

**BOARD
OF
DIRECTORS**

ASIAN DEVELOPMENT BANK

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**TECHNICAL ASSISTANCE TO AZERBAIJAN
FOR CAPACITY BUILDING FOR STRATEGIC ECONOMIC
POLICY FORMULATION IN THE MINISTRY OF FINANCE**

The attached Report is circulated for the information of the Board. The President approved the technical assistance on 31 May 2001.

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ASIAN DEVELOPMENT BANK

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**TECHNICAL ASSISTANCE
TO THE
REPUBLIC OF AZERBAIJAN
FOR
CAPACITY BUILDING FOR STRATEGIC ECONOMIC POLICY FORMULATION
IN THE MINISTRY OF FINANCE**

May 2001

CURRENCY EQUIVALENTS

(as of 22 May 2001)

Currency Unit	—	Azerbaijani Manat (AZM)
AZM1.00	—	\$0.0002
\$1.00	—	AZM4,628

ABBREVIATIONS

ADB	—	Asian Development Bank
DFID	—	Department for International Development, United Kingdom
MOF	—	Ministry of Finance
MPG	—	Macroeconomic Policy Group
NBA	—	National Bank of Azerbaijan
TA	—	technical assistance

NOTES

- (i) The fiscal year of the Government ends on 31 December.
- (ii) In this report, "\$" refers to US dollars.

I. INTRODUCTION

1. A Consultation Mission of the Asian Development Bank (ADB) was fielded to Azerbaijan in October 2000 to consult with the Government in preparing ADB's Economic Report and Interim Operational Strategy for Azerbaijan. In the course of discussions, the Government and ADB agreed that there is a pressing need for assistance to strengthen economic policy-making capacity within the Ministry of Finance (MOF) and to improve the quality of economic policy advice. Subsequently, ADB sent a Reconnaissance Mission to Azerbaijan in November 2000 and a further Consultation/Contact Mission in February 2001 to discuss with the Government the details of the envisaged technical assistance (TA). The Government has accorded high priority to this TA, and the Government and ADB reached understanding on the TA objectives, scope, terms of reference, implementation arrangements, and cost estimates. ADB Management approved concept clearance on 20 March 2001. The TA framework is in Appendix 1.

II. BACKGROUND AND RATIONALE

2. Following an extremely difficult period of internal and external instability and war with neighboring Armenia in the first three years of independence, Azerbaijan embarked on serious economic stabilization and reform late in 1994. After years of transition and reforms, the country still faces tremendous development challenges in deepening structural reforms, rationally managing future oil revenues, and promoting nonoil sector development. The challenges are especially reflected in the slow progress in building good governance and undertaking institutional reforms, which have emerged as the major obstacle to further progress in development in Azerbaijan. In particular, the short period since independence has provided little experience in managing public investment and allocating resources for infrastructure and social development based on market practice. This lack of experience has an especially important implication, in view of the move toward greater reliance on internal resources in formulating macroeconomic policy. These resources are becoming available following successful development of "early oil" production and the sharp rise in oil prices during 2000.

3. MOF has been in a key position responsible for economic policy formulation in general and public resource management in particular. In Soviet times, however, the role of MOF in Azerbaijan was very limited. It functioned as the local implementing and paying agency for budget plans made in Moscow. The transition to a MOF capable of making and implementing fiscal policy has been a major area of reform. The Department for International Development (DFID) and the British Know How Fund (BKHF) of the British Government have been assisting this reform with high-level economic policy advice to MOF. Since July 1999 a DFID-BKHF project has incorporated enhanced emphasis on capacity building within MOF. Strategic policy advice and assistance in negotiations with the International Monetary Fund have continued, but the focus of the assistance has shifted to institutional capacity building in the form of support for the Macroeconomic Policy Group (MPG) established within MOF in July 1999. MPG currently consists of eight middle- to senior-level MOF staff, and one DFID-funded expatriate resident economic adviser, tasked to support the development of a sound economic policy framework. DFID-BKHF advice has contributed to Azerbaijan's positive progress in macroeconomic stabilization.

4. Despite the improvement, there remains a great need to reinforce the process of reforms and continue the transition to a national MOF capable of making and implementing fiscal policy. This objective will involve important issues such as improving the recently established treasury system and implementing a new tax code. Other important areas that need assistance include

interenterprise arrears, securities market development, value added tax policy and administration, installing of an external debt management system, and developing of an economic information system. Further assistance is needed to accelerate policy and institutional progress by addressing measures of structural reform in support of pro-poor growth and poverty reduction, and by further strengthening MOF's internal capacity to conduct policy analysis.

