

ASIAN DEVELOPMENT BANK

TAR: AZE 35458

TECHNICAL ASSISTANCE

TO THE

REPUBLIC OF AZERBAIJAN

FOR

CAPACITY BUILDING

AT THE MINISTRY OF ECONOMIC DEVELOPMENT

December 2004

CURRENCY EQUIVALENTS

(as of 2 December 2004)

Currency Unit	–	manat (AZM)
AZM1.00	=	\$0.000204
\$1.00	=	AZM4,908.50

ABBREVIATIONS

ADB	–	Asian Development Bank
CER	–	Center of Economic Reforms
EMG	–	economic modeling group
MOED	–	Ministry of Economic Development
MOF	–	Ministry of Finance
NBAR	–	National Bank of Azerbaijan Republic
TA	–	technical assistance

TECHNICAL ASSISTANCE CLASSIFICATION

Targeting Classification	–	General Intervention
Sector	–	Law, economic management, and public policy
Subsector	–	Economic management
Themes	–	Sustainable economic growth, governance
Subthemes	–	Promoting macroeconomic stability, promoting economic efficiency and enabling markets, and public governance

NOTE

In this report, "\$" refers to US dollars.

<p>This report was prepared by B. Ganiev, Operations Coordination Division, East and Central Asia Department.</p>

I. INTRODUCTION

1. At the request of the Government of Azerbaijan, technical assistance (TA) for capacity building at the Ministry of Economic Development (MOED) was included in the 2002 non-lending program of the Asian Development Bank (ADB) for Azerbaijan.¹ However, the TA was not fully processed in 2002, because the Government did not find its initial design sufficiently attractive, whereas ADB could not accept the alternative design proposed by the Government.

2. When the 2003 Country Programming Mission visited Azerbaijan in May 2003, the Government requested that ADB give priority to this TA and expedite its preparation. It was agreed that the TA would be scheduled for approval in 2004 and that ADB and MOED staff would collaborate closely during the rest of 2003 to work out a TA design that would be attractive to the Government and acceptable to ADB. In September 2003, ADB sent a reconnaissance mission to Azerbaijan, which agreed with the Government on key features of the TA, including its purpose and methodology. This was followed by a fact-finding mission, which visited Azerbaijan in December 2003 and reached an understanding with the Government on details of the TA, including outputs, key activities, inputs, cost estimates, financing plan, implementation arrangements, and outline terms of reference for consultants. The TA framework is in Appendix 1.

II. ISSUES

3. Azerbaijan is at an early stage of a major resource boom. Several large-scale investment projects have recently been launched in its oil sector.² Following the planned completion of these projects in 2005–2007, oil production and exports are expected to expand rapidly, with the extraction of crude oil almost quadrupling during 2005–2010. This will provide a substantial windfall to the country and ensure that economic growth, which averaged about 10% over the last 6 years, will remain buoyant at least through the end of this decade.

4. However, this hydrocarbon-driven economic expansion will have only a limited direct impact on poverty reduction, because it will not generate many new jobs and most oil revenues will accrue to state coffers and international oil companies developing Azerbaijan's oil fields. Furthermore, like any resource boom involving large inflows of foreign exchange into the domestic economy, the oil boom in Azerbaijan will complicate macroeconomic management and is likely to cause appreciation of the real exchange rate and "crowding out" of the non-oil tradables sector by the oil sector and the nontradables sector over the medium term, a phenomenon known as the "Dutch disease." The boom may also lead to unproductive public expenditures and rapid accumulation of external debt, as happened in many other resource-rich countries. In the long term, economic growth driven by the oil sector will not be sustainable, because, unless new fields are discovered, the oil boom in Azerbaijan is expected to be relatively short-lived.

5. Hence, despite bright medium-term growth prospects, Azerbaijan faces formidable economic challenges. To avoid the "resource curse" experienced by many other oil-rich countries, Azerbaijan needs to (i) maintain macroeconomic stability in the face of large foreign exchange flows related to the exploitation of hydrocarbon resources; (ii) allocate the oil windfall over time optimally and use it efficiently to the benefit of all segments of the population,

¹ It first appeared in the *ADB Business Opportunities* (Internet edition) on 9 February 2002.

