, development of rural areas, poverty reduction and social/territorial cohesion; promote sustainable development including the protection of the environment, 7) Further convergence of economic legislation and administrative practices, 8) Strengthening EU-Azerbaijan energy and transport cooperation, in order to achieve the objectives of the November 2004 Baku Ministerial Conferences, in particular with a view to developing regional transport networks and energy markets in the region and integrating them with EU networks and markets, 9) Enhancement of cooperation in the field of Justice, Freedom and Security, including in the field of border management and 10) Strengthen regional cooperation.

¹¹ The ENP Action Plan is the most recent document setting specific EU-Azerbaijan policy objectives. Although it comes to an end in 2011, the priority areas for action defined therein will determine the assistance priorities beyond that date.

social standards, thus contributing to poverty reduction and improving the situation of legal employment in Azerbaijan, including through education and vocational training. Reducing regional imbalances and improving local development capacities are further important issues in this respect as is the promotion of sustainable development and mainstreaming it into all the relevant sectoral policies.

Trade-related issues, market and regulatory reform

EC assistance will be offered to support the process of market and regulatory reform, as envisaged in the PCA and the ENP Action Plan, and in particular to help Azerbaijan with its WTO accession process. The priorities mentioned in this section also reflect the recommendations made by the World Bank in its 2003 "Integrated non-oil trade and investment strategy" for Azerbaijan.

EC assistance will provide support for regulatory approximation in a broad range of areas including:

- Customs legislation and procedures, to make them compatible with international and EU standards, in particular with a view to facilitating trade with the EU, and to meet the World Customs Organisation's standards on security of the international trade supply chain;
- Technical regulations, standards and conformity assessment, sanitary and phyto-sanitary issues (SPS);
- Right of establishment and company law, financial services and markets;
- Strengthening of the overall administrative capacity of the tax administration and reform of the tax system in compliance with general EU and international principles in order to improve revenue collection;
- Competition;
- Consumer protection policy;
- Development of the legislative and administrative framework for SMEs;
- Intellectual and industrial property rights;
- Public procurement;
- Statistics.

At the same time, support will be given to administrative capacity building in all the above-mentioned areas, notably - in addition to tax authorities - to the trade and economic ministries and customs authorities.

Cooperation in the field of Justice, Freedom and Security

The ENP Action Plan with Azerbaijan defines the broad areas of cooperation in the field of justice, freedom and security (JLS). In this context EC assistance will focus on: i) migration and asylum, ii) border management, including document security/biometrics and visas, iii) organised crime and terrorism and iv) the judiciary and the rule of law. EC assistance should promote institutional reform and capacity building, such as support for fundamental overhaul of the judicial system, measures to bring the border guard service

and the asylum system fully into line with European standards and stepping up the fight against the widespread corruption and money laundering.

Energy, transport, environment, information society and media

Strengthening the administrative capacity to formulate and implement of sectoral strategies and policies converging with the relevant EU policies and legislation is a general priority in the energy, transport, information society and environment sectors.

In the energy sector, support will go towards implementing the necessary economic and legislative domestic reforms designed to rationalise the Azerbaijani energy market and integrate the country into EU energy markets, including in the context of the EU-Azerbaijan Memorandum of Understanding on the establishment of an Energy Partnership signed on 7 November 2006. EC assistance will also pursue the objective of strengthening regional cooperation on energy, including as part of the so-called Baku Process. Finally, due attention will have to be paid to improving energy efficiency and energy savings, adopting measures to tackle climate change and promoting new or renewable energy sources.

In transport, assistance will focus on improving the efficiency, security and safety of transport operations and on developing intermodality in the areas identified as priorities within the framework of the Baku Working Groups and adopted during the Ministerial Transport Conference of May 2006 in Sofia.¹² This concerns road, aviation and maritime navigation safety plus maritime and aviation security, where training measures should also be envisaged. Another area for assistance should be the rail sector where steps should be taken towards ensuring interoperability between the Azerbaijani railway system and the EU network. In road transport, taking into account that the country is a contracting party to AETR, support should be given for the implementation of the digital tachograph. Preparations for investment in selected major trans-national axes retained under the High level Group report, notably the TRACECA corridor, and further assessment of infrastructure projects are also to receive support. This support for infrastructure development will be subject to full compliance with the relevant requirements of the EU *acquis* and will have to be closely coordinated with the activities undertaken by other international donors and with the project funded by the Tacis regional programme.

