

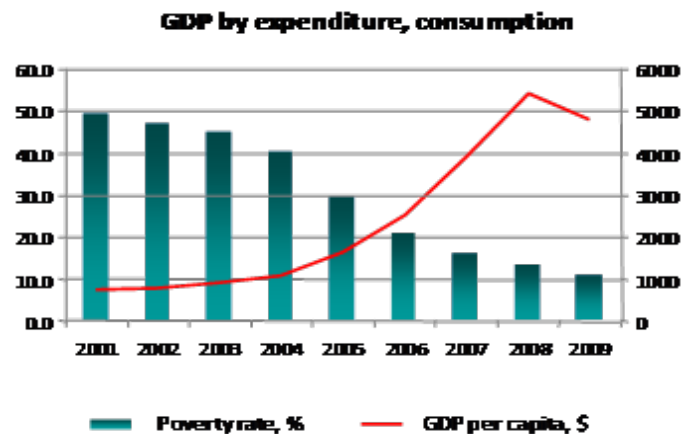
Diagnostic Facility for Shared Growth (DFSG) Fifth Call for Proposals Application Form

Title of the Proposed Study:	Azerbaijan: The Challenge of Inclusive Growth in a Resource Rich Economy
Country:	Azerbaijan
Proposed Start Date:	April 1, 2011
Proposed End Date:	December 31, 2011
Total Amount Requested:	US\$ 75,000
Request for Cross Support:	
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Trust Fund Certified (Yes/No):	Yes

Azerbaijan: The Challenge of Inclusive Growth in a Resource Rich Economy

1. Background

Azerbaijan has experienced unprecedented growth and rapid reduction in poverty within the last decade. GDP grew by 18.2 percent on average between 2003 and 2009. As a result, per capita income has risen from \$1268 in 2003 to \$3459 in 2009 (constant 2005 dollars). The rate of population under the poverty line decreased from 49 percent in 2003 to 15.8 percent in 2008. This achievement is impressive; however, the transmission mechanisms between GDP growth and poverty alleviation and sustainability of these mechanisms are far from obvious.



There are two major effects shaping the inclusive growth in opposite directions in Azerbaijan. On one hand, increasing oil-dependence of the economy undermines the prospects of productive employment in non-oil sectors. On the other hand, increasing oil revenues raise the average wages, and enable significant social transfers. GDP growth was

driven mainly by the boom in the oil sector, which grew by 27 percent on average between 2003 and 2009. Non-oil sectors, on the other hand, grew by 11.3 percent on average, where the main determinants of this growth were growing construction and services sectors (20.5 percent and 11.4 percent on average, respectively). Agriculture sector grew only by 4.5 percent on average within the same interval.

Azerbaijan's medium term challenge is to foster non-oil sector growth if it wishes to continue to increase on the income-ladder and become a successful upper middle income country. The sustainability in the area of poverty reduction might also hinge on this success—in particular if this achievement was “purchased” through transfer and wage-inflation rather than by enhancing the country's human capital and providing opportunities for its utilization.

2. Objective

The proposed study will shed light on how oil-dependent growth, which usually does not have a large impact on employment, facilitated significant gains in poverty reduction in Azerbaijan within a short period of time. It will also investigate the sustainability of this process. Pro-active government policies including increasing the minimum wage, transfers to households and pensions, all of which are made possible by growing oil revenues, seemed to work in reducing the number of people below the poverty line significantly. However, in the absence of a rigorous analysis that explicitly elaborates the transmission channels between oil dependent growth and poverty reduction, it is not easy to estimate the sustainability of this poverty alleviation strategy.

Therefore, this study will:

Rigorously document the sources of growth and detail the determinants of poverty reduction in Azerbaijan in comparison with other resource rich country experiences, looking not only at GDP data by sector, but also at official data on SME, the manufacturing survey and export performance,

Identify the channels of transmission with a special emphasis on (a) fiscal spending based on oil revenues, (b) Dynamics of non-oil growth including non-oil exports and SME development in urban and rural areas, and (c) the impact of labor and transfer income on the improvement of household's living conditions (by examining household surveys).