² The term "oil sector" refers to the oil and gas sector.

especially the poor; and (iii) promote the development of the non-oil sector to create productive jobs and achieve balanced and sustainable growth.

6. Overcoming these challenges requires strengthening the Government's capacity for economic policy management, especially that of MOED. MOED was established in April 2001 on the basis of five dissolved Government agencies and is responsible for key aspects of economic policy management, including formulation and implementation of economic and social development strategy, economic policy analysis, macroeconomic forecasting, and cooperation with international financial institutions. MOED played a leading role in the formulation of Azerbaijan's Programme on Poverty Reduction and Economic Development for 2003–2005 and the State Programme on Socio-Economic Development of Regions for 2004–2008 and is overseeing the implementation of these programs. To carry out its broad mandate, MOED needs substantial capacity building, particularly in policy analysis and formulation of medium- and long-term economic and social programs.

7. Furthermore, various government agencies with economic policymaking responsibilities need to improve coordination of their analytical work. Policy analyses done at MOED, Ministry of Finance (MOF), and National Bank of Azerbaijan Republic (NBAR) are not well coordinated among these agencies, with limited exchange of outputs. Consequently, work is often duplicated, and the agencies sometimes disagree on important economic issues. This results in inefficient use of scarce human resources and causes undue delays in the decision-making process.

8. As part of its efforts to meet these needs, the Government is trying to strengthen the Center of Economic Reforms (CER) of MOED and to develop CER into its principal economic think tank providing strategic policy advice and coordinating analytical work done at various Government agencies. CER was established in 1994 on the basis of the Science and Research Institute of Economy of the former State Committee of Economy and Planning. Its overall mandate is to advance economic reforms. Its responsibilities include conducting applied economic research, monitoring economic and business developments, providing analytical support to MOED and other Government agencies, and helping MOED review and formulate economic policies. With an annual budget of about \$200,000, CER employs a total of 70 people, including 17 with graduate degrees in economics or mathematics.³ Following the appointment of new management in late 2002, CER underwent a major reorganization, which enhanced its focus on key areas of economic reforms. CER now needs to strengthen its capacity to undertake advanced policy analysis and help the Government formulate medium- and long-term economic programs in the context of a transition economy experiencing a natural resources boom.

9. Recently, CER has been charged with developing, in collaboration with other Government agencies, models for making macroeconomic projections and analyzing the impact of economic policies and external shocks on the economy and poverty, which could be used in formulating macroeconomic and structural policies, updating the Medium-Term Expenditure Framework and the Public Investment Program, and preparing the medium-term macroeconomic framework for an annual budget and next national poverty reduction strategy. CER has started work on these models, but does not have sufficient capacity to develop them fully.

³ More information about CER is available at www.cer.az.

10. Multilateral and bilateral development agencies have been providing the Government with a considerable amount of TA aimed at capacity building at MOED and improving the quality of policy analysis at various Government agencies. ADB supported the Macroeconomic Policy Group of MOF under the TA for capacity building at MOF. The IMF provided training in financial programming to the MOF and NBAR staff. The World Bank has been assisting MOED with capacity building for appraisal of public investment projects. The World Bank also developed an oil model and an RMSM-X for Azerbaijan as part of its public expenditure review process.⁴ The European Union is providing TA for capacity building at MOED, which focuses on institutional strengthening of the ministry. However, none of these TA projects aim to build capacity for policy analysis at MOED, a key policymaking agency. Nor do any of them seek to improve coordination of analytical work done at various Government agencies. While the models developed by the World Bank can be helpful in checking sustainability of prevailing economic trends and feasibility of macroeconomic projections, Government officials have not been trained to use and maintain them. Furthermore, these models have been created using Microsoft Excel, which makes comprehending and modifying them relatively difficult.

11. Considering that support for good governance and institutional strengthening is one of the three strategic thrusts of ADB's interim operational strategy for Azerbaijan, the Government has requested ADB's assistance in capacity building at CER (under MOED), particularly in developing the models for economic policy analysis. CER staff has shown a strong interest in the TA and has taken an active part in its preparation.