As regards the environment, support will focus on implementing multilateral environmental agreements, in particular the UN Framework Convention on Climate Change and its Kyoto Protocol and UN-ECE conventions. Activities to improve water quality, such as through the relevant component of the EU Water Initiative, are also envisaged. Further priority areas are nature protection (in particular the fight against deforestation) and waste management. Prevention of industrial risks, together with

¹² This is in line with the recommendations of the High Level Group on the extension of the trans-European transport networks towards neighbouring countries and regions and in accordance with the priorities identified within the framework of the follow-up Working Groups to the Baku Ministerial Transport Conference of November 2004.

remediation of environmental damage linked to oil and gas extraction and the cleaning up of areas affected by hydrocarbons or chemical pollution, should also be considered among the more pressing priorities.

As far as the information society is concerned support will be provided not only for the abovementioned policymaking, capacity-building and regulatory aspects including for the establishment of a regulator but also to promote the use of new information society technologies and online services by businesses, the administration and citizens.

People-to-people contacts

Assistance in reforming and upgrading the education system with a view to working towards convergence with EU standards and practices, as well as support for youth exchanges and cooperation, will be essential to underpin democratic development, social stability and economic competitiveness. This will include reinforced participation in programmes such as Tempus and Youth in Action, greater opportunities for Azerbaijani nationals to participate in exchange programmes such as Erasmus Mundus, and investigating the possibilities for cooperation within EU programmes in the field of culture.

The further development of people-to-people contacts at the regional level will feature prominently among EC assistance priorities in this sector, being an important means of triggering confidence building, and thus contributing to the peaceful settlement of protracted conflicts in the region.

Support for scientific and technological cooperation will also be important in terms of contributing to the sustainable and equitable economic development of Azerbaijan, including through fuller participation in research-related activities such as the 7th Framework Programme, joint research projects, the Marie Curie international mobility scheme for scientists and practical training at the seven institutes of DG Joint Research Centre (DG JRC).

5.3. Instruments and means

From 2007 on, EC assistance will be provided through a set of new instruments. While the European Neighbourhood and Partnership Instrument (ENPI), including not only its national but also its transnational/regional, cross-border and thematic components, will be the principal new tool for providing assistance to Azerbaijan, certain measures, in particular in the area of conflict prevention and crisis management and resolution, may also be supported under the future Stability Instrument.

The introduction of these new external assistance instruments will substantially increase flexibility. Technical assistance will no longer be the predominant channel for the Commission's external assistance programmes for Azerbaijan.

As indicated in the ENP Action Plan, new cooperation tools like Twinning or TAIEX will play an essential role in achieving the priority objectives set out in the Action Plan. These instruments, together with other types of assistance (infrastructure and equipment funding, pool funding and budgetary support - including in the context of sector-wide approaches (SWAPs)) will be available and used whenever appropriate.

Twinning and TAIEX are already expected to be phased in under the current Tacis programmes for Azerbaijan, in particular to help the national authorities to prepare coherent sectoral strategies. As appropriate, Azerbaijan will receive support for participation in Community programmes, agencies and networks, insofar as these are open to the country. The clearer framework provided by the ENP Action Plan will help to ensure the consistency of EC assistance within specific sectors.

Interest rate subsidies and other ways of blending grants and loans can leverage investments by international financial institutions in the fields of environment, energy and transport. Whenever interest rate subsidies are considered, their relevance shall be assessed on a case-by-case basis and care should be taken to avoid significant market distortions. As regards environment, relevant sectors include water management, waste management and industrial pollution. For energy, possible areas include renewable energy resources and energy efficiency. Energy infrastructure/network investments should in principle be commercial operations given their financial return. In exceptional circumstances, though, where specific EU interests are involved (notably, energy security of supply) and it appears difficult to get a project started, targeted interest rate subsidies or other ways of combining grants and loans might also be considered for particular investment projects. Regarding transport, interest rate subsidies or other blending schemes would focus on catalysing funds for critical infrastructures of strategic importance, such as cross-border measures on the priority axes or the missing links necessary for their completion.

Support for investments in transport and energy infrastructure and in environment will be provided primarily through EIB lending, conditional upon the extension of the Bank's mandate to the South Caucasus region.

As appropriate, Azerbaijan will receive support for participation in Community programmes, agencies and networks, insofar as these will be open to the country. The clearer framework provided by the ENP Action Plan will contribute to ensuring the consistency of EU assistance within specific sectors.

ENPI national allocation for Azerbaijan

Assistance provided under the national ENPI envelope for Azerbaijan will focus on the following three priority areas which have been selected on the basis of joint EU-Azerbaijan policy objectives and the EC's comparative advantage as a donor and lessons learnt from previous assistance and complementarity with other donors. Depending on developments regarding the peaceful settlement of the conflict over Nagorno-Karabakh, the EC will provide specific assistance related to all aspects of conflict settlement and settlement consolidation.

