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**Economic and trade relations between Azerbaijan and the EU**

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**Declaration:**

I hereby declare that I am the sole author of the thesis entitled “Economic and Trade Relations Between Azerbaijan and the EU“. I duly marked out all quotations. The used literature and sources are stated in the attached list of references.

**In Prague on 08 September 2011**

.....  
**Maya Goryashenko**

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## Introduction

In today's world of continuous globalization and deep interdependence among states in terms of information exchange, production-related operations and logistics issues, going deeper into the realm of politics and applicable international and domestic legal framework - foreign trade and economic cooperation are obviously the two central factors of growth and ongoing development of the economy. International trade, being the medium of exchange of technologies, innovations, production-flow solutions and intangibles alike the mentioned ones, allow developing countries to acquire technology from developed ones in order to enhance their productivity and improve their product mix, thus let them better compete with new counterparts.

The strategic location of Azerbaijan between Europe and Asia on the "Great Silk-Road" on the shore of the Caspian Sea, at the crossroad between Western Asia and Eastern Europe and strong position in the Caucasus with the remarkable natural resources, attracts the attention of EU member-states and yields a good incentive to develop and deepen economic cooperation in a number of spheres from production and logistics to research and development.

The relations between the EU and Azerbaijan commenced their development during the period of the last two decades, after the moment when Azerbaijan gained its independence in 1991. The formal beginning of relations with the EU commenced when Azerbaijan signed the first Partnership and Cooperation Agreement with the European Union in 1996<sup>1</sup>.

Azerbaijan enlarged its participation in cooperation with the EU by joining the Council of Europe on January 25, 2001. The country has been intensively involved in its activities and has ratified 50 treaties. Later in 2004, Azerbaijan was enrolled in the European Neighborhood Policy (ENP). The main ideas comprise of the country's transition into a market economy; the realization of economic, political and administrative reforms,

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<sup>1</sup> European Commission External Relations: Azerbaijan: EU-Azerbaijan Partnership and Cooperation Agreement (PCA) signed in 1996 and entered into force in 1999:  
[http://ec.europa.eu/external\\_relations/azerbaijan/index\\_en.htm](http://ec.europa.eu/external_relations/azerbaijan/index_en.htm)

possibilities to invest in the infrastructure of the country; partial integration into the European economy and the further plans of the EU to benefit from its natural resources.

Azerbaijan and the EU share similar opinions on many policies and are currently working together to align their interests and goals particularly in the competitive energy sector.

The EU, being one of the key world players, can positively influence the country's integration into the world economy, its modernization and development. It may further improve the quality of life in the country and its citizens, strengthen its democracy, competitiveness and play a role in the peaceful resolution of the Nagorno-Karabakh conflict.

Besides that, the benefits of international trade have been proved by the theory of competitive advantage of David Ricardo in 1917. According to which the countries should specialize in producing and exporting those products from which they gain a competitive advantage and this will have a large effect on both production and exports.

During the last few decades after signing contracts with leading European and American companies and the construction of Baku-Tbilisi-Ceyhan pipeline which brings oil from the shelf of the Caspian to the Mediterranean Sea, Azerbaijan has become more dependent on its exports. Oil and natural gas constitute over 90% of the country's exports<sup>2</sup>.

On one side, the country's high level of oil revenues improves general living standards and increases foreign currency reserves; while inversely, it can bring high inflation and cause decline in other industries. In fact, some developing countries which are not endowed with natural resources show better results than those rich in oil, for example. These symptoms are historically known as the 'resource curse', or 'Dutch disease.' This term was first used by Richard Auty who provided analysis, showing resource rich countries performed worse than resource-poor ones.<sup>3</sup>

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<sup>2</sup> www.cia.gov World Factbook .Country: Azerbaijan

<sup>3</sup> Richard M. Auty, "Sustaining Development in Mineral Economies: The Resource Curse Thesis", London: Routhledge,1993

Taking into account all these factors, my thesis is devoted to the economic interaction between Azerbaijan and the EU, including Azerbaijan's main opportunities for trade, the country's obstacles and their future possible improvement.

The thesis proceeds as follows: in the first chapter I focus on the historical development of the country and main lines. Later, its recent macroeconomic outlook, achievements and economic performance will be described. In the second chapter, an analysis of relations between the EU and Azerbaijan is provided outlining its trade flows. Later trade policies of both parties are examined. In addition, I will also stress the importance of the country's accession to the WTO. The final chapter will delve into the possibilities and obstacles of further development of relations between Azerbaijan and the EU, finishing with a SWOT analysis. Using this marketing tool, I have tried to evaluate current aspects and future possible areas from different perspectives.

After the collapse of USSR, the former centrally-planned economic system of the country had become ineffective and the country had to adjust, replace and upgrade its capabilities. New technology and skills were also required. The country could upgrade its systems by importing Western technologies and successful practices and by reaching for external help and financial support.

Observing the latest political conflicts and instability in the large oil and gas-exporting countries in North Africa and the Middle East and the reliance of the EU on Russian gas, the case of Nabucco pipeline which represents a combination of geopolitical and commercial dilemmas is very interesting to study.

Finally, the thesis finishes with conclusion and summary of main findings.



## **1 The Economy of Azerbaijan**

### **1.1 History of Development, Analysis and Main Themes**

This chapter is organized into two parts; the first one highlights the history of the socio-economic development of Azerbaijan and the process of its formation when the country faced a new stage of independence after decades under the Soviet regime. The second portion provides an analysis of the macroeconomic outlook and latest economic achievements.

The Republic of Azerbaijan, formally Azerbaijan is located in the southern part of the Caucasus in Eurasia on the western shore of the Caspian Sea. The country borders the Russian Federation to the North, the Islamic Republic of Iran to the South, and the Georgian Republic to the East. A small enclave of the Nachchivan Autonomous Republic is located between Armenia and Iran, and has a small border with Turkey.

The country became independent from the Soviet Union in 1991. Its population is estimated at 8,372,371 (July 2011) and territory at 86.600 square km<sup>4</sup>.

Years of Soviet rule and a centrally planned economy created many disproportions in both economic and other spheres of development. During those times, a significant part of exports and imports was intended for other Soviet republics, mainly Russia. The collapse of the USSR followed by political instability was accompanied by a large economic slowdown, and the country lost its major trade partners which had a negative impact on production and national output.

It is interesting to note, that after the dissolution of Soviet Union, the country's concern was to preserve its national borders and resolve ethnic and political conflicts. One of the reasons was its location among the strong powerful neighbors, namely Russia, Iran and Turkey that wanted to keep control over the new market. These partially explains why for Azerbaijan political stability was one of the questions of a great importance. The country's first two consecutive governments have failed to stabilize the economy. The

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<sup>4</sup> [www.cia/the-world-factbook/org](http://www.cia/the-world-factbook/org) Country profile: Azerbaijan

new president Heydar Aliyev came to power in 1993 and started the country's gradual reformation through effective political and economic tools and assistance of Bretton Wood institutions.

From an economic point of view, the period after the independence can be divided into two main phases. The first period of 1991-1995 was characterized by economic recession and instability. The second after 1996 is a period of an increase in macroeconomic stability and fast economic development. The country entered a period of transition to a market-based economy with the Law on Basic Economic Development. This initial reform was based on price liberalization and resulted in hyperinflation.<sup>5</sup> The price of consumer goods increased in 1991 by 2.07 times against figures of 1990, and was growing several times every year (10.12% in 1992, 12.3% in 1993 and 17.63% in 1994)<sup>6</sup>.

In 1992, the performance of the country's economy declined by 31.2% in national income compared to the previous year. Industrial production dropped by 34.3%, consumer goods production by 26.8% and food production by 26.8%.<sup>7</sup> For four years as of 1991, the actual salaries of population reduced by 5.7%. Moreover, the government pursued ineffective monetary and fiscal policies, which were followed by a budget deficit, a drop in real incomes and reduction of foreign reserves.<sup>8</sup>

As a result of above mentioned crisis, the country went through a large-scale socio-economic downturn. As shown in Chart 1 below, real GDP declined until 1996, posting continuous growth during the next several years and reached double-digit rates in 1998. This growth was mainly reached by successful measures of political, fiscal and economic stabilization reforms which will be described later. In addition, oil production increased followed by development in the construction and service sector.