III. THE TECHNICAL ASSISTANCE

A. Purpose and Output

12. The goal of the TA is to support the Government's efforts to create a policy environment conducive to broad-based, socially equitable, and sustainable economic growth. Its purpose is to help the Government build capacity for economic policy analysis and advice at CER.

13. The expected outputs of the TA are

- (i) models for making macroeconomic projections and analyzing the impact of economic policies and external shocks on the economy and poverty;
- (ii) enhanced skills of CER staff and government officials to carry out economic policy analysis;
- (iii) quarterly economic reviews in Azeri and English, analyzing prevailing economic trends and short- and medium-term macroeconomic projections; and
- (iv) policy notes and papers on specific economic issues of particular importance to the country.

B. Methodology and Key Activities

14. The goal and purpose of the TA will be pursued by undertaking the following activities:

⁴ RMSM-X (Revised Minimum Standard Model eXtended) is a tool for economic policy analysis.

- (i) establish an economic modeling group (EMG), consisting of CER staff members and officials of MOED and other relevant government agencies;
- (ii) provide training in economic modeling and policy analysis to CER staff and government officials;
- (iii) conduct economic surveys to collect the data needed for currently unavailable economic modeling and policy analysis; and
- (iv) build a partnership between CER and leading policy think tanks of foreign countries, in particular, by undertaking joint projects.

15. Officials of MOED, MOF, NBAR, State Statistics Committee, and State Oil Fund of Azerbaijan Republic indicated that they would join or support the EMG. To encourage them to do so, CER agreed that, under the TA, the same or equivalent training opportunities would be offered to all group members, irrespective of the agency for which they worked. CER also made a commitment to preserve the EMG and maintain the economic models developed under the TA after its completion. The TA is therefore expected to strengthen capacity for policy analysis at several government agencies and improve coordination of analytical work done at these agencies.

16. To avoid duplication and overstretching of the Government's absorptive capacity, the TA has been designed in consultation with other development agencies that are providing related technical assistance to the Government. The TA takes into account lessons learned from other capacity-building TAs—most notably, that, for a TA to be successful and sustainable, strong government ownership and greater focus on training of government officials are needed. The TA also builds on and complements other capacity-building TAs. In particular, it will harness the basic oil-augmented RMSM-X of Azerbaijan and the economic database developed under the ADB-financed TA for capacity building at MOF.

C. Cost and Financing

17. The total cost of the TA is estimated at \$750,000 equivalent, comprising a foreign exchange component of \$420,000 and a local currency component of \$330,000 equivalent. ADB will provide \$600,000 to cover the entire foreign exchange cost and \$180,000 equivalent of the local currency cost. The TA will be financed on a grant basis by ADB's TA funding program. The Government will cover \$150,000 equivalent of local currency cost in kind by providing counterpart staff, office space, conference rooms, training facilities, and local transport. Detailed cost estimates are in Appendix 2.

D. Implementation Arrangements

18. The TA will be implemented over 24 months, from March 2005 to March 2007. MOED will be the Executing Agency for the TA, with CER responsible for its day-to-day implementation. MOED will appoint a part-time project director, who will supervise the project implementation on behalf of the Government and ensure timely provision of the Government's inputs to the project. In addition, MOED will take the lead in establishing the EMG. CER will coordinate the work of the EMG and set up a team responsible for preparing and publishing quarterly economic reviews. ADB will make its Advance Payment Facility available to MOED, as needed.

19. The services of two international consultants for a total of 10 person-months and of one domestic consultant (project coordinator) for 24 person-months will be required to implement the project. An international expert in economic modeling (5 person-months) will train EMG members in economic modeling and help them develop models for economic policy analysis. An international expert in policy analysis (5 person-months) will train CER staff and government officials in policy analysis and help CER prepare quarterly economic reviews. Both international consultants will work intermittently, in accordance with the work plans agreed on with MOED and ADB at the beginning of their services. The project coordinator (24 person-months) will be responsible for day-to-day management of the project under the supervision of the project director and the ADB project officer and provide administrative support to the international consultants. The consultants will be engaged by ADB as individuals, in accordance with the *Guidelines on the Use of Consultants by Asian Development Bank and Its Borrowers* and other arrangements satisfactory to ADB for the engagement of domestic consultants. The consultants will follow ADB's *Guidelines for Procurement* to purchase equipment and software. The outline terms of reference for the consultants are in Appendix 3.