Priority Area 1: Support for Democratic Development and Good Governance

Sub-priority 1: Public administration reform and public finance management, including public internal control and external audit

Sub-priority 2: Rule of law and judicial reform

Sub-priority 3: Human rights, civil society development and local government

Sub-priority 4: Education, science and people-to-people contacts/exchanges

Priority Area 2: Support for socio-economic reform (with emphasis on regulatory approximation with the EU acquis), fight against poverty and administrative capacity building

Sub-priority 1: Promoting mutual trade, improving the investment climate and strengthening social reform

Sub-priority 2: Supporting the implementation of the SPPRED/SPRSSD, of the State Programme for Regional Development and of government plans for the non-oil sector (strengthened competitiveness and diversification of the economy).

Sub-priority 3: Sector-specific regulatory aspects, including public accounting

Priority Area 3: Support for legislative and economic reforms in the transport, energy and environment sectors.

Sub-priority 1: Energy, including reforms of the domestic legislative framework and markets

Sub-priority 2: Transport, including reforms of the domestic legislative framework and markets

Sub-priority 3: Environment

ENPI Eastern transnational/regional programme¹³

The regional ENPI component will help to achieve the objectives outlined in this strategy by addressing a limited number of priorities relevant to Azerbaijan but with a genuine regional dimension in terms of both joint implementation and impact.

¹³ Details are given in a separate Regional Strategy Paper/Regional Indicative Programme.

At sectoral level, this relates in particular to **transport** (development of trans-national transport links in line with the recommendations of the High Level Group, the Transport Ministerial Conference in Baku of 14 November 2004, the recommendations of the Baku working groups adopted during the last Baku Transport Ministerial Conference and the TRACECA Strategy adopted during the TRACECA Ministerial Conference in May 2006 in Sofia), **energy** (covering, in the context of the follow-up to the Energy Ministerial Conference in Baku on 13 November 2004, all regional aspects in this domain, in particular in relation to harmonising energy markets, the supply and transit of oil and gas, electricity, energy efficiency, energy savings and renewables and facilitating investment in energy projects of common interest) and the **environment** (targeting *inter alia* the regional dimension of the EECCA component of the EU Water Initiative and regional aspects of protection and sustainable management of forests, regional cooperation concerning regional seas, and compliance with multilateral agreements).

Beyond that, certain aspects of **border and migration management, the fight against trans-national organised crime and customs** can also be addressed more effectively at regional level where action at regional level completes action taken at national level. This could include action on customs and border management, the fight against transnational organised crime and migration and asylum management. Finally, there will be scope for regional activities regarding **SME cooperation** and **civil society cooperation**.

ENPI Inter-Regional Programme¹⁴

The ENPI Inter-Regional programme will include activities that for reasons of coherence, visibility and administrative efficiency are best implemented in the same way for all neighbouring countries. Examples are TAIEX, TEMPUS and the new Scholarship Programme.

ENPI cross-border cooperation (CBC)/Neighbourhood and Partnership Programmes (NPPs)¹⁵

As outlined in previous Communications,¹⁶ four overarching objectives will be addressed through these programmes: **i)** promoting economic and social development in the border areas, **ii)** working together to address common challenges in fields such as the environment, public health and the prevention of and fight against organised crime, **iii)** ensuring efficient and secure borders and **iv)** promoting local “people-to-people” type action.

The specific objectives and issues to be addressed in each programme will be set from a local perspective, by the NPP partners themselves to reflect their local priorities.

¹⁴ Details are given in a separate strategy paper for the Inter Regional Programme.

¹⁵ Details are given in a separate CBC Strategy Paper/Indicative Programme.

¹⁶ See in particular COM(2003) 393 final of 1 July 2003 (“Paving the way for a New Neighbourhood Instrument”).

NPPs will be based on two types of programmes: bilateral programmes (typically involving two countries sharing a border) and multilateral programmes (e.g. for the Black Sea).

The programmes will support the full range of projects, from small-scale local initiatives with local administrations and NGOs/civil society organisations to large-scale projects involving a large number of partners at regional and sub-national level.

Azerbaijan will be involved in the CBC Black Sea Basin Programme.

ENPI thematic programmes¹⁷

A total of five thematic programmes will be available under the new instruments: Migration and Asylum, Food Security, Investing in people, Local actors in Development, Environment and Sustainable Management of Natural resources including Energy. Out of these, the thematic programmes on “Migration and Asylum” (ex-Aeneas) and “Investing in People” are particularly relevant to Azerbaijan, as well as the New Instrument for Democracy and Human Rights. As many of these issues will, however, also be addressed under the national/regional ENPI budgets, additional thematic activities will be launched only if they provide clear added value.

Stability Instrument

The main goal of the Stability Instrument is to provide an effective, timely, flexible and integrated response to crises, emerging crises or continued political instability.

In the case of Azerbaijan this is particularly relevant to the Nagorno-Karabakh conflict, which continues to call into question Azerbaijan’s territorial integrity and challenges its security.