Develop policy implications for a better inclusive growth strategy in resource rich economies. Specifically, identify feasible policy mechanisms that have two key characteristics: a strong negative correlation between economic growth rate and poverty rate during economic expansion, and a weak correlation between the two rates during economic downturn in resource rich economies.

3. Consistency with DFSG Objectives

This study will employ inclusive growth framework to investigate the sustainability of fiscal policy oriented poverty alleviation mechanisms applied in Azerbaijan. Specifically, the study

aims to elaborate the pace and pattern of growth in Azerbaijan economy. Going beyond what the aggregate data shows, we will use the following focal points to understand better how the oil dependence and inclusive growth could coexist in Azerbaijan:

- Market driven sources of economic growth, specifically dynamic adjustment in SME's and non-oil exports,
- Changes in productivity and productive employment in non-oil sectors,
- Financial transfer dependence of household wealth, *i.e.* through additional employment or as a result of direct transfers,
- Dynamic changes in market structure and innovation.

4. Technical Soundness and Originality

The proposed study will build on a body of analytical work in diversification and employ both macroeconomic and microeconomic indicators. The following components will use a variety of data sources including Labor Force Survey (LFS) and Living Standards Measurement Study (LSMS):

1st Component: Growth Analytics: A detailed growth decomposition in non-oil sectors that aims to elaborate the sources of growth and employment will be conducted. A special emphasis will be on the impact of incentives generated through the fiscal system on value added and creation of additional employment.

2nd Component: Export Diagnostics: Given the small country size and the fact that oil sector is not successful in creating jobs, non-oil exports are the most obvious source of inclusive growth in the medium run. This component will use a product level non-oil export data to measure the constraints and opportunities in extensive and intensive margins. Literature points to short-lived exporting relationship between developing countries and destination markets as the major limitation against diversification. This study will investigate the Azerbaijan exports in a dynamic way to verify or reject this statement for Azerbaijan.

3rd Component: Analysis of Labor Market: A detailed analysis will provide the marginal impact of social transfers on the labor market of Azerbaijan. Specifically, the impacts of rising minimum wages, real wages and transfers to households on informality and low productivity jobs will be investigated.

5. Relevance to Country Priorities

Azerbaijan's vision is to move toward a diversified, globally integrated market economy based on a sustainable non-oil sector, with an emphasis on non-oil exports. This was first outlined in the State Program for Poverty Reduction and Economic Development (SPPRED) 2003-05. Recently, this vision was proven to be reinforced by the two year Joint Economic Research Program (JERP) agreed between The Bank, Central Bank of Azerbaijan and Finance Ministry of Azerbaijan (2011). Similarly, the Country Economic Memorandum (CEM-2008) highlights the diversification and productivity priorities for Azerbaijan. The proposed study will

complement the JERP and CEM by bringing the sustainability and methodology of inclusive growth at the center of policy dialogue.

6. Knowledge Sharing

The proposed study will be disseminated in several channels that have already been established by ongoing cooperation in economic research between The Bank and the Government of Azerbaijan. A workshop will be organized to discuss the preliminary findings of the two components. Participation of stakeholders and participants from other Bank regions will enable the team to gather alternative inputs. The final reports will be of key importance in providing significant inputs to the High Level Forum planned to be organized by the Azerbaijan Government in cooperation with The Bank. Finally, the completed reports will be major contributions to the publication planned for JERP studies.

7. Client and Donor Engagement

Economic diversification is already a major concern for many constituents of the client. In this regard, this work is proposed to complement a fee-based study requested by the Central Bank of Azerbaijan to the Bank (and supported by the Minister of Finance) on broad economic diversification—but where the issue of inclusive growth is not planned to be included. This way, the vehicles for client engagement will be those of the fee for service—co-preparation, roundtables, and possible presentation at the in-country Presidential Forum. The team will also make sure that relevant donors be involved

Budget

	FY 2010	FY 2011	FY10&11	FY10&11
Activity / Category	DFSG	DFSG	DFSG Sub-Totals	Other (BB, TF, donors)
Activity				
- Consultants	\$20,000	\$20,000	\$40,000	
- Travel	\$10,000	\$10,000	\$20,000	
- Media & Workshops		\$5,000	\$5,000	
- Other (Roundtable)		\$10,000	\$10,000	
Sub-Totals	\$30,000	\$45,000	\$75,000	