20. Outputs of the TA will be widely disseminated. In particular, the economic models developed and the policy notes and papers prepared under the TA will be made available to all government agencies with economic policymaking responsibilities. The quarterly economic reviews published by CER will be provided to government agencies free of charge and sold to the public in conformity with Azerbaijan's existing legislation. Reports prepared by consultants engaged under the TA as well as the evaluation of its outcomes will be disseminated within the Government and ADB.

IV. THE PRESIDENT'S DECISION

21. The President, acting under the authority delegated by the Board, has approved the provision of technical assistance not exceeding the equivalent of \$600,000 on a grant basis to the Government of Azerbaijan for Capacity Building at the Ministry of Economic Development, and hereby reports this action to the Board.

TECHNICAL ASSISTANCE FRAMEWORK

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
Goal A policy environment more conducive to broad-based, socially equitable, and sustainable economic growth	Increases in Azerbaijan's ratings for performance-based allocation of Asian Development Fund resources	ADB staff's assessment of Azerbaijan's performance for performance-based allocation of Asian Development Fund resources	
Purpose Enhanced capacity for economic policy analysis and advice of the Center of Economic Reforms (CER) of the Ministry of Economic Development (MOED)	Substantial contributions from CER to update of Medium-Term Expenditure Framework and Public Investment Program and preparation of medium-term macroeconomic framework for an annual budget and next national poverty reduction strategy	CER's annual reports	Assumption: CER will play an increasingly important role in economic policy analysis and formulation in Azerbaijan.
Outputs Models for making macroeconomic projections and analyzing impact of economic policies and external shocks on the economy and poverty Enhanced skills of the CER staff and government officials to carry out economic policy analysis Quarterly economic reviews in Azeri and English, providing an analysis of prevailing economic trends and short- and medium-term macroeconomic projections Policy notes and papers on specific economic issues of particular importance to the country	The basic oil-augmented RMSM-X of Azerbaijan, created under the technical assistance (TA) for capacity building at the Ministry of Finance will be further developed and at least two more models for economic policy analysis will be developed by the end of TA implementation. By the end of TA implementation, at least five CER staff members and two MOED officials will be able to carry out policy analysis, using the economic models developed under the TA. Eight quarterly economic reviews will be prepared and published during TA implementation. At least 12 policy notes and papers will be prepared during TA implementation.	Reports by consultants CER's annual reports Reports by consultants CER's annual reports The quarterly economic reviews Policy notes and papers	Assumption: CER will use these models effectively in economic policy analysis. Risk: Development of models will take more time than expected and therefore not be completed by the end of TA implementation. Assumption: CER staff members and government officials who will have received training under the TA will stay in public service long enough for the Government to benefit from their enhanced skills Assumption: Preparation of quarterly economic reviews, policy notes, and papers will enhance CER's capacity for policy analysis, and the demand for quarterly economic reviews will be maintained throughout TA implementation.

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TECHNICAL ASSISTANCE FRAMEWORK—Continued