Equally important for Azerbaijan are measures to address the effects on the civilian population of anti-personnel mines, unexploded ordnance or other explosive devices. Such measures may, where appropriate, be targeted under the Stability Instrument and the national and regional budgets of the ENPI.

Future EC contributions to the Science and Technology Centre (STCU) are also expected to be provided under the Stability Instrument.

¹⁷ Financial resources allocated to each thematic programme will be programmed on the basis of a single strategy document. When establishing the policy mix CSPs/RSPs should identify opportunities for adding value to the NIPs/RIPs by using thematic programmes.

List of abbreviations and acronyms

AP	Action Plan (also: ENP Action plan or EU-Moldova ENP Action Plan)
BSEC	Black Sea Economic Cooperation Pact
CBC	Cross-border Cooperation
CEP	Country Environment Profile
CFSP	Common Foreign and Security Policy
CIS	Commonwealth of Independent States
CoE	Council of Europe
EIB	European Investment Bank
EBRD	European Bank for Reconstruction and Development
ECHO	European Commission Humanitarian Aid Office
EIDHR	European Initiative for Democracy and Human Rights
ENP	European Neighbourhood Policy
ENPI	European Neighbourhood and Partnership Instrument
FDI	Foreign Direct Investment
FSP	Food Security Programme
FTA	Free Trade Agreement
GDP	Gross Domestic Product
GNI	Gross National Income
GUAM	Georgia, Ukraine, Azerbaijan and Moldova (regional organisation)
HDI	Human Development Index
IFIs	International Financial Institutions
IMF	International Monetary Fund
JHA	Justice and Home Affairs
JLS	Justice, Liberty and Security
MDG	Millennium Development Goals
MoU	Memorandum of Understanding
NGO	Non-governmental organisation
NPP	Neighbourhood and Partnership Programme
OECD	Organisation for Economic Cooperation and Development
OSCE	Organisation for Security and Cooperation in Europe
PCA	Partnership and Cooperation Agreement
PPP	Purchasing power parity
RIP	Regional Indicative Programme
RSP	Regional Strategy Paper
SME	Small and medium enterprises
SPS	Sanitary and phyto-sanitary issues
STCU	Science and Technology Centre
SWAP	Sector-wide Approach
TAIEX	Technical Assistance Information Exchange Unit
UNECE	United Nations Economic Commission for Europe

UNDP United Nations Development Programme
WMD Weapons of Mass Destruction
WTO World Trade Organisation

Azerbaijan at a glance

Land area 86.6 km ²	Population 8 265 700 (2004)	Population density 95.5 per km ²
Population of biggest city Baku: 1 855 300 (2004) compared to 1 771 000 (1995)		
Annual population change (% per year)		
2000: +0.8	2001: + 0.8	2002: +0.8
		2003: + 0.8
		2004: +1.0

Sources: World Development Indicators
State Statistical Committee of AZERBAIJAN



Economic indicators

	2000	2003	2004
GDP (current US\$) per capita growth (annual %)	5.3 billion	7.3 billion	8.5 billion
GDP growth (annual %) per capita PPP in current international \$	11.1	11.2	10.2
GDP per capita (constant 2000 US\$)	...	10.4	...
GNI per capita, Atlas method, current US\$	610.0	820.0	940.0
GNI Atlas method (current US\$) per capita, PPP (current international \$)	4.9 billion	6.8 billion	7.8 billion
Inflation GDP deflator (annual %) % CPI	12.5	6.0	6.4
Exports of goods and services (% of GDP) in current US\$ (billion)	39.0	42.1	49.7
Imports of goods and services (% of GDP) in current US\$ (billion)	38.4	65.6	74.0
Nominal exchange rate (local currency unit per \$)			
Total debt service (% of exports of goods, services and income) (% of GNI)	5.8	6.6	5.2
Cash surplus/deficit (% GDP)	..	..	..

Source: *World Bank Development Indicators*

Selected social indicators

	2000	2003	2004
Adult literacy rate over 15s (%)	..	..	98.8
Primary school enrolment (% net)	94.3	95.6	96.8
Secondary school enrolment (% net)	75.4	83.7	83.1
Life expectancy at birth	71.8	72.2	72.3
Underweight children <5 (%)	16.8	..	..
<5 mortality rate (per 1 000 live births)	93.0	..	89.8
Maternal mortality rate (per 100 000 live births)	77.0	..	74.6
1-year-olds fully immunised against measles (%)	99.0	98.0	98.0
1-year-olds fully immunised against tuberculosis (%)	..	..	..
Births supervised by trained personnel (%)	84.1	..	..
Households with access to improved water source (%)	..	..	..