5. Assistance to MPG and other key departments of MOF is especially needed. MPG, which groups together officials from existing departments of MOF, has been directed to draw together expertise in budget, treasury, revenue forecasting, and financing matters, to track the Government's financial program and serve as liaison with the National Bank of Azerbaijan (NBA). Moreover, the role of MPG should now be enhanced so that MPG can assume principal responsibility for policy advice on the Government's medium-term economic program (both formulation and implementation), and for coordination among agencies with economic policy responsibilities. The skills acquired in MPG also need to be extended to other departments of MOF (and other agencies such as NBA) so as to widen the range of officials involved in macroeconomic policy work and increase the cadre of trained professionals.

6. The Government has just finalized the Interim Poverty Reduction Strategy Paper. A macroeconomic framework leading to stability and an environment conducive to rapid economic growth are necessary conditions for poverty reduction. Policy and institutional progress now needs to be accelerated by addressing measures of structural reform in support of pro-poor growth and poverty reduction, and by further strengthening the internal capacity of MOF to conduct policy analysis.

7. With the increasing need for assistance to enhance economic policy making and management capacities of MOF, ADB support is necessary and indeed timely. ADB's assistance is even more critical because of the falling support of DFID to MPG, due to DFID's new regional development strategy that will refocus its aid to non-ADB member countries in the Caucasus. The DFID commitment to MPG and MOF has begun to fall significantly in 2001; and assistance will cease completely by the end of 2002. With continued and expanded assistance activities under the ADB TA, enhanced impact will be achieved through MOF's improved capacity in formulating macroeconomic policies and managing public resources.

III. THE TECHNICAL ASSISTANCE

A. Objective

8. The TA will support the development of a sound economic policy framework so as to strengthen economic policy-making capacity within MOF and improve the quality of economic advice.

B. Scope

9. The goal and purpose of the project will be pursued by executing the following components:

- (i) assistance to develop a sustainable MPG with a strongly entrenched institutional role capable of delivering relevant advice to high-level officials. A training program will enhance the skills of MPG staff;

- (ii) provision of strategic policy advice on matters of structural reform and macroeconomic policy, as required by MOF or by other senior economic officials of the Government;
- (iii) continuous improvement of the economic information base for economic policy making within MOF;
- (iv) enhanced forecasting and program design capacity in MOF and improved policy analysis in key areas of fiscal reform, such as detailed tax forecasting (including forecasting of petroleum revenues), improved domestic debt management, analysis of the composition of public expenditure (with a poverty-related focus on social sectors) and of the wage bill; and
- (v) a macroeconomic framework and criteria for a public investment program, to be developed in coordination with MPG and the Debt Management Department of MOF, and strengthening the Project Evaluation Unit.

10. Specific policy areas also to be addressed include a strategy for utilities tariff reforms that would be fiscally sustainable while offering an affordable level of basic services, and a linked strategy on fees and charges for health and education. A fiscal package to support Azerbaijan's aim of membership in the World Trade Organization may also be prepared.

C. Cost Estimates and Financing Plan

11. The TA is estimated to cost \$953,000 equivalent, of which \$762,000 is the foreign exchange cost and \$191,000 equivalent is the local currency cost (to be financed by the Government). The Government has requested ADB to finance the entire foreign exchange cost of \$762,000. ADB will finance the TA on a grant basis from the ADB funded TA program. The Government will finance the local currency cost by providing office space, staff support, and other in-kind contributions. Detailed cost estimates are in Appendix 2.

D. Implementation Arrangements

12. MOF will be the Executing Agency. The TA will be implemented over 30 months commencing mid-2001, with completion in December 2003. A consulting firm will be selected and engaged in accordance with ADB's *Guidelines on the Use of Consultants*. The firm will be responsible for the overall conduct of the TA, including providing the services of an international project director/periodic economic adviser (86 person-days) and a number of international specialist, short-term advisers (90 person-days), and support to MPG. The consulting firm will also provide the services of an international resident economic adviser (12 person-months) with primary responsibility for managing further development of MPG and for providing wide-ranging policy advice to senior Government officials on a daily basis. All procurement of equipment and materials, and service payments under the TA will be in accordance with arrangements satisfactory to ADB. The Government will assign personnel to MPG, allocate office space, and provide free access to information and data with MPG.