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
Activities Establish an economic modeling group (EMG), consisting of CER staff members and officials of MOED and other relevant government agencies Provide training in economic modeling and policy analysis to CER staff and government officials Conduct surveys to collect data needed for economic modeling and policy analysis but currently unavailable Build a partnership between CER and leading economic policy think tanks of foreign countries	The EMG will be set up within 2 months after the TA starts. About 20 CER staff members and government officials will receive training in economic modeling and policy analysis in Azerbaijan. About 10 CER staff members and government officials will receive training in economic modeling and policy analysis abroad. At least four surveys will be conducted during TA implementation. CER will carry out at least two joint projects with leading economic policy think tanks of foreign countries during TA implementation.	Quarterly progress reports by project coordinator CER's annual reports Quarterly progress reports by project coordinator CER's annual reports Survey reports prepared by CER upon completion of each survey Outputs of the joint projects CER's annual report	Risk: Not all relevant government agencies will join and/or support EMG, thereby rendering it less effective. Risk: CER staff members and government officials will not be able to devote adequate time to training because of their heavy workload. Assumption: Surveys will be designed and conducted properly. Assumption: Leading economic policy think tanks of foreign countries will be willing to collaborate with CER.
Inputs Government contribution: office space, conference rooms, training facilities, and local transport Working hours of government officials Data and information required to develop tools for policy analysis and preparation of quarterly economic reviews ADB contribution: ADB staff resources for TA administration	CER will provide a furnished office to EMG and make conference rooms, training facilities, and local transport available for TA activities, as needed. 60 person-months Timely provision of data and information to CER by various government agencies 1.5 person months	Reports by consultants Performance evaluation review of the ADB staff member responsible for TA administration	Assumption: Government will provide all its inputs and will do so on time. Assumption: ADB staff will administer the TA effectively.

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TECHNICAL ASSISTANCE FRAMEWORK—Continued

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
International consultancy	10 person-months, including 8 person-months in the field	Reports by consultants ADB's TA performance report system and TA information system	Risk: Consultants engaged by ADB will not carry out their assignments satisfactorily.
Domestic consultancy	24 person-months		
Financing of training CER staff members and government officials	\$90,000		
Financing of economic surveys and preparation of quarterly economic reviews and policy papers	\$52,000		
Purchase of equipment and software needed for economic modeling	\$50,000		

COST ESTIMATES AND FINANCING PLAN
(\$'000)

Item	Foreign Exchange	Local Currency	Total Cost
A. Asian Development Bank (ADB) Financing^a			
1. Consultants			
a. Remuneration and Per Diem			
i. International Consultants	223.6	0.0	223.6
ii. Domestic Consultants	0.0	36.0	36.0
b. International and Local Travel	30.0	5.0	35.0
c. Reports and Communications	0.0	16.0	16.0
2. Equipment ^b	15.0	35.0	50.0
3. Training, Seminars, and Conferences	75.0	15.0	90.0
4. Studies, Surveys and Reports	10.0	42.0	52.0
5. Miscellaneous Administration and Support Costs	3.4	4.0	7.4
6. Contingencies ^c	63.0	27.0	90.0
Subtotal (A)	420.0	180.0	600.0
B. Government Financing^d			
1. Office Accommodation and Transport	0.0	58.0	58.0
2. Remuneration and Per Diem of Counterpart Staff	0.0	72.0	72.0
3. Others	0.0	20.0	20.0
Subtotal (B)	0.0	150.0	150.0
Total	420.0	330.0	750.0

^a Financed by ADB's technical assistance funding program.

^b Includes equipment and software needed for economic modeling. Equipment and software are to be purchased.

^c Includes physical and price contingencies totaling 15% of ADB financing.

^d To be provided in kind.

Source: ADB and Center for Economic Reform estimates.

OUTLINE TERMS OF REFERENCE FOR CONSULTANTS

A. International Expert in Economic Modeling (5 person-months)

1. The international expert in economic modeling will have (i) an advanced degree in economics and/or mathematics; (ii) extensive experience in economic modeling, preferably in transition economies and resource-rich countries; (iii) good knowledge of the RMSM-X and E-views; and (iv) strong interpersonal and training skills. The expert will provide field-office services for a total of 4 person-months and home-office services for a total of 1 person-month. The consultant will carry out the following tasks:

- (i) Develop a work plan and a training program of the economic modeling group (EMG) for the duration of the project.
- (ii) Train EMG members to use and further develop the E-Views-based oil-augmented RMSM-X of Azerbaijan created under ADB-funded technical assistance (TA) for capacity building at the Ministry of Finance.¹
- (iii) Assist EMG members in developing other models for policy analysis, taking into account the Government's needs, availability and quality of data, as well as time and resource constraints.
- (iv) Help the Government update the Medium-Term Expenditure Framework and the Public Investment Program and prepare the medium-term macroeconomic framework for an annual budget and the next national poverty reduction strategy.
- (v) Assist the Center of Economic Reforms (CER) in preparing policy notes and papers, using the economic models developed under the TA.
- (vi) Provide inputs, as required, to quarterly economic reviews to be published by CER.