Source: World Bank Development Indicators

Azerbaijan - Country Environment Profile

1) State of the environment

The key environmental issues in Azerbaijan relate to air quality, water quality, waste management, nature protection, coastal and marine pollution and land use (in particular desertification).

Air pollution from stationary sources decreased during the 1990s due to reduced industrial production. The oil industry and energy production remain the main contributors to air pollution. Emissions from mobile sources are increasing due to growth in car use.

As regards **water quality**, there is a shortage of waste water treatment facilities and sewerage systems need to be improved. Large quantities of untreated wastewater are discharged into the Kura River, the main water artery of Azerbaijan. There is a shortage of safe drinking water.

Waste management constitutes a challenge, including prevention, collection, treatment, recovery and final disposal. Hazardous waste management requires special attention. Some collection and disposal activities are taking place. Stocks of obsolete pesticides constitute an important challenge.

As regards **nature protection**, Azerbaijan's rich biodiversity is under threat. Forest land has decreased over the last decade, largely due to illegal logging. This process could lead to land erosion, increased desertification, snow slides in mountainous zones, and a significant drop in biodiversity. There are also pressures on biodiversity in the Caspian Sea.

Concerning **coastal and marine pollution**, land and water pollution on the Absheron peninsula around Baku city is severe. Pollution sources include oil pollution, untreated wastewater from Baku city, disposal of solid waste and unregulated storage of hazardous waste.

With regard to **land use**, desertification and soil degradation of agricultural lands is a challenge. Arable lands have tended to degrade due to overgrazing, erosion (in particular due to deforestation), salination, chemical pollution and shortage of public awareness.

With regard to **industrial pollution**, most industrial activities are concentrated on the Absheron peninsula (including power industry, oil production and refining industry, chemical industry and metallurgy), in particular in the cities of Baku and Sumgait, entailing severe pollution of the area.

Important **trans-boundary environmental issues** include the use and protection of shared waters – in particular the Kura-Araks river system and the Caspian Sea. The Kura-Araks/Araz river system is an essential source of fresh water for the Southern Caucasus region and existing problems in the Kura river basin relate to both quantity and quality of water. Water quality is affected by discharges of municipal and industrial wastewaters and return flow from agriculture.

As regards **global environmental issues and climate change in particular**, Azerbaijan acceded to the Kyoto Protocol in 2000 and therefore needs to implement its relevant provisions and, where appropriate, implement concrete policies and measures to reduce greenhouse gas emissions, in particular in the energy and heavy industry sectors.

2) Environment policy

The main policy document in environment policy is the **National Programme on Environmentally Sustainable Socio-Economic Development**, which was adopted in 2002. It includes an action plan for 2003 – 2010, which covers environmental protection and effective use of natural resources, global environmental issues, industrial installations, agriculture and tourism, education, science and culture. The Ministry of the Environment and Natural Resources is responsible for the provision of guidelines and scientific data needed to support implementation. Furthermore, a **National Environmental Health Action Plan (NEHAP)** was adopted in 2001 and **the State Programme on Poverty Reduction and Economic Development** for 2003 – 2005 also contains a section on environmental issues. An updated programme for the period 2006-2015 is under preparation; it will be entitled SPPRSD (State Programme on Poverty Reduction and Sustainable Development). Azerbaijan also adopted a **National Environmental Action Plan** in 1998, which is set to be revised.

The 2003 state programme for the restoration and expansion of forests proposes activities in several areas, together with financial sources and performance indicators. In 2003-2004, Azerbaijan also adopted a national programme on hydrometeorology, together with a strategy on hazardous waste management. A national programme on natural resources management is being developed as is a national biodiversity strategy and action plan.

Policy documents finalised under the Caspian Environmental Programme include the National Caspian Action Plan and the Caspian Strategic Action Programme of 2004.

3) Environmental legislation and implementation

The Constitution of Azerbaijan, adopted in 1995 and amended in 2002, enshrines the right of citizens to a healthy and clean environment. The Constitution also outlines the division of environmental responsibilities between central and local bodies.

The Law on Environmental Protection and Utilisation of Natural Resources was adopted in 1992. It aimed to introduce, among other things, the polluter pays principle, opened the door for the use of economic instruments, envisaged bridging the gap between existing national and international environmental standards, and enhanced the role of public awareness. It was replaced by the Law on Environmental Protection adopted in 1999 (and amended in 2001, 2002, 2003 and 2004), which together with the Law on Environmental Safety adopted in 1999 is a central piece of legislation in the area of environmental policy. It is a framework law in style but it is relatively detailed.