13. Transborder Investment Advisory Services Limited (Transborder) of the United Kingdom was originally selected in 1999 for the DFID-financed assistance to MPG following a competitive tender process. In view of Transborder's satisfactory performance, the firm's significant experience in economic policy work in Azerbaijan, and the Government's desire that Transborder continue its assistance to MPG, it is proposed that Transborder be selected and

engaged under direct consultant selection procedures in accordance with para. 6.14 of ADB's *Guidelines of the Use of Consultants*.

14. The consulting firm will submit an inception report to MOF and ADB within one month of the start of services. The report will (i) focus on initial assessment and a realistic plan for future actions during the adviser's services, and (ii) should cover, as appropriate, other areas of the adviser's responsibilities as specified in the terms of reference. After the initial report, the consulting company will submit to MOF and ADB quarterly reports detailing the project progress. The last quarterly report will be completed as the final report of the TA, and will describe comprehensively the accomplishments of the TA and assess in detail the results achieved in meeting the objectives. Government participation in supervising and monitoring the preparation of these reports is essential. The terms of reference for the international consultants and for MPG are in Appendix 3 and 4, respectively.

IV. THE PRESIDENT'S DECISION

15. The President, acting under the authority delegated by the Board, has approved the provision of technical assistance, on a grant basis, to the Government of the Republic of Azerbaijan in an amount not exceeding the equivalent of \$762,000 for the purpose of Capacity Building for Strategic Economic Policy Formulation in the Ministry of Finance, and hereby reports such action to the Board.

TECHNICAL ASSISTANCE FRAMEWORK

Design Summary	Performance Targets	Monitoring Mechanisms	Assumptions and Risks
Goal Support development of a sound economic policy framework	A sustained economic policy framework, consistent economic policy advice that maintains economic stability and rational allocation of resources	Technical assistance (TA) review missions, and TA progress reports	Political commitment to stability, structural reform, and enhanced development of the non-oil sector is maintained.
Purpose Build economic policy-making capacity within the Ministry of Finance (MOF) and improve the quality of economic policy advice	Enhanced Macroeconomic Policy Group (MPG) performing the following functions: (i) improved information base for both economic and poverty assessment, (ii) effective monitoring and reporting on country performance indicators, (iii) enhanced economic forecasting, including for the oil and gas sector, and (iv) improved cooperation and coordination between MOF and other Government agencies	TA review missions, progress reports, final report	No major changes in the structure and staff of MOF. Trained staff remain in MPG during TA implementation and after its completion.
Outputs (i) Further assist the development of a sustainable MPG in MOF with enhanced skills delivering relevant advice to high-level officials and with a strongly entrenched institutional role. A training program will enhance the skills of MPG members; (ii) Provision of strategic policy advice on matters of structural reform and macroeconomic policy, as required by the minister of finance or by other senior economic officials of the Government; (iii) Continuous improvement of the economic information base for economic policy making within MOF; (iv) Enhanced forecasting and program design capacity in MOF and improved policy analysis in key areas of fiscal reform: detailed tax forecasting (including forecasting of petroleum revenues project by project), improved domestic debt management, analysis of the composition of public expenditure (with a poverty-	(i) Staff retained by MPG and same staff receive training; (ii) Regular internal MOF memos advising on issues of strategic policy and structural reform; (iii) Continued quarterly and annual economic survey reporting on the economy of Azerbaijan; (iv) Annual drafting and revision of the macroeconomic and budget forecast and other economic forecasts; (v) Submission of specialist reports by short-term advisers on a wide range of key economic policy issues; and (vi) Macroeconomic framework for Public Investment Program (PIP).	TA progress report, Project review missions, TA final reports	Remuneration is higher in the private sector. Wage decompression, remuneration, and incentives will be addressed by Government. Local staff will continue to serve the MPG. Mitigation measures could include more training for non-MPG staff and other incentive schemes to MPG staff. Cooperation from other Government ministries, departments, and agencies will continue and be enhanced.