2. The expert will submit an inception report to ADB and the Government within 1 month after services start. The report will provide (i) the work plan and training program of the EMG; (ii) the expert's detailed work plan, including work in the field and home offices; and (iii) a brief description of the additional models to be developed by the EMG and the rationale for developing them. All of these will need to be prepared in close consultation with members of the EMG and endorsed by the project director. The expert will also submit a progress report following each trip to Azerbaijan and a final report upon completing the entire assignment, including home-office services.

B. International Expert in Policy Analysis (5 person-months)

3. The international expert in policy analysis will have (i) an advanced degree in economics; (ii) technical expertise in economic policy analysis; and (iii) extensive experience in economic policy analysis, preferably in transition economies and resource-rich countries. Knowledge of the Azeri language would be an advantage. The expert will provide field-office

¹ RMSM-X (Revised Minimum Standard Model eXtended) is a tool for economic policy analysis. EViews is a software package for the estimation and simulation of economic models.

services for a total of 4 person-months and home-office services for a total of 1 person-month and will carry out the following tasks:

- (i) Assess CER's needs for capacity building in economic policy analysis, including the priorities that need to be addressed under the TA.
- (ii) Develop a training program for CER staff members and government officials involved in TA activities.
- (iii) Help CER prepare quarterly economic reviews in Azeri and English, providing an analysis of prevailing economic trends and short- and medium-term macroeconomic projections.
- (iv) Help CER design economic surveys to collect data needed for economic modeling and policy analysis but currently unavailable.
- (v) Help CER prepare policy notes and papers on specific economic issues of particular importance to the country.
- (vi) Help the Government update the Medium-Term Expenditure Framework and the Public Investment Program and prepare the medium-term macroeconomic framework for an annual budget and the next national poverty reduction strategy.
- (vii) Advise senior government officials on matters of macroeconomic policies and structural reforms, as required.
- (viii) Provide inputs, as required, to the economic models to be developed by the EMG.

4. The expert will submit an inception report to ADB and the Government within 1 month after services start. The report will provide (i) the assessment of CER's needs for capacity building; (ii) the training program for CER staff members and government officials involved in TA activities; (iii) the expert's detailed work plan, including work in the field office and home office; and (iv) the framework for quarterly economic reviews. All of these will need to be developed in close consultation with CER staff and endorsed by the project director. The expert will also submit a progress report following each trip to Azerbaijan and the final report upon completing the entire assignment, including home-office services.

C. Domestic Project Coordinator (24 person-months)

5. The domestic project coordinator will have (i) a degree in economics, preferably at the graduate level; (ii) a minimum of 5 years of work experience in project administration or a similar job; and (iii) good oral and written communication skills in both Azeri and English. Familiarity with economic modeling and policy analysis will be an advantage. The project coordinator will be based at CER for the entire duration of the project and will carry out the following tasks:

- (i) Be responsible for day-to-day management of the project under supervision of the project director and the ADB project officer.
- (ii) Provide administrative support to international consultants engaged by ADB under the project.

- (iii) Help CER establish links with leading policy think tanks of foreign countries.
- (iv) Help government officials involved in the project arrange training abroad and internships at economic think tanks and policymaking agencies of foreign countries.
- (v) Provide interpretation and translation services for project-related activities, as needed.
- (vi) Request cash advances from ADB and cover project-related expenses in accordance with ADB's rules and procedures.
- (vii) Arrange to procure equipment, software, and training materials needed for project activities.
- (viii) Manage the EMG's office, including maintenance of office equipment and provision of office supplies.

6. The project coordinator will submit quarterly progress reports to ADB and the Government, describing progress made in project implementation during the previous quarter and major project activities planned for the following quarter. Upon completion of the project, the project coordinator will also submit a final report providing a comprehensive assessment of the accomplishments of the project and results achieved in meeting its purpose.