The effectiveness of the Law on Environmental Protection and Utilisation of Natural Resources depends partly on the quality of implementation rules and regulations, although in some cases it can be applied without secondary legislation. The Law defines State ecological expertise (SEE), under which environmental impact assessments are applied. It also calls for strategic environmental assessments (SEA), but does not make them mandatory. Public participation is required under SEE. A law was adopted in 2002 on access to environmental information, and a report on the state of the environment was last published in 2004.

Azerbaijan has adopted some sector and issue-specific legislation, such as on air quality, waste management, nature and biodiversity, forestry, air quality, water quality, land use and mineral resources. New legislation on water quality is under preparation.

Overall, environmental legislation is in place in several areas but still needs further development, in particular with regard to implementation legislation. Azerbaijan faces difficulties with implementation and enforcement legislation due to limited administrative capacities and financial resources, especially at regional and local levels.

4) Administrative capacity

The Ministry of Ecology and Natural Resources (MENR) was established in 2001, with responsibility for the formulation and implementation of environment policy, development of environmental protection measures, screening of projects for potential adverse environmental impacts, monitoring of implementation of environmental legislation and imposing sanctions, and administering a pollution permit system. In addition, its forestry and fisheries departments are tasked with the promotion of sustainable use of resources.

Broadly, the Ministry has around 20 specialised departments (including, among others, Caspian Environmental Monitoring, Department of Forestry and State Environmental Inspection), 5 subordinated research-oriented agencies, 29 regional environment and natural resource departments and 41 enterprises for forest protection and regeneration.

Other government bodies play an important, even if indirect, role, including the Ministry of Agriculture, Ministry of Economic Development, Ministry of Education, Ministry of Fuel and Energy, Ministry of Health, Ministry of the Interior, Ministry of Justice, and

Ministry of Transport, the State Committee for Architecture and Construction, the State Committee on Land and Mapping, the State Committee on Land Improvement and Irrigation, the State Statistical Committee, the State Oil Company of Azerbaijan and the State Traffic Police. Each of these agencies has a unit specifically responsible for the environmental dimension of their activities.

Municipalities are responsible for water supply and sanitation activities and land use decisions within their areas of jurisdiction. Strengthening of regional and local environmental structures require special attention.

In order to enhance strategic planning, implementation and enforcement of environmental legislation, a major challenge facing Azerbaijan is to strengthen administrative capacity need to be boosted, in particular at regional and local levels, including with regard to coordination between the relevant authorities.

5) Participation in regional and international processes

Azerbaijan has ratified the relevant international and regional environmental conventions to which it is party.

Azerbaijan participates in the **“Environment for Europe” process**, which is a multilateral framework created in 1989 to steer the process of invigorating environmental awareness in the countries of Central and Eastern Europe, emerging from the old regimes and moving closer to the EU. The core activities of this process are undertaken by a Task Force co-chaired by the Commission and a NIS environment minister.

At regional level, Azerbaijan participates in regional cooperation under **the Caspian Environment Programme**.

Azerbaijan also participates in **the Eastern European, Caucasus and Central Asia component of the EU Water Initiative**, a regional component of the EU Water Initiative, as announced at the 2002 World Summit on Sustainable Development. The initiative aims to promote better water governance and coordination between stakeholders.

Azerbaijan also participates in **the Europe and North Asia Forest Law Enforcement Governance (FLEG) process** concerning forest governance and the protection and sustainable management of forests in the region.

Azerbaijan is a co-founder (together with Georgia, Armenia and the European Commission) of **the Caucasus Regional Environmental Centre (REC)**, The REC Caucasus with headquarters in Georgia, sets out to address regional environment issues in the Southern Caucasus through the promotion of regional co-operation between various stakeholders at all levels, involving civil society, governmental bodies, local communities and the business sector. The REC Caucasus also aims to foster public participation in environmental decision-making.

6) Key environment areas where action is required

Azerbaijan faces significant challenges to promote environment protection. Key areas include air quality, water quality, waste management, nature protection, coastal and marine pollution and land use (in particular desertification).

As regards climate change, Azerbaijan needs to implement the relevant provisions of the Kyoto Protocol to the UN Framework Convention on Climate Change. Azerbaijan has significant possibilities to use flexible mechanisms under this Protocol.

Institutional and administrative capacity needs strengthening, in particular as regards strategic planning, implementation and enforcement. A fully operational Regional Environment Centre (REC) could help to promote environmental awareness and protection by providing a forum for cooperation between the various stakeholders.

The key environment areas where action is required are identified in the environment section of the EU - Azerbaijan Action Plan, established in the framework of the European Neighbourhood Policy. It defines a set of priorities for action with regard to environmental governance and issue-specific activities, and on international and regional cooperation on environment issues. Progress towards implementing the Action Plan will also help to achieve the objectives of the Partnership and Cooperation Agreement.

Priorities of other donors, including Member States

Member States and the EIB

From **EU-25** Germany, Sweden, France, the United Kingdom (UK), Greece and Italy provide aid.