(Reference in text: page 1, para. 1)

Design Summary	Performance Targets	Monitoring Mechanisms	Assumptions and Risks
related focus on social sectors) and of the wage bill; and (v) Development of a macroeconomic framework and criteria for a public investment program, to be developed in coordination with MPG, the debt management department of MOF, and strengthening the Project Evaluation Unit.			
Activities (i) Resident Economic Adviser, 18 person-months, DFID. (ii) Resident Economic Adviser, 12 person-months, ADB. (iii) Project Director/Periodic Economic Adviser, 3 person-months, over 30-month period, ADB. (iv) Series of Specialist Short-Term Advisers, 3 person-months total, ADB. (v) In-country training and study tour. (vi) Equipment		TA review missions, TA progress reports, TA final reports	

COST ESTIMATES AND FINANCING PLAN
(\$)

Item	Foreign Exchange	Local Currency	Total Cost
A. Asian Development Bank Financing			
1. Consultants (International)			
a. Remuneration and Per Diem ^a	464,000	0	464,000
b. International Travel	80,000	0	80,000
c. Communications (international), Reports and Interpretation	8,000	0	8,000
2. Office Equipment (computers, UPS ^b , software, printers, fax, etc.)	20,000	0	20,000
3. Training, Seminars, and Conferences			
a. Training (in-country) ^c	65,000	0	65,000
b. Training (study tour abroad)	25,000	0	25,000
4. Contingencies	100,000	0	100,000
Subtotal (A)	762,000	0	762,000
B. Government Financing			
1. Office Support/Office Accommodation	0	75,000	75,000
2. Counterpart Staff	0	55,000	55,000
3. Others			
a. Communications (local)	0	8,000	8,000
b. Training (in-country)	0	10,000	10,000
c. Interpretation/Translation	0	15,000	15,000
d. Transport	0	5,000	5,000
e. Contingency	0	23,000	23,000
Subtotal (B)	0	191,000	191,000
Total	762,000	191,000	953,000

^a For resident economic adviser, 12 months of ADB financing from January to December 2003. The Department for International Development (DFID) will finance the position from mid-2001 to end-2002.

^b UPS = uninterrupted power supply.

^c Distance Masters' courses, English, workshops, and fees.

Source: Government and Staff estimates.

(Reference in text: page 3, para. 11)

TERMS OF REFERENCE FOR INTERNATIONAL CONSULTANTS

1. The project consists of two major activities. The first includes appointing a project director/periodic economic adviser (PD/PEA), providing for short-term specialist advisers, and training, and equipment. This activity will cover the entire period of the TA. The second activity is recruiting a resident economic adviser who will reside in Baku. A consulting company, selected by the Asian Development Bank (ADB), will be contracted to supply all services.

A. Project Director/ Periodic Economic Adviser

2. The PD/PEA will take overall responsibility for the TA. The PD/PEA will supervise and assist in further development of a Macroeconomic Policy Group (MPG) in the Ministry of Finance (MOF). This task will be done in close cooperation with the head and deputy head of MPG and the resident adviser. Overall responsibility for supervision and management of MPG will be gradually handed over to the head and deputy head of MPG in the course of the project. The PD/PEA will also be principally responsible for giving strategic policy advice. The PD/PEA will make regular visits to Baku, amounting to 86 working days of services during the TA period. The project director will also:

- (i) supervise and guide the work of the long term resident economic adviser;
- (ii) work with the resident economic adviser to identify MPG's requirements of specialist support; agree on these with the Department for International Development (DFID), ADB, and MOF, ensure that short-term specialists are appropriately briefed on counterparts requirements; and ensure appropriate follow-up actions are implemented;
- (iii) depending on the project director's expertise, provide additional specific and limited strategic policy advice on matters of structural reform and macroeconomic policy, as required by the minister of finance or by other senior economic officials of the Government; manage specialist inputs to these structural policy areas as required;
- (iv) be responsible for overall management and direction of the TA including preparation of work programs and submission of the inception report, quarterly monitoring reports, and end-of-project reports to ADB; and
- (v) provide strategic policy advice, in consultation with MOF and ADB, on issues that focus on policies to improve the regulatory and fiscal climate for private business development, as well as policies on medium- and long-term fiscal management, particularly in relation to management of oil revenues and the external debt.

3. It is recognized that the topics for strategic policy advice may change. It is therefore important that the TA and its consultants respond flexibly to emerging policy-making needs in Azerbaijan.

(Reference in text: page 4; para. 14)

B. Resident Economic Adviser

4. A resident economic adviser, based in MOF, will reside in Baku for 12 person-months. Together with MPG staff, the economic adviser will be responsible for developing the economic information system, for the day-to-day work program of MPG, and for giving economic advice to senior ministry officials on implementing the Government's economic and financial program. The resident adviser will:

- (i) ensure that personal development plans and work programs are maintained for all MPG staff and updated annually, and that these plans and programs are implemented or modified where circumstances change. Staff management responsibilities will be progressively transferred to the head and deputy head of MPG in the course of the TA;
- (ii) ensure appropriate on-the-job training and external training for MPG staff in line with their personal development plans;
- (iii) help identify MPG's requirements of specialist support, ensure that all short-term specialists are appropriately briefed in Baku and that appropriate follow-up actions are implemented;
- (iv) provide wide-ranging, relevant, strategic policy advice on structural reform and macroeconomic policy, as required by the minister of finance or by other senior economic officials of the Government;
- (v) in supporting MPG, on a daily basis, facilitate assistance to local counterparts in developing an economic information system in MOF, and help MPG develop external relations with other agencies of Government and with international financial institutions; and
- (vi) in sharing the provision of strategic policy advice with the project director, select, in consultation with ADB and DFID, issues that focus on policies to improve the regulatory and fiscal climate for private business development, as well as policies on medium- and long-term fiscal management, particularly in relation to the management of oil revenues and the external debt.

C. Short-Term Specialist Advisers

5. Additional specialist expertise (90 person-days) will be brought from time to time, as required, for either supporting the work of MPG or providing strategic policy advice. The areas of specialist expertise cannot be fully anticipated at the outset of the TA and a flexible approach to determining areas of specialist assistance must be adopted. It is nevertheless anticipated that specialist assistance will be required in the following areas: domestic debt management, macroeconomic framework for a public investment program, public expenditure review, promoting investments to generate employment; review of policies on competition and regulation; formulating utility tariff reform for sustainable service and poverty reduction, public welfare user fees, and developing a fiscal package to support Azerbaijan's aim of membership in the World Trade Organization (WTO). The short-term specialist services will consist of field visits for two person-months and homework for one person-month.

TERMS OF REFERENCE FOR THE MACROECONOMIC POLICY GROUP

1. MPG is headed by a deputy minister and gives policy advice to the minister and deputy ministers of the Ministry of Finance (MOF), as necessary. MPG comprises one person each from the Debt Management Unit, the Tax Policy Department, Treasury, and the Social Expenditures department, and two persons from the Budget Department. MPG will be supervised by the advisers financed by the ADB-DFID.

2. The core task of MPG includes continued development of the macroeconomic information system and forecasting framework. The following modules are to be maintained and developed:

- (i) consolidated operations of general government fiscal tables (plus oil fund), covering republican and local budgets, and social security funds; the government financing table;
- (ii) monetary tables, balance sheet of the National Bank of Azerbaijan, the monetary survey, and the consolidated balance sheet of the commercial banks; information on prices and interest rates;
- (iii) national accounts ("real" sector data, comprising components of gross domestic product, trade data, sectoral production information, wage and employment data); and
- (iv) balance of payments (details of external transactions on trade, current and capital accounts; links to the other three tables by consolidating trade data, changes in reserves, and capital flows).

3. Within the core framework, MPG will also develop and maintain a number of specific management or analytical tools of special importance to Azerbaijan and MOF: the Azerbaijan debt recording and management model (already developed with DFID assistance); oil revenue forecasting model; detailed tax forecasting framework by type of tax, sector, and major taxpayers – to be developed in collaboration with the Tax Policy Department of MOF and the Ministry of Taxes; domestic debt management tools, to complement the external debt management system already installed; public expenditure analysis designed to improve efficiency and targeting of social expenditures; and the macroeconomic framework and fiscal criteria for design of a public investment program.

4. MPG will develop relationships between the main variables in the information system, incorporating these, together with the usual accounting identities, into an economic forecasting framework. This framework will be developed and used to design and monitor the Government's short- and medium-term economic and financial program.

5. MPG will prepare an annual statement of economic policy and performance to be issued by MOF in conjunction with the presentation of the budget.

6. MPG will provide advice as necessary to the minister and deputy ministers within MOF. Subject to the requirements of the minister, MPG will act as coordinator for the information and briefing requirements of the international financial institutions for their Azerbaijan programs.

7. Staff of MPG are expected to devote approximately half their working time to the activities of MPG. This estimate is very approximate as there are times when the work of MPG is full-time, and departmental responsibilities will overlap with the work of MPG.
8. MPG will require extensive liaison outside MOF, particularly with NBA, Cabinet of Ministers, Ministry of Economic Development, Ministry of Taxes, and State Customs Committee. MPG will retain dedicated accommodation in MOF.
9. The TA will continue to provide regular advice to MOF in its interaction with the International Monetary Fund and other international financial institutions. MPG itself should play a leading role in these interactions.
10. The appointed consulting company will manage and administer the TA outside Azerbaijan. Inside Azerbaijan, the administrative support staff of MPG will perform those functions.