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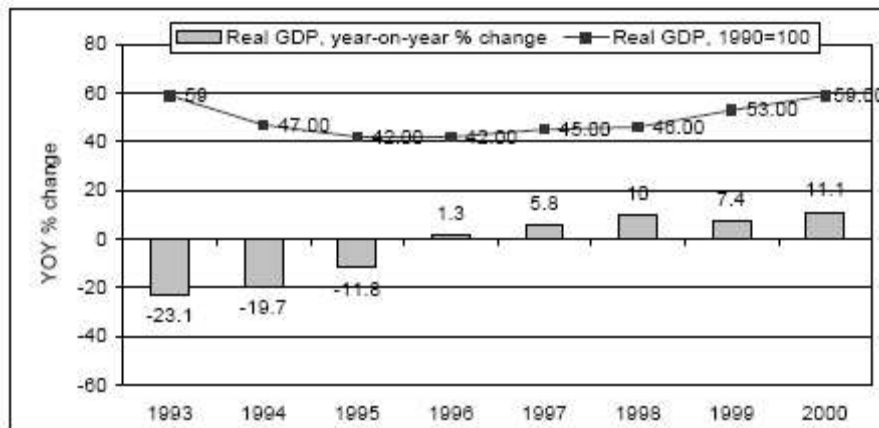
<sup>5</sup> J. Laurila, "Power of Politics and Oil as Determinants of Transition: the case of Azerbaijan." Bank of Finland. Institute of Economics in Transition 1999, p. 22, 50

<sup>6</sup> Azerbaijan Trade and Trade facilitation Review .ADB Governance, Finance and Trade Division. East and Central Asia Department .2003

<sup>7</sup> Economist Intelligence Unit. Azerbaijan country report. 1993, p. 40

<sup>8</sup> Azerbaijan. Trade and Trade Facilitation Review. Governance, Finance and Trade Division. East and Central Asia Department. 2003

**Chart 1. Real GDP, 1993-2000**



Source: ASSC, Economic Trends Quarterly Issue, Azerbaijan July-September 2001

In 1995, the Azerbaijani government started a stabilization program, in cooperation with the IMF, the World Bank and EBRD. Under the supervision of IMF the following reforms took place<sup>9</sup>:

- Firstly, the exchange rate was unified. Domestic and foreign trade regimes were liberalized. Import licensing requirements and quantity restrictions except for certain sensitive goods such as works of art, weapons, explosives and drugs, have been abolished. Previously the Ministry of Trade has had a monopoly on most trade operations. Foreign exchange operations were controlled and hard currency was hard to come by. Prices were dictated and regulated by the state. Local organizations and state individual enterprises were permitted to conduct limited trade with non-Soviet States. Additionally, movement of goods and capital was limited and fed a large black market.
- Secondly, privatization began with the adoption of “The State Program of State Property in Azerbaijan, 1995-1998”. To be able to take part in privatization process, the privatization checks were distributed to every citizen of Azerbaijan, who was born before January 1<sup>st</sup>, 1997. Within ten months about 95 percent of the population had received vouchers and a system of vouchers auctions was put in

<sup>9</sup> IMF, “Azerbaijan Republic: Recent Economic Developments”, Staff Country Report No 98/93, August 1998, pg.21-22

place but later resulted in the creation of secondary markets where people sold them for a lower price. By the end of 1997 around 450 medium enterprises were privatized through voucher auction. In addition to privatization, more than 1300 small enterprises were sold by April 1998.

- Finally, the Parliament adopted a new “Law on Land Reform.” More than 28,000 private farmers registered as legal entities, which was previously impossible as land was state-owned. This led to an increase of employment in the agricultural sector which is the second largest export sector with wheat being a major crop.<sup>10</sup> Kolkhozes and sovkhoses were transformed into farms. Owing to this, primary food products such as meat, dairy, potatoes and others were produced domestically instead of importing them from neighboring countries.

These reforms led to a reduction in domestic inflation to 84.5 % in 1995, to 4% in 1997 and deflation rate of 0,8 % in 1998. Additionally in late 1994 the country signed a number of PCA (production sharing agreements) with foreign companies. These agreements allowed the companies to develop hydrocarbon deposits in the Caspian Sea and increased a number of FDI flowing in the energy sector. A new pipeline Baku-Tbilisi-Ceyhan was constructed with financial assistance from foreign investors with the biggest being British Petroleum.

It should be noted that in the period of 1991-1994 the country was burdened with a military conflict with neighboring Armenia. By May 1994, when a ceasefire agreement initiated by the Minsk group took place, Armenian forces held not only Nagorno-Karabakh, but also seven surrounding territories of Azerbaijan.<sup>11</sup> The major population of the territory was historically Armenian, but Nagorno-Karabakh is actually a part of Azerbaijan under International law. The conflict resulted in the deaths of more than 30,000 people and created over 1 million refugees and Internally Displaced Persons on both sides. Over 20% of Azerbaijan's territory remains under Armenian occupation.

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<sup>10</sup> IMF, “AR: Recent Economic Developments”, Staff Country Report No 98/93, 1998, p.21

<sup>11</sup> Cia/the-world/Factbook. country profile :Azerbaijan

Despite the cease-fire, large numbers of incidents along the “line of contact” take place every year.<sup>12</sup>

Although numerous dialogues between the presidents of both sides together with international authorities have taken place since then, the peaceful resolution of the conflict has not been achieved to date.

These territories historically and economically were responsible for an insignificant part of the GDP and their loss did not deprive the country from its share in domestic output. However, considering the agricultural potential of the lost lands and expenses to support the refugees (for example, housing), government expenditures have increased and reduced the potential use of the tourism service sector, since most of the recreational summer camps buildings are used to house these displaced persons, and therefore reduce potential GDP.<sup>13</sup> Even though most of the refugees and IDPs are able to work, they do not have permanent places of residence and jobs. They earn their living by random incomes and insufficient governmental allowances.

## **1.2 Macro-economic outlook and recent economic achievements**

After the stabilization reforms described in the previous chapter, Azerbaijan has entered a new phase of its development. Following the construction of oil and gas pipelines, their exports have largely increased and this sector has changed from manufacturing to service provision and exploitation. Previously all the exports pipelines were operating through Russia. In order to lessen the country’s dependence on Russian routes, the government has taken a strategic decision to diversify export of energy resources through alternative routes.

Presently, Azerbaijan has seven pipelines through which oil and gas are delivered to different destinations. Azerbaijani oil is exported via oil pipelines to the Black Sea and the Mediterranean Sea. Natural gas is supplied via Georgia, Russia and Turkey. Baku-

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<sup>12</sup> Commission of European Communities. Azerbaijan Country Report 2005. p.11

<sup>13</sup> J. Laurila, “Power of Politics and Oil as Determinants of Transition: the case of Azerbaijan.” Bank of Finland. Institute of Economics in Transition 1999, p. 50

Tbilisi-Ceyhan (BTC), the country's largest oil pipeline which has delivered 700,000 barrels of oil per day in 2009 and 950,000 in the previous year. The second largest pipeline, Baku-Tbilisi- Erzurum (BTE) which runs parallel to BTC has carried 9.5 bln cubic meters of gas from the Shah Deniz field in 2009.<sup>14</sup>

### Economic and social reforms

In 1999 Azerbaijani Government with support of IMF and World Bank has taken a decision to establish a State Oil Fund (SOFAR), for the reason of management of substantial receipts from the oil sector. This fund was a new institution in the country's history due to the fact that Azerbaijan didn't previously have a practice in supervision of large profits coming within such a short time. SOFAR has partially financed construction of the BTC gas pipeline with 298 mio AZN directed towards Azerbaijani share, allocated 24.4 mio AZN for financing "The state program on the education of Azerbaijani youth abroad in the years 2007-2015", helped to settle the problems of refugees and IDPs and other infrastructural projects. Current assets of the fund are estimated at 30 357.5 mio AZN.<sup>15</sup>

Large energy cash flows allowed the country to continue modernization programs which had positive impact on poverty reduction. The national poverty level decreased from 44.7% in 2003 to 11% in 2009. This was due to several reasons:

1. higher minimum wage (it was increased from 75 to 90 AZN);
2. higher average wage reaching 274 AZN per month in 2008;
3. increase of social securities payments. For example, pensions have augmented from AZN 14 in 2002 to AZN 75 2008;
4. remittances from abroad increased 10-fold in nominal dollar terms since 2001, reaching approximately \$1.2 billion in 2008.<sup>16</sup>

### Macroeconomic development

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<sup>14</sup> 2009 Investment climate Statement –Azerbaijan .Bureau of economic ,energy and business affairs

<sup>15</sup> State Oil Fund of AR [www.oilfund.az/en](http://www.oilfund.az/en)

<sup>16</sup> Azerbaijan country memorandum .A New Silk Road: Export-led Diversification. Poverty Reduction and Economic Management Unit Europe and Central Asia Region December 2009.Document of the World Bank

The country's macroeconomic position continued to improve during the latest decade. The World Bank considers Azerbaijan as an upper-middle-income country. Its GDP per capita is 4,807 USD. The country experienced a peak in its economic growth in the period of 2008-2009. Its GDP real growth rate was 10.8% in 2008 and 9.3 % in 2009 respectively but slowed in 2010 to 5%<sup>17</sup>. According to the World Bank forecast it is expected to be positive in the following two years at a rate of around 4%<sup>18</sup>.

Positive changes in selected macroeconomic indicators show that the share of services in the structure of economy as a % of GDP has increased from 23.8% in 2008 to 31.8% in 2009. Household final consumption expenditures have boosted to 36.8 % in 2009 from 24.5 % from the year before, with annual 4.5% annual growth<sup>19</sup>. The current account of the country is positive and equals to \$8,798 mio (2009) as seen in the table below. Yet, it is two times smaller than the year before. This is primarily due to the world economic slowdown and low energy prices. The annual average nominal price of crude oil in 2008 was nearly two times higher at 91.48\$ per one barrel compared to 53.48\$ in 2009.<sup>20</sup> The price of natural gas fell to \$4.0/MMBtu from \$8.9 for the same period<sup>21</sup>. This indicates correlation between the country's revenues and volatile prices of energy resources and proves once again the need for diversification of its economy. Up to present Azerbaijan has no borrowings at high interest rates. Hence, gross external debt- private as well as public sector borrowing- have been limited. In 2010, private sector external debt stood at 2 %. Government external debt has consistently been less than 20% of GDP at approximately 4.4% in the same year<sup>22</sup>. Overall public debt (external and internal) was around 14% of GDP. Because the country can cover its financing needs thanks to energy receipts, the principal reasons for undertaking external borrowing are: to implement high priority development projects with the assistance of international financial institutions; for the purpose of help to Azerbaijani companies seeking for access international capital

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<sup>17</sup> Cia.org world fact book. Country-Azerbaijan

<sup>18</sup> Azerbaijan at a glance report. World Bank February 2011

<sup>19</sup> ibid

<sup>20</sup> [www.inflationdata.com](http://www.inflationdata.com)

<sup>21</sup> [www.forecastchart.com](http://www.forecastchart.com)

<sup>22</sup> Black Sea Trade and Development bank. Azerbaijan Country Strategy 2011-2014 at [http://www.bstadb.org/about-us/key-documents/Country\\_Strategy\\_2011-2014\\_Azerbaijan.pdf](http://www.bstadb.org/about-us/key-documents/Country_Strategy_2011-2014_Azerbaijan.pdf)

markets and for promotion of development in such areas of financial sector as secondary markets, pension schemes and insurance.<sup>23</sup>

**Table 1. Selected economic indicators.**

<b>STRUCTURE of the ECONOMY</b>				
	<b>1989</b>	<b>1999</b>	<b>2008</b>	<b>2009</b>
<i>(% of GDP)</i>				
Agriculture	..	19.2	6.3	8.2
Industry	..	40.7	69.9	60.0
Manufacturing	..	6.3	4.5	..
Services	..	40.1	23.8	31.8
Household final consumption expenditure	..	71.8	24.5	36.7
General gov't final consumption expenditure	..	15.6	10.6	13.7
Imports of goods and services	..	41.9	24.8	24.8
	<b>1989-99</b>	<b>1999-09</b>	<b>2008</b>	<b>2009</b>
<i>(average annual growth)</i>				
Agriculture	-3.9	6.2	6.1	6.0
Industry	-2.7	20.3	10.0	2.5
Manufacturing	-14.1	6.6	7.1	..
Services	-4.7	10.1	13.7	4.5
Household final consumption expenditure	-0.8	12.1	15.4	0.1
General gov't final consumption expenditure	-2.2	18.6	13.6	4.7
Gross capital formation	50.7	19.9	7.7	-8.4
Imports of goods and services	20.1	19.1	13.2	-5.3

Source: World Bank .Azerbaijan at a glance 2011. Available at  
[http://devdata.worldbank.org/AAG/aze\\_aag.pdf](http://devdata.worldbank.org/AAG/aze_aag.pdf)

The factors of dependence of the country revenues on energy resources upon their volatile prices and the EU being a major exporter show another link with the European economic situation. Indeed, we can see in BOP that exports dropped by a much higher amount than the country's imports during the slow economic activity in European markets.

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<sup>23</sup> Ibid



**Table 2.BOP of Azerbaijan for the period of 1999-2009**

<b>BALANCE of PAYMENTS</b>	<b>1989</b>	<b>1999</b>	<b>2008</b>	<b>2009</b>
<i>(US\$ millions)</i>				
Exports of goods and services	..	1,282	32,133	21,875
Imports of goods and services	..	1,919	11,464	10,323
Resource balance	..	-637	20,669	11,551
Net income	..	-45	-5,266	-3,064
Net current transfers	..	82	1,050	310
Current account balance	..	-600	16,454	8,798
Financing items (net)	..	752	-4,404	173
Changes in net reserves	..	-152	-12,050	-8,971

Source: World Bank .Azerbaijan at a glance 2011.Available at  
[http://devdata.worldbank.org/AAG/aze\\_aag.pdf](http://devdata.worldbank.org/AAG/aze_aag.pdf)

### Trade

Azerbaijan's trade presents many opportunities. The country is becoming a regional trade center and a hub for transport of goods between Russia, the Middle East and Central Asia. It imports products from China, such as light manufacturing; from Iran - carpets, fruits, vegetables, foodstuffs; from Turkey - carpets, and clothing. The domestic demand is growing thanks to the increased income of the population and the growing middle class. Improved road infrastructure can potentially reduce transportation costs and in turn possibly increase the total turnover. But, Doing Business reports in the Table 11 of the thesis suggest that other barriers in the business environment, such as trading across borders and paying taxes as well as the cost of security and police protection represent significant challenges.

The trade to GDP ratio in 2010 accounted for 56.3 % with exports being 38.9 % and imports 17.4 % respectively. We can see that exports are two times higher than imports. The large amount of exports is explained by hydrocarbons. Azerbaijan's main trading partner is the EU (27) with 52.6% in exports and 34.1 % value in imports. Azerbaijan's 5 major importers after the EU are: Turkey with 18.1%, Russia with 14.1 %, China with 9.9 %, Ukraine with 6.6 % and the USA with 2.9 % of the total share of imports respectively.

Exporters are US (8.9 %), Russia (4.4%), Switzerland (3.9%), Indonesia (3.9%) and Turkey (3.7%). In the structure of imports the main commodities are machinery and transport equipment (40.6%), manufactured goods (21.6%) and food (13.1%). In exports - mineral fuels, crude material and lubricants (90%).

**Table 3. Structure of imports of Azerbaijan**

№	Sections of commodities	2006	2007	2008	2009	2010
	<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
0	Food and live animals	7.6	11.5	11.4	10.4	13.1
1	Beverages and tobacco	2.1	3.5	3.2	4.1	4.0
2	Crude materials, inedible, except fuels	2.9	2.6	2.9	1.7	2.7
3	Mineral fuels, lubricants and related materials	11.6	2.5	1.6	1.1	1.1
4	Animal and vegetable oils, fats and waxes	0.7	0.8	0.9	1.1	1.3
5	Chemicals and related products	5.8	7.4	8.3	8.1	8.9
6	Manufactured goods	17.2	18.9	16.9	17.4	21.6
7	Machinery and transport equipment	46.2	45.7	47.5	47.4	40.6
8	Miscellaneous manufactured articles	5.8	7.1	7.2	8.6	6.6

Source: Azerbaijan Statistics Committee [www.azstat.org](http://www.azstat.org)

**Table 4 .Azerbaijan main trade partners 2010**

The Major Imports Partners				The Major Export Partners			
Rk	Partners	Mio euro	%	Rk	Partners	Mio euro	%
	<b>World (all countries)</b>	<b>7,137.8</b>	<b>100.0%</b>		<b>World (all countries)</b>	<b>15,953.7</b>	<b>100.0%</b>
1	EU27	2,437.6	34.1%	1	EU27	8,391.8	52.6%
2	Turkey	1,290.9	18.1%	2	United States	1,415.5	8.9%
3	Russia	1,009.6	14.1%	3	Russia	703.7	4.4%
4	China	704.4	9.9%	4	Switzerland	627.5	3.9%
5	Ukraine	470.5	6.6%	5	Indonesia	614.9	3.9%
6	United States	210.5	2.9%	6	Turkey	594.2	3.7%
7	Belarus	125.1	1.8%	7	Thailand	543.3	3.4%
8	Switzerland	115.2	1.6%	8	Ukraine	481.5	3.0%
9	South Korea	88.3	1.2%	9	Canada	407.5	2.6%
10	Israel	79.8	1.1%	10	Georgia	307.2	1.9%
11	Iran	74.1	1.0%	11	Malaysia	304.3	1.9%
12	Japan	71.9	1.0%	12	Croatia	293.2	1.8%

Source: World Bank .Azerbaijan and EU bilateral trade and trade with the world 2011 Available at <http://ec.europa.eu/trade/creating-opportunities/bilateral-relations/regions/south-caucasus/>

According to the regional trade statistics, three major importers are BRIC countries (24.8%), CIS (24.5%) and EU Candidates including FYROM Macedonia, Turkey and Croatia (18.1%). In Exports- NAFTA (11.4%), CIS (10.6 %) and ASEAN (9.2%).

**Table 5 .Azerbaijan main trade partners 2010**

Azerbaijan's imports from			Azerbaijan's Exports to ...			
Partner regions	Mio euro	%	Partner regions	Mio euro	%	
ACP	28.0	0.4%	ACP	0.6	0.0%	
Andean Community	8.8	0.1%	Andean Community	0.1	0.0%	
SEAN	46.2	0.6%	ASEAN	1,466.9	9.2%	
BRIC	1,768.0	24.8%	BRIC	1,023.8	6.4%	
CACM	5.6	0.1%	CACM	0.2	0.0%	
EU Candidate Countries	1,293.5	18.1%	EU Candidate Countries	887.4	5.6%	
CIS	1,749.3	24.5%	CIS	1,683.8	10.6%	
EFTA	132.0	1.8%	EFTA	628.4	3.9%	
Latin American Countries	56.5	0.8%	Latin American Countries	0.5	0.0%	
MEDA (excl EU and Turkey)	85.4	1.2%	MEDA (excl EU and Turkey)	63.5	0.4%	
Mercosur	33.9	0.5%	Mercosur	0.2	0.0%	
NAFTA	234.6	3.3%	NAFTA	1,823.0	11.4%	

Source: World Bank .Azerbaijan and EU bilateral trade and trade with the world. Available at <http://ec.europa.eu/trade/creating-opportunities/bilateral-relations/regions/south-caucasus/>

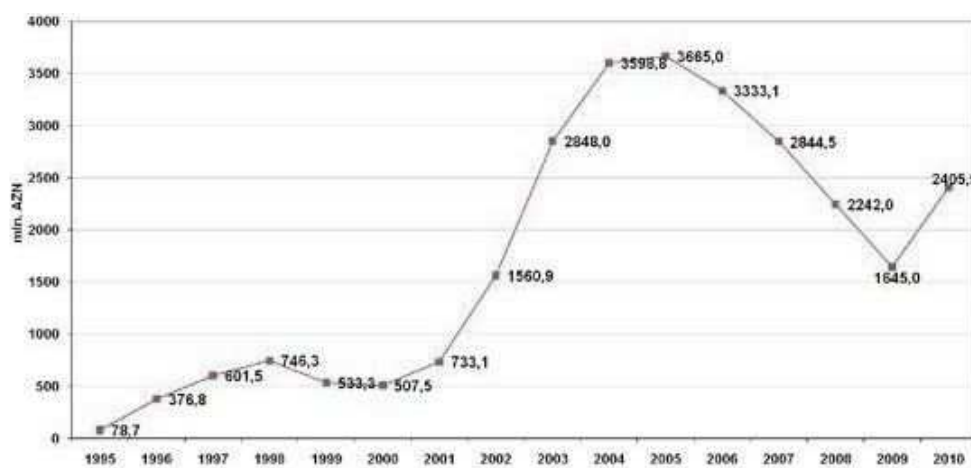
### Foreign Investment

The country has experienced high investment inflows during the period from 2002-2005 followed by a recession in the following years until 2009. But since then their number have started to peak again. Nevertheless the country has made positive changes in attracting investments. The total investments directed to the fixed capital of the country in 2010 amounted to 12.5M AZN. That is 19.2 % higher compared to 2009. In comparison with the previous year the amount directed to fixed capital was 21.2% more. 75.2% or

7309.3M AZN of the total amount were in domestic investments, 24.8% or 2406 mio AZN were in foreign investments<sup>24</sup>. Since 1994 the country has signed 37 bilateral investment agreements. OECD reports that Azerbaijan with USD 1 bln on average per annum is the third largest country in cumulative FDI inflow among the CIS countries after Russia with USD 11bln and Kazakhstan with USD 3 bln during 2000-2006<sup>25</sup>. 65% of them are resource-seeking and directed in the oil and gas sector .They are done through specific Production and Sharing Agreements. Based on this agreement, the state grants an exclusive right to the investor to use the subsoil area for a specific time at a specific price. Meanwhile, the investor conducts these activities at their own risk and makes payments to the state. Outside this sector, the FDI has been low. However, the dynamics of the nonenergy FDI in Azerbaijan largely relates to the development of hydrocarbons. They include the oil services industry, construction and building materials and telecommunications. Traditional manufacturing and agriculture receive little FDI<sup>26</sup>.

Domestic and foreign investments directed to fixed capital are shown below:

**Chart 2. Foreign Investment aimed to Fixed Capital 1995-2010**  
(Mio AZN)



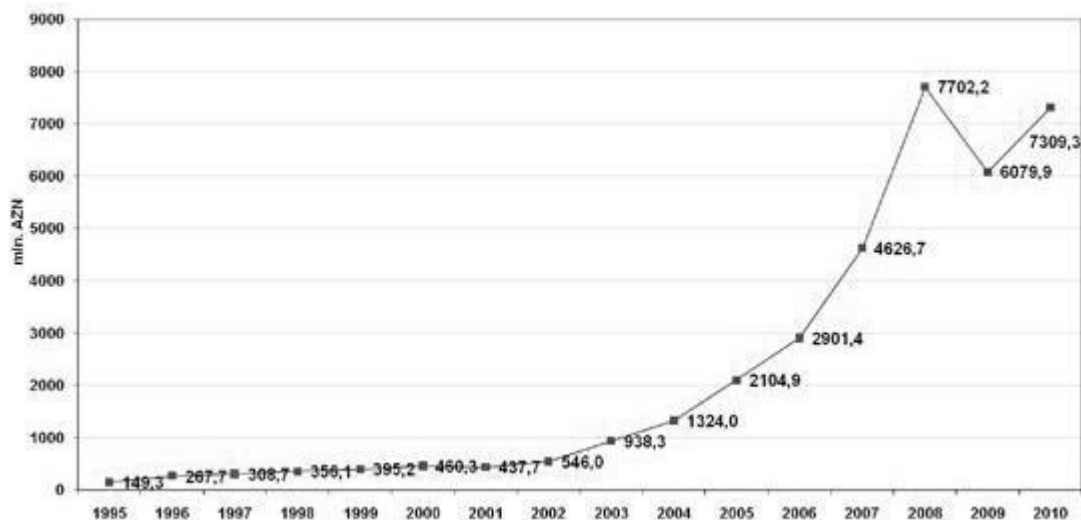
Source: Ministry of Economic Development of Azerbaijan. Available at <http://www.economy.gov.az/eng>

<sup>24</sup> Ministry of economic development of Azerbaijan [www.economy.gov.az](http://www.economy.gov.az)

<sup>25</sup> OECD Global Forum on International Investment. March 2008 The motives and impediments to FDI in the CIS at <http://www.oecd.org/dataoecd/24/52/40401047.pdf>

<sup>26</sup> Investment Climate in Azerbaijan. Country Report UN Economic and Social Commission for Asia and the Pacific.2003

**Chart3.Domestic investment aimed to fixed capital 1995-2010**  
(Mio AZN)



Source: Ministry of Economic Development of Azerbaijan. Available at [www.economy.gov.az](http://www.economy.gov.az)

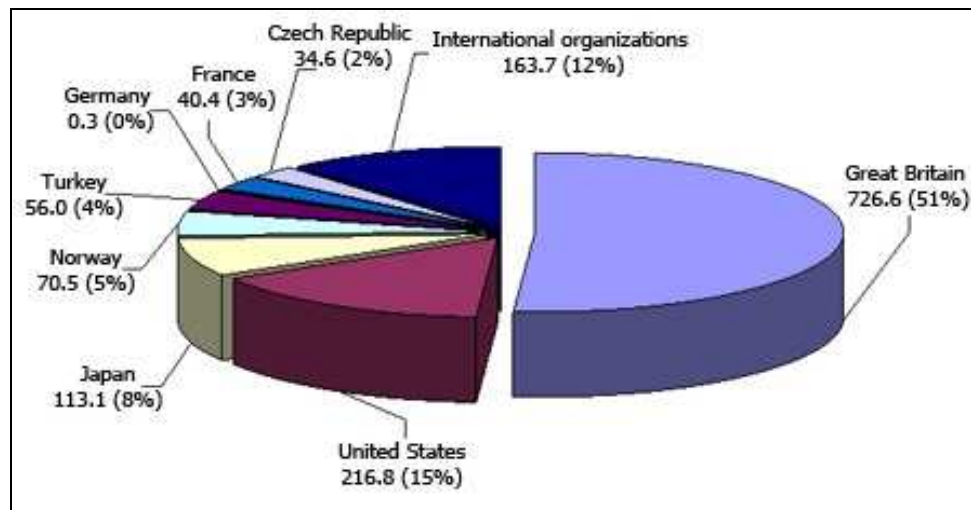
The country's biggest investors are the UK (51%), USA (15%) and international organizations (12%)<sup>27</sup>. In the private sector this improvement was achieved mainly due to of a one-stop-shop business registration which halved the time, cost and number of procedures to open a business. Investment activity is regulated by the law of Azerbaijan 'On investment activity' from 13.01.1995 and other legislative acts and international treaties of Azerbaijan and aims at pursuing economic, scientific-technical and social policy. The country officially welcomes foreign investors by establishing the principle of non-discrimination and includes provisions on investment protection. Nevertheless, investors have to obtain the required legal permissions and licenses<sup>28</sup>.

The government continues to improve the investment climate. These measures include comprehensive anti-corruption measures, simplified tax regime, establishment of the Chamber of Accounts and improved public procurement rules. Besides natural resources, there are other attractive factors such as macroeconomic stability, the widespread availability of a motivated young labor-force and its geographic location.

<sup>27</sup> Ministry of economic Development of Azerbaijan  
[www.economy.gov.az](http://www.economy.gov.az)

<sup>28</sup> The Law of AR on investment activity .13.01.1995

**Chart 4. Foreign investment by country directed to fixed capital 2010 (M AZN)**



Source: Ministry of Economic Development of AR [www.economy.gov.az](http://www.economy.gov.az)

State investments are realized through financial means from the State Oil Fund and State Budget. Oil revenues are often directed to the state expenses projects. The statistics shows that their number has grown over the last several years from 7.5% or 159.9 mio AZN in 2005 to 31.3 % or 1902.2 mio AZN in 2007 of total budget expenses<sup>29</sup>. However, this large growth also reflects the high inflation rate of around 16% in 2007 as a result of high fuel prices. Transportation received the largest portion of 389.5 mio AZN from investment budget which accounts for 1/5 of total state investments. The law-security, in second place, with 11.9% or 227.5 mio AZN followed by the fuel and power engineering sector with 8.14% or 155.9 mio AZN. The following place belongs to the renovation of administrative buildings which have received 7.4% or 142 mio AZN. From the table below we can see that economically important areas such as agriculture, one of the labor intensive sectors as well as education, healthcare, social maintenance receive little state support which creates questions about the rational division of state as well as their actual utilization. Additionally, there is a big difference in territorial distribution of investments. Baku, being the capital and economic leader but with only 3% of all territory has received

<sup>29</sup> Monitoring of budget investments. Public Association for Assistance to Free Economy .Zohrab Ismayil January 2008 available at [www.sources.revenuewatch.org/en](http://www.sources.revenuewatch.org/en)

the largest portion of 55%, the remaining 10 regions received only 17.2 % altogether.<sup>30</sup> Presently in the country, for regulation and realization purposes of state investments, there is no common normative –legal basis and its preparation is postponed every year. This creates a problem of planning state investment allocation, preparation of the State Investment Program and the regulation of the process.

**Table 6. Selective structure of state investments in 2005-2007 (thousands AZN)**

#	Title of sphere	2005	%	2006	%	2007	%
1	Transportation	24540.2	15	86300.0	9.8	389495.0	20.33
2	Law-security system	3395.0	2.1	25620.0	2.9	227417.0	11.87
3	Fuel and power engineering	16540.0	10.1	272500.0	30.9	155891.0	8.14
4	Renovation of adm. buildings	3440.0	2.1	16000.0	1.8	142163.0	7.42
5	Education	6931.8	4.2	36706.0	4.2	94395.0	4.93
6	Health	4060.0	2.5	20518.0	2.3	71040.0	3.71
7	Science	2800.0	1.7	1400.0	0.2	6041.0	0.32
8	Agriculture	886.6	0.5	1892.0	0.2	131148.0	6.85
9	Soc.maintenance	738.8	0.5	1385.0	0.2	6041.0	0.32

Source: Monitoring of budget investments. Public Association for Assistance to Free Economy .Zohrab Ismayil January 2008 available at [www.sources.revenuewatch.org/en](http://www.sources.revenuewatch.org/en)

### Midterm challenges outside the energy sector and regional development

Diversification of Azerbaijan's economy and the extension of development of rural areas are high priority tasks in the medium and long-term perspective. This is based on several facts. First, the country's main economic driver remains its mineral resources which one day will be exhausted. BP suggests that with the current level of production they are

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<sup>30</sup> Ibid

expected to be depleted by 2024. Second, there is a broad difference between the capital region and the rural areas. It is demonstrated in the lack of access to education and healthcare on one hand, and infrastructure, capital and commercial opportunities on the other. In order to progress in these areas, the government under the President Aliyev has approved a “State Program on social and economic development of the regions of Azerbaijan 2009-2013”. This program consists of combined measures including the upgrade of infrastructure and supply of public goods, opening of new enterprises, improvement of production efficiency, as well as implementation of structural reforms in the rural areas of the country.

Some of the labor-intensive areas of economy are services and agriculture. The agricultural sector has high potential given the fact that the country has a big variety of climatic zones, fertile lands and longstanding agricultural experience. The services sector including construction and tourism has recently started to develop but needs substantial investment. There is a good prospect to increase revenues from tourism taking into account such favorable factors as biodiversity, the Big and Small Caucasus Mountain ranges and the country’s cultural heritage. Much of the work in these areas will depend on policies and institutions as well as improved quality of service.

#### Agricultural sector

This sector employs the largest amount of people equal to 38.4% in 2010 of the population compared to only 1% in mining.<sup>31</sup> Poverty has been diminishing in rural zones thanks to its large contribution. Azerbaijan’s agricultural sector has been growing at an average annual rate of 5% over the last 5 years but still operates below its production capabilities.<sup>32</sup> Despite investment and modernization of the sector, it is facing several constraints. They include shortfalls in the legal and regulatory systems, administrative barriers to investment (high tax rates, operational costs and monopolistic practices). For example, AgroLeasing Company is unofficially the only source of leasing machinery and fertilizers to farmers. Additionally, the farmers complain that a 15-20% bribe for loans is

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<sup>31</sup> Statistical Committee of AR [www.azstat.org](http://www.azstat.org)

<sup>32</sup> Azerbaijan country memorandum .A New Silk Road: Export-led Diversification. Poverty Reduction and Economic Management Unit Europe and Central Asia Region December 2009.Document of the World Bank



a normal practice<sup>33</sup>. Other factors are access to credit, infrastructural weaknesses (irrigation and the availability of secondary roads).

### Services sectors

Starting from 2001, Azerbaijan's service sector has seen the biggest dynamics outside the energy economy. This segment is crucial for the country's development due to several reasons. Firstly, the tertiary sector can stimulate growth. This is because it can create employment on one hand and on the other hand it helps to optimize productivity along the value chain by meeting consumer needs. In developed countries this sector occupies the largest portion in their economy and as income continues to rise, people's demands become less 'material' but their need for services: health, entertainment, education etc increases. The services sector is accounting for some three-quarters of the GDP for the EU and employs over three quarters of the population.<sup>34</sup> Secondly, the importance of the country in geographical terms is high, given its location on the Great Silk Road. The Great Silk Road is an ancient transcontinental trade highway which for centuries connected the East and the West and spanned 19 countries along its route. The concept of reviving this route as a channel of world cooperation in the areas of culture, trade, tourism and diplomacy has grown in the greater public interest since the 5 Central Asian countries gained their independence in 1991. The concept was introduced at the UN General Assembly in Bali, Indonesia, in 1993. Today the World Tourism Organization largely participates in the fulfillment of its restoration.

The service sector accounted for 31.8% of GDP in 2009. This is twice as high as in 2005. In its structure, construction with 36% and education along with public health together at 13.7% has major positions.<sup>35</sup>

Azerbaijan is counting on the potential of its tourism sector which has many opportunities in the short and medium terms. These opportunities are, for example, the recent improvement of infrastructure and transportation. The promising tourism sector is slowly

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<sup>33</sup> [www.eurasianet.org](http://www.eurasianet.org) Central Eurasia Project of the Open Society Institute .Azerbaijan Country profile

<sup>34</sup> European commission <http://ec.europa.eu/trade/creating-opportunities/economic-sectors/services/> 21

<sup>35</sup> Azerbaijan country memorandum .A New Silk Road: Export-led Diversification. Poverty Reduction and Economic Management Unit Europe and Central Asia Region December 2009.Document of the World Bank

improving. 2011 was declared the year of tourism in the country. The number of local visitors according to the State Statistical Committee in 2010 has doubled in comparison with 2006 and was around 6300 people. Whilst the number of foreigners has reached 3918 in the same year which is a 150% growth over the numbers in 2006. The Ministry of Culture and Tourism continues to carry out series of measures. They include websites and publication of magazines issued both in local and foreign languages, participation in international exhibitions and cooperation with travel companies. Since 2001 Azerbaijan has become a member of the Universal Tourism Organization. Additionally, their work has been realized in the framework of Intergovernmental Agreements on cooperation in the sphere of tourism signed by the Republic of Azerbaijan and by Turkey, China, Uzbekistan, Kyrgyzstan, Poland, Italy, Georgia, Ukraine and Bulgaria. The related problem of addressing training for unqualified personnel occupies an important place in the development of tourism policy. The representatives of private sector (hotels, travel agencies) and the students taking education in the sphere of tourism are participating in courses in order to improve their skills. For the last few years, the capital has attracted mostly business and congress travelers. Many high-standard 4 and 5 star brand hotels are represented in the capital Baku with 5 of them opening this year. But the availability of middle and low budget accommodation and catering services at affordable prices for tourists is not yet sufficient, both in the capital and in other regions.

### Construction.

Azerbaijan has seen three phases of its construction boom: the first, in 2001-2004 was due to the construction of the BTC pipeline. The second in the following years was as a result of growing demand in the real estate sector and services. Within the construction segment of the economy, growth was high in hotels and restaurants which accounted together for 32%. The third stage which began slowly in 2005 but has been increasing up until the present day was initiated by the government. Financed from the State Oil Fund, which is being used to manage energy revenues, numerous construction and renovation projects throughout the country have taken place. This has improved the quality and availability of housing and infrastructure<sup>36</sup>.

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<sup>36</sup> ibid

### ICT sector

The internet penetration rate in 2010 was 44% compared to 29.7% in 2009 and 18.8% in 2008 respectively. The number of Internet users in 2009 was about 3.7 mio people and broadband subscriptions increased up to 100,000 by the end of 2009 compared to 15,000 in 2007<sup>37</sup>. One of the reasons for slow intensification of Internet is its high cost given the moderate average wages. A DSL connection of 64 Kbps costs around USD 40–50 per month, and unlimited monthly access costs around USD 35<sup>38</sup>. While the average monthly wage is 274 AZN (about USD 300). The Ministry of Communications and Information Technologies (MCIT), together with the Ministry of Education, Microsoft, and Hewlett Packard, has started to launch the National PC Initiative aiming to provide conditions for a rapid increase of the PC penetration rate (up to 15 percent) and e-society development. The project targets selling more than 100,000 PCs in the country and supplying each Internet user with free Internet hours. The state-funded Program on Information of the Education System (2008–2012) plans to provide Internet connectivity to all the schools of Azerbaijan. Currently, more than 200 secondary schools have been connected to the Internet (ADSL). The number of mobile users is 8 mio (around 90 %) of the population. Fixed line access is low at 16% with little growth over the last few years.<sup>39</sup>

### Fiscal policy and administration

The Government has made important changes in the reduction of taxes and improvement of administration. Particularly, corporate tax rate was lowered (to 20% from 22%), social security contribution lowered (from 28% to 25%) and VAT (from 20% to 18%). In administration Azerbaijan has launched electronic filing, established nationwide call centers, tax payment through the Internet and reduced the number of forms that need to be filed (from 90 to 15).<sup>40</sup>

### Financial sector and Banking sector.

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<sup>37</sup> <http://www.internetworldstats.com/>

<sup>38</sup> <http://opennet.net/research/profiles/azerbaijan>

<sup>39</sup> <http://www.internetworldstats.com>

<sup>40</sup> Azerbaijan country memorandum .A New Silk Road: Export-led Diversification. Poverty Reduction and Economic Management Unit Europe and Central Asia Region December 2009.Document of the World Bank

Azerbaijan's financial sector has increased in size even though from a low base. The number of credit providers has grown from 47 to 94 from 2002-2008. The majority of increase was in household and services. Based on Doing Business Report 2011, Azerbaijan scores 46 out of 181 in getting credit as compared for example, to Russia with 89 and Turkey with 72.<sup>41</sup> Lending to GDP is about 17% (that is compared to 50% required in the EU accession countries). Recent reforms and the development of financial infrastructure under the assistance of Bretton Wood institutions have improved access to financial services.

Azerbaijan's banking sector has expanded in the last few years. At the end of 2008, 46 banks were present in the market so that number has nearly doubled from 2000. The exchange rate of the New Azeri Manat (AZN) is managed by the Central Bank, which is in fact pegged against the US dollar since large part of revenues is USD denominated. The country's largest bank is the International Bank of Azerbaijan (IBA) which is a state bank and the second largest, Kapital Bank, was privatized in 2008. The Banking system is quite concentrated with 83% of total bank assets held by the five biggest banks at the end of 2008. Presently, there are 23 banks versus 15 in 2004 with foreign ownership. Foreign banks are Yapi Kredi Azerbaijan of Turkey, Microfinance Bank with a number of European shareholders, Nikoil Bank of Russia and UniCredit of Italy are operating with 100 percent foreign capital. Other banks have some share of foreign capital.

The World Bank suggests that many parts of financial sector including banking, insurance, leasing and other remain underdeveloped. Particularly in the areas of international accounting and financial standards and access to credit for the private sector and others.<sup>42</sup>

### Labor market

The State Statistical Committee indicates that the unemployment rate stood at an average of 6% during the period of 2005- 2009 compared to 9.7 % in 2003.<sup>43</sup> But other international sources estimate that the unemployment rate is much higher. Employment is

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<sup>41</sup> Azerbaijan .Doing business Report 2011

<sup>42</sup> Ibid

<sup>43</sup> Statistical Committee of AR. [www.azstat.org](http://www.azstat.org)

high in agriculture (38.4%), wholesale and retail trade (16.3%) and education (8.5%)<sup>44</sup>. It is quite difficult to track the real number of unemployed since many of them are not officially registered and the proportion of undeclared work exists to large extent. According to the World Bank only 41% of the employed in 2009 had labor contracts. The reason is that many employers are not willing to pay taxes, social security and follow the laws. Data on unemployment shows vast differences between the regions. There is nearly no unemployment in Nachchivan Autonomous Republic. Unemployment is largely below average in Absheron, Sheki-Zagatala and Aran zones. On the contrary, it is high in Kalbajar-Lachin and Guba-Khachmaz zones (21.2 % and 13.5 % accordingly). 47% of internally displaced persons are unemployed<sup>45</sup>.

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<sup>44</sup> Ibid

<sup>45</sup> Ibid

## **2 Analysis of relations between the EU and Azerbaijan**

### **2.1 Legal framework for EU-Azerbaijan economic relations**

The history of relations between the EU and Azerbaijan started to develop soon after the independence of the country.

In the early years of its formation, the relations developed in the form of different assistance programs, such as TRASECA (Transport Corridor Europe-Caucasus-Asia), TACIS (Technical Assistance for the Commonwealth of Independent States, INOGATE (Interstate Oil and Gas Transport to Europe) and others.

Under the EU's TACIS program, EUR 414 million were allocated in technical, humanitarian and food areas in the country<sup>46</sup>. INOGATE works in the field of investments, sustainable energy policy and convergence of energy markets. TRASECA is focused mainly on transport and supports 25 technical and 11 investment projects in cooperation with Azerbaijan. The contribution of the EU in 26 of these projects exceeds EUR 100 million [5].

The TRASECA Programme contributes to the creation of an International Logistical Center at Alat, a new port on the Caspian Shelf, which is expected to be operational in 2015-2016. This port will enable the country to become an important link in the chain of hubs that connect Asia to Europe.

As a part of INOGATE and TRASECA in 2004, Azerbaijan announced a dialog on energy and transport cooperation between the EU and its member states, called the Baku Initiative. Its main task is to enhance cooperation among participants by creating an integrated energy market.

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<sup>46</sup> Official website of the Ministry of Economic Development of Azerbaijan [www.economy.gov.az](http://www.economy.gov.az)

The first stage of the EU-Azerbaijan legal framework commenced with the Partnership and Cooperation Agreement (PCA) which was signed on 26 April 1996, and came in force in June 1999. Heiki Talvitye (Finland) serves as a special representative of the EU in the South Caucasus, strengthening the EU's presence in the region.

In 2006, the country joined the European Neighborhood Policy (ENP). The basis of this policy is defined in PCA aiming at the establishment of closer gradual economic relations beyond previous levels of cooperation. According to the ENP, the Action Plan is a key document which regulates further relations between the EU and Azerbaijan. It covers 3-5 years. The following 10 strategic objectives of the EU and Azerbaijan cooperation are described in this plan<sup>47</sup>:

- Contribute to the peaceful solution of the Nagorno-Karabakh conflict
- Strengthen democracy in the country ,including through fair and transparent electoral processes, in line with international requirements;
- 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)
- Improve the business and investment climate ,particularly by strengthening the fight against corruption
- Improve functioning of customs
- Support balanced and sustained economic development ,with 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;
- Further convergence of economic legislation and administrative practices;
- Strengthening EU-Azerbaijan energy bilateral cooperation and energy and transport cooperation, in order to achieve the objectives of the November 2004 Baku Ministerial Conference;

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<sup>47</sup> Available at [http://ec.europa.eu/environment/enlarg/pdf/enp\\_action\\_plan\\_azerbaijan.pdf](http://ec.europa.eu/environment/enlarg/pdf/enp_action_plan_azerbaijan.pdf)

- Enhancement of cooperation in the field of Justice, Freedom and Security, including in the field of border management;
- Strengthen regional cooperation;

The policy also specifies the aspects of energy supply security for the EU, including the modernization of energy infrastructure in Azerbaijan, its rational use, saving and usage of renewable resources.

Assistance in the ongoing reforms in Azerbaijan is offered through a set of new instruments; for example, budget support programs including Twinning, TAIEX and SIGMA under which €61 mio aid was allocated for 2007-2009<sup>48</sup>. Other types include infrastructure and technology financial support; grants and technical assistance in transport, energy and environment; and the right to participate in Community and Thematic Programs.

In the sphere of education, for the purpose of its modernization and upgrade, the Azerbaijani students, teaching and management staff are able to participate in TEMPUS, Erasmus Mundus and Jean Monet programs as well as through different joint projects in cooperation with the European partner universities. This is especially important for the future of the nation since the quality of local education, especially outside Baku, is much below international standards. For example, about 100 people from Azerbaijan have benefited from the country's participation in the EU-funded Erasmus Mundus Programme over the last three years<sup>49</sup>.

Launched in May 2009 in Prague, Azerbaijan together with Georgia, Armenia, Belarus, Moldova and Ukraine became a member of the Eastern Partnership Agreement. It is expected to replace the previous PCA and profoundly deepens Azerbaijan-EU ties. Additionally, it covers such areas as free trade agreements, visa liberalization and integration to the EU.

When speaking about its relations with the EU, the country is largely interested in its presence on the EU's energy market. The possibility of the creation of a free trade

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<sup>48</sup> Ibid

<sup>49</sup> ENPI Information and Communication Support Project [www.enpi-info.eu](http://www.enpi-info.eu)



agreement is not possible at the moment, primarily due to the country's absence from the World Trade Organization (WTO).

Elmar Mammadyarov, the Minister of Foreign Affairs stated: "Azerbaijan does not have a goal of becoming a member of the EU, but rather wishes to raise living and other standards up to the European level."<sup>50</sup>

In addition to the above described initiatives, according to the President of AR order dated June 2005, the State Commission on Integration of Azerbaijan to the EU (including 9 groups) was set up to contribute to the cooperation. This Commission acts as the central body of the Government to ensure coordination and oversight of activities of all governmental agencies in the framework of relations with the EU, implementation of the Azerbaijan-EU ENP Action Plan, preparation of the National Progress Report of Azerbaijan and other relevant measures.

Furthermore, the opening of a Representative office of the European Commission in Baku with the participation of the so-called EU troika took place (the representative of EU current, previous and next presidency country).

## **2.2 Analysis of EU-Azerbaijan trade flows**

Azerbaijan benefits from the General System of Preferences (GSP), which is non-reciprocal preferential access to the EU market granted to developing countries. According to the current GSP Regulation valid for the period from 1 January 2009 to 31 December 2011, the country is entitled to special incentives for sustainable development and good governance (GSP+), offering exceptional access to the EU market.

Azerbaijan-EU trade relations are covered by a PCA agreement (described in the previous chapter), including additional measures for:<sup>51</sup>

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<sup>50</sup> Elmar Mammadyarov, 5 July 2010. <http://avciya.az/eng/2010/07/05/elmar-mammadyarov-azerbaijan-is-not.html>

<sup>51</sup> European Commission Trade [www.ec.europa.eu/trade](http://www.ec.europa.eu/trade)

- Non-preferential trade which prohibits imposing discriminatory tariffs on each side and binds the quantity of traded goods;
- Both party's legislation and procedures to enhance trade between them, Azerbaijan's economic integration into the EU and wider access to the European markets.

Based on the principle of the Gravity model, we know that countries trade mainly based on two factors: their economic size (for example GDP) and geographic distance. Given this, the country's GDP is slightly higher (\$54.370 bln) than the lowest scoring within the EU (except for the ex-Soviet Baltic States), Slovenia (\$47.849 bln) and Bulgaria (\$44.702 bln) and significantly lower than others.<sup>52</sup> The EU's major trade partners are the US (14.4%), China (13.9%) and Russia (8.6%), explained by their economic power. The portion from the CIS in total is 11.4% or EUR 324,168.83 million.

The share of the EU trade with Azerbaijan is insignificant if taken in global comparison and accounts for only 0.4% which totals €12,110.3 mio compared with Ukraine (1%) and Belarus (0.3%). For Azerbaijan, on the contrary, the EU is the main trading partner with 46.7% overall, out of which 34.1% are imports and 52.6 % are exports. As stated in the chapter 1.2, Turkey (8.2% of total), Russia (7.4%) and the US (7%) are the Azerbaijan's second, third and fourth trade partners, respectively. Imports of the EU from Azerbaijan are 99.3% (€9,698.8 mio) are mineral fuels, lubricants and related materials. The EU's exports to Azerbaijan are more diversified than its imports. The major item with 47% (€1,106.2 mio) is machinery. The demand for large volumes of machinery comes from the necessity for the hydrocarbon industry and investments in infrastructure. Other important products are manufactured goods and semi-manufactured goods, chemicals, iron, steel, agricultural products and others. According to the tables, we can see that the total amount of the EU's imports from Azerbaijan has doubled from 2006-2008, but then slightly shrank in recent years. One of the reasons could be the weakened global economy. The country's export flows to the EU remain quite concentrated with mineral resources being the main source. No significant changes have occurred for its

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<sup>52</sup> International Monetary Fund. Nominal GDP by Country 2010 [www.imf.org](http://www.imf.org)

diversification over the last decade. On the contrary, the amount of exports to Azerbaijan is steadily growing.

**Table 7. EU (27) Imports from Azerbaijan.**

Product Groups	2006		2008		2010	
	Millions euro	%	Millions euro	%	Millions euro	%
<b>0000 - Total</b>	<b>5,448.4</b>	<b>100.0%</b>	<b>10,611.0</b>	<b>100.0%</b>	<b>9,763.5</b>	<b>100.0%</b>
<b>1000 - Primary products</b>	<b>5,115.7</b>	<b>93.9%</b>	<b>10,537.0</b>	<b>99.3%</b>	<b>9,716.5</b>	<b>99.5%</b>
1100 - Agricultural products	32.9	0.6%	15.7	0.1%	17.7	0.2%
1200 - Fuels and mining products	5,082.7	93.3%	10,521.3	99.2%	9,698.8	99.3%
<b>2000 - Manufactures</b>	<b>330.0</b>	<b>6.1%</b>	<b>50.0</b>	<b>0.5%</b>	<b>44.5</b>	<b>0.5%</b>
2100 - Iron and steel	1.4	0.0%	2.7	0.0%	0.6	0.0%
2200 - Chemicals	11.2	0.2%	8.2	0.1%	7.8	0.1%
2300 - Other semi-manufactures	4.9	0.1%	2.7	0.0%	1.1	0.0%
2400 - Machinery and transport equipment	25.8	0.5%	31.9	0.3%	31.3	0.3%
2410 - Office and telecommunication equipment	0.8	0.0%	3.4	0.0%	1.6	0.0%
2420 - Transport equipment	1.2	0.0%	2.1	0.0%	1.1	0.0%
2430 - Other machinery	23.9	0.4%	26.5	0.2%	28.6	0.3%
2500 - Textiles	0.9	0.0%	0.2	0.0%	0.1	0.0%
2600 - Clothing	0.1	0.0%	0.0	0.0%	0.1	0.0%
2700 - Other manufactures	285.7	5.2%	4.2	0.0%	3.6	0.0%
<b>3000 - Other products</b>	<b>2.7</b>	<b>0.0%</b>	<b>24.1</b>	<b>0.2%</b>	<b>2.3</b>	<b>0.0%</b>

Source: Eurostat. Azerbaijan-EU bilateral trade and with the world. 2011 Report.

**Table 8. EU(27) exports to Azerbaijan**

SITC Product Groups	Rev.3	2006		2008		2010	
		Millions euro	%	Millions euro	%	Millions euro	%
<b>0000 - Total</b>		<b>1,954.8</b>	<b>100.0 %</b>	<b>2,061.9</b>	<b>100.0 %</b>	<b>2,346.8</b>	<b>100.0 %</b>
<b>1000 - Primary products</b>		<b>140.9</b>	<b>7.2%</b>	<b>199.2</b>	<b>9.7%</b>	<b>208.6</b>	<b>8.9%</b>
1100 - Agricultural products		117.2	6.0%	167.3	8.1%	183.5	7.8%
1200 - Fuels and mining products		23.7	1.2%	31.9	1.5%	25.0	1.1%
<b>2000 - Manufactures</b>		<b>1,802.9</b>	<b>92.2%</b>	<b>1,840.5</b>	<b>89.3%</b>	<b>2,128.5</b>	<b>90.7%</b>
2100 - Iron and steel		96.9	5.0%	61.5	3.0%	87.1	3.7%
2200 - Chemicals		117.0	6.0%	170.2	8.3%	214.5	9.1%
2300 - Other semi-manufactures		126.0	6.4%	169.8	8.2%	168.1	7.2%
2400 - Machinery and transport equipment		1,023.6	52.4%	1,088.0	52.8%	1,106.2	47.1%
2410 - Office and telecommunication equipment		132.4	6.8%	149.7	7.3%	156.2	6.7%
2420 - Transport equipment		221.1	11.3%	339.9	16.5%	352.6	15.0%
2430 - Other machinery		626.1	32.0%	597.9	29.0%	594.5	25.3%
2500 - Textiles		7.2	0.4%	6.2	0.3%	9.1	0.4%
2600 - Clothing		29.1	1.5%	46.4	2.2%	51.9	2.2%
2700 - Other manufactures		401.5	20.5%	298.1	14.5%	491.4	20.9%
<b>3000 - Other products</b>		<b>8.9</b>	<b>0.5%</b>	<b>14.5</b>	<b>0.7%</b>	<b>5.5</b>	<b>0.2%</b>

Source: Eurostat. Azerbaijan-EU bilateral trade and with the world. 2011 Report.

Trade with major EU partners by country in 2010 is presented in the following table below. As we see from it, main European partners are Italy with 25.8% share of total turnover, France – 7.1 % and Germany- 2.2 % and United Kingdom – 1,11% .

**Table 9. Major EU trade partners 2010. (thousands USD)**

Countries	Export	Special weight, %	Import	Special weight, %	Turnover	Special weight, %
Italy	7 097 224,49	33,28	118 209,66	1,79	7 215 434,15	25,84
France	1 856 523,56	8,71	136 109,57	2,06	1 992 633,13	7,14
Germany	9 906,28	0,05	607 176,74	9,20	617 083,02	2,21
United Kingdom	6 441,58	0,03	302 749,70	4,59	309 191,28	1,11
Greece	255 012,62	1,20	12 075,91	0,18	267 088,53	0,96
Portugal	224 613,47	1,05	753,79	0,01	225 367,26	0,81
Spain	178 522,20	0,84	18 975,48	0,29	197 497,68	0,71
Netherlands	128 902,13	0,60	46 386,47	0,70	175 288,60	0,63
Bulgaria	136 535,78	0,64	12 929,92	0,20	149 465,70	0,54
Romania	94 249,53	0,44	22 939,87	0,35	117 189,40	0,42
Malta	116 509,69	0,55	537,02	0,01	117 046,71	0,42
Austria	779,24	0,004	87 554,16	1,33	88 333,40	0,32
Belgium	1 286,66	0,01	44 499,98	0,67	45 786,64	0,16
Cyprus	37 905,74	0,18	5 408,51	0,08	43 314,25	0,16
Sweden	99,48	0,001	42 744,55	0,65	42 844,03	0,15
Finland	24,71	0,0001	39 808,95	0,60	39 833,66	0,14
Czech rep.	233,69	0,001	37 780,85	0,57	38 014,54	0,14
Poland	5 771,17	0,03	25 719,47	0,39	31 490,64	0,11

Source: Ministry of Economic Development [www.economy.gov.az](http://www.economy.gov.az)

Further deeper enhancement of trade flows will be possible upon Azerbaijan's accession to the WTO which the country applied for in 1997. Once a member of the WTO, the country can further benefit from trade liberalization and the possibility to sign the Free Trade Agreement, one of the points of Eastern Partnership agreement. This will allow trade liberalization not only in goods, but also in services and capital. I will discuss in more detail the country's perspectives as a WTO member in the following section.

### **2.3 Trade Policy of Azerbaijan**

The Ministry of Economic Development is the major governing institution for trade policy formulation and its implementation in Azerbaijan. The State Customs Committee

regulates tariffs and duties. After being analyzed by the Tariff Council, the anticipated tariffs and duties are recommended to the Cabinet of Ministers for their approval. Foreign trade regulation is based on the decree “On Further Development of Foreign Trade Regulations,” which was implemented on 17 December 1996.

The country signed its first free trade agreement with CIS countries in 1994, but this was not implemented. Presently, only imports from Russia, Ukraine, Georgia and Kazakhstan are duty-free.<sup>53</sup> Their share is 22, 2 %<sup>54</sup>. Other CIS countries are subject to standard tariffs. Azerbaijan is a member of GUAM a regional Organization for Democracy and Economic Development together with other three post-Soviet states Georgia, Ukraine, and Moldova since 1997, but this organization has brought little economic change.

In 1999, Azerbaijan signed a Partnership and Cooperation Agreement (PCA) with the EU. One of the purposes of this agreement is establishment of wider consistency in the legislation of both parties. Additionally, under PCA, Azerbaijan benefits from MFN status with the EU and the US.

When speaking about trade strategy and territorial preferences, we must distinguish between hydrocarbons and other products. After the stabilization program in 1995-1996 (discussed in chapter 1.1), the country’s trade strategy was based on strengthening the oil and later gas sectors. As previously mentioned, they constitute around 90% of the country’s exports. Focusing on this strategy in short and medium terms has been the right decision. But in the longer term, the country has to define a clear strategy of using energy revenues to promote areas outside this sector. Sufficient markets for oil and gas already exist. The main destinations for oil are firstly European markets, followed by US; and for gas –Russia, Georgia, Turkey and the EU. The non-energy products cater mostly neighboring CIS countries, Turkey and Iran. The major route through which these exports flow is Georgia, the others are not viable due to political, safety and infrastructural problems. But the latest World Bank reports suggest that even the route through Georgia is still not adequate in terms of internationally accepted standards. If these constraints were to be eliminated, larger intratrade opportunities could be opened in the region.

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<sup>53</sup> Trade and Trade Facilitation Review. ADB, March 2003.

<sup>54</sup> Azerbaijan and EU bilateral Trade and Trade with the world 2011. available at <http://ec.europa.eu/trade/creating-opportunities/bilateral-relations/regions/south-caucasus>

Outside the energy sector, agro-processing, light engineering and mechanical works related to oil sector are potential areas. To be able to promote them, the constraints summarized earlier in this thesis need to be eliminated. The regional trade including the country itself is particularly important for the products outside the energy sector, since the country is most unlikely to become a supplier of labor intensive components to companies located in sophisticated high income markets. Because even if the salaries are low, they are still higher than in the countries of South-East Asia and North-Africa.

### **Import Regulations**

Import tariffs. Ad valorem (as a percentage to value), specific tariffs (amount per unit) and the combination of both of them are practiced. Currently, ad valorem duties are applied to imports at the rates of 15%, 5.3% and 0.5%. Specific tariffs are applied at the rate of 15%<sup>55</sup>. Every importer is a subject to a Custom Processing Fee equal to 15% of the customs value of the good, which applies no matter whether VAT is paid or not. According to the World Bank, Azerbaijan ranks 58th out of 125 countries in tariff restrictiveness and its MFN applied simple - (9.2%) and import-weighted (5.1%) tariff averages, which are lower than in other countries with similar per capita levels, although above the European and Central Asian (ECA) countries group. The maximum MFN tariff is 294.5% for felt carpeting<sup>56</sup>.

For safeguard and health purposes, import quotas and prohibitions are used for alcohol and tobacco.

Preferential tariffs. According to Chapter 6 of the “Law of the Azerbaijan Republic on Custom Tariffs,” ‘preferences apply to goods originating from countries which have an established customs union or free trade zone with Azerbaijan, or from developing countries with a national system of preferences’<sup>57</sup>. Such privileges are established through the decisions of the Cabinet of Ministers.

Tariff exemptions. They apply to medicines and medical equipment, humanitarian goods, as well as goods for military use, diplomatic missions and international organizations.

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<sup>55</sup> [www.wto.org](http://www.wto.org). tariff profile Azerbaijan

<sup>56</sup> Azerbaijan: Trade Brief. <http://info.worldbank.org/etools/wti/docs/wti2008/brief13.pdf>

<sup>57</sup> Ibid

Companies working in the hydrocarbon industry are duty-free and VAT-exempted. The same extends to the equipment and supplies necessary for their performance.

### **Export Regulations**

Approximately 64% of Azerbaijan