Germany has been cooperating with Azerbaijan since the early 1990s through the GTZ and the KfW (Kreditanstalt fuer Wiederaufbau), nowadays mostly in the fields of economic development and reform, the development of the private sector and in the field of legal reform and reforms of the judiciary. Annual funding from Germany amounts to around €3 m per year.

Italy provides humanitarian aid, mainly targeting refugees and internally displaced people, and aid in healthcare of approximately €1 m per year.

Sweden (SIDA) provides assistance to Azerbaijan, under its new country strategy, of approximately €1 m per year. The funds are mainly earmarked for the alleviation of poverty, the promotion of democracy and human rights and in particular the promotion of women's rights. Sweden implements its projects mostly through UN agencies.

France has an annual budget for bilateral aid and cooperation programmes of approximately 400 000 euros, which is mostly used in the cultural sphere. IN addition, the French Ministry of Finance provides soft loans to the Azerbaijani government for large infrastructure projects.

Denmark promotes stabilization of the Caucasus region, including Azerbaijan, by improving the conditions for the refugees, internally displaced persons (IDPs) and minorities in society. The regional programme will achieve these objectives by strengthening the authorities and the actors within the civil society to integrate refugees, IDPs and minorities into society. 3,200,000 euros have been committed to activities in the Caucasus region from 2005-2007.

The **UK** does not provide aid to Azerbaijan under its Department for International Development (DFID), but it does provide small grants, mostly in the areas of human rights, democratisation, freedom of the media, elections and humanitarian assistance. The annual budget for this does not exceed 250 000 Euro.

Greece provides aid of annually approximately 100 000 Euro to Azerbaijan under its bilateral programme. This is spent on humanitarian and health measures.

Under the New European Neighbourhood Policy, Azerbaijan is now also eligible for **European Investment Bank (EIB) lending**.

Other donors, including IFIs

The **World Bank's** country assistance strategy for 2006-2008 is currently still under preparation. In 2005, the World Bank committed 100 million US\$ to Azerbaijan, with a total commitment on active projects of currently 421 million US\$. The current main priorities of the World Bank's assistance to Azerbaijan are to help the country to effectively manage the windfall from the oil boom to maintain macroeconomic stability, to avoid "Dutch disease" and to facilitate non-oil growth, employment and pro-poor expenditures. Further priorities include generating greater employment opportunities by improving the business environment and access to financial services and by building infrastructure and improving access to state services.

Azerbaijan is also a large recipient of **United States Technical Assistance (USAID)**. For the financial year 2006 USAID has scheduled funds of 35 million US\$. There are four main priorities for USAID funding: *Economic Growth (35% of funding)*, mainly through enhanced banking supervision; greater transparency and efficiency of treasury and financial management; reform in the energy sector regulation; and capacity building in capital budget preparation. *Democracy and Human Rights (21% of funding)* mainly through support for democratic local government and decentralisation; promotion and support for free and fair elections; strengthening of democratic political parties; strengthening of civil society; establishment and safeguarding of media freedom and freedom of information; and promotion and support for anti-corruption reforms. *Social and humanitarian issues (25% of funding)* and a *Training and small grants programme (19% of funding)*

The **Asian Development Bank (ADB)** operates on the basis of its 2005-2006 country programme, which sets priorities in the sectors of education, energy, rural development and transportation. For 2006, projects (loans) in the areas of flood mitigation, urban water supply and sanitation and highway improvement for a total value of 104 million US\$ have been approved.

As at 31 December 2005, the **European Bank for Reconstruction and Development (EBRD)** had signed 30 agreements in Azerbaijan, totalling €86 million and covering a wide variety of sectors. Its strategic approach is to support economic diversification with the aim of poverty alleviation. Its future activities will focus primarily on the development of the private sector, including through intensified policy dialogue with the authorities on improving the investment climate. The EBRD's country strategy, which was approved in March 2005, outlines the following strategic priorities: development of the non-oil sector and regional economic diversification; enhancement of the competitiveness of the banking sector, while at the same time using the sector as an intermediary to provide support for micro, small and medium-sized enterprises; upgrading of public infrastructure - roads, rail, power, telecommunications; and continuing development of the natural resources sector, with due regard to the environment, transparent management and effective utilisation of revenues.

In its programme for 2005-2009 the **United Nation Development Programme (UNDP)** puts the main focus of its programmes in the following areas: effective and transparent management of state oil and pipeline revenues, in order for these revenues to contribute to the development of the non-oil sector, generation of employment in the non-oil sector, private investment in the non-oil sector, and reform of the social protection system; plus improvement of national environmental protection and natural resource management, combating drug trafficking, mine action and the fight against HIV/AIDS.

Norway provides substantial aid in the humanitarian sector, particularly to assist internally displaced people.

The **Council of Europe, the OSCE and Switzerland** also provide assistance to Azerbaijan.

“Policy mix” considerations in the context of the Azerbaijan CSP

CFSP: Efforts towards the peaceful settlement of the conflict over Nagorno-Karabakh play an important role in the context of the **Common Foreign and Security Policy (CFSP)**. The EU has been gradually increasing its involvement in international efforts to find a peaceful solution to the conflict since the appointment (July 2003) of an EU Special Representative for the Southern Caucasus.

Both the Soviet inheritance and the protracted conflict over Nagorno-Karabakh have left Azerbaijan with thousands of **Anti-Personnel Landmines (APL)**. No one knows exactly how many landmines are buried in Azerbaijan. At one time, the Red Cross estimated that there might be as many as 50 000, but this number is inexact because there are no maps recording where the land mines were buried or how many might exist.

The land mines were buried during the Nagorno-Karabakh war and run from the Iranian border (near Fizuli) in the south, to the Georgian border (near Gazakh) in the northwest. There are also some mines in the regions between Nakhcivan and Armenia. The EC has been providing financial support to address the APL problem in the context of its Mine Actions (the 2005-2007 is currently under implementation) and will probably extend its activities once the Nagorno-Karabakh conflict is settled.

Other problems to be addressed in this context are the **small arms and light weapons** and Soviet **rocket fuel deposits**; the latter pose a very serious problem to the environment.

Energy: As a producer and a transit country, Azerbaijan is becoming a fundamental partner with the EU with a view to diversifying the Union’s energy supply. Against this background, support for energy-related issues will be one aspect of the EU’s overall relations with the country and EC assistance strategy.

Transport: Due to its geographical location, Azerbaijan can play an increasingly important role in the framework of the East-West and North-South transport corridors. The EC has a strategic interest in providing support for areas identified as important in this context and for priority measures in line with the recommendations of the High Level Group on the extension of the major trans-European transport axes towards neighbouring countries and regions. The Commission also adopted in March 2005 a Communication proposing the creation of a wider European Common Aviation Area including the neighbouring countries of the EU by 2010. In the **transport** sector Azerbaijan played an active part in the EU-Black Sea-Caspian Basin Ministerial Conferences on Energy and Transport which took place in Baku in November 2004 and continues to play an active role in their follow-up Working Groups. Azerbaijan also participates actively in the TRACECA Secretariat and TRACECA meetings and adopted the TRACECA Strategy

and the conclusions of the Baku transport working groups during the Baku and TRACECA Ministerial conferences that took place back-to-back in May 2006 in Sofia.

JLS cooperation: Azerbaijan is primarily a country of origin and transit for trafficking in persons. However, available evidence suggests that Azerbaijan may also be considered a country of destination. A considerable number of Azerbaijani citizens, especially women, fall victim to various forms of trafficking. Drug trafficking is also becoming a very serious problem. The South Caucasus, strategically located between Asia and Europe, is today a major transit point for narcotics. Corruption, instability and separatist conflicts are all cited as being behind the region's rise in smuggling. EC cooperation with Azerbaijan and South Caucasus on JLS matters is therefore an area which forms an important part of the ENP Action Plan.

Development Cooperation: Azerbaijan belongs to the World Bank category of lower middle-income countries, even though the situation could change in the medium term thanks to oil and gas revenues. General principles and EC policies regarding **development cooperation** therefore still apply. The Azerbaijani government adopted a State Programme for Poverty Reduction and Economic Development (SPPRED) in 2003 and is currently finalising a follow-up programme which should cover the period from 2006 to 2015. The new external assistance strategy for Azerbaijan should therefore have a strong focus on poverty reduction, in particular at regional and local community level.

Trade: In the area of **trade policy** the EU is a key import and export market for Azerbaijan. Azerbaijan currently benefits from the EU Generalised System of Preferences (GSP), but is not making a very good use of it, its exports to the EU remaining heavily dominated by hydrocarbons. Azerbaijan's increased compliance with WTO requirements in the process of its accession to WTO and its further regulatory approximation with the EU *acquis* on several trade-related issues envisaged in the PCA and the ENP Action Plan should help the country to increase and diversify its exports to the EU and to the rest of the world. Improving the system of certification and the control of rules of origin are important prerequisites in this regard.

Environment: As regards environmental protection, **global and transboundary environment threats** like climate change affect Azerbaijan as well as the EU. Both parties are committed to implementing the Kyoto Protocol and the UN Framework Convention on Climate Change. Transboundary environmental threats include the use and protection of shared waters, in particular the Caspian Sea. The EC is currently providing support in this area on a regional basis and envisages follow-up measures under future assistance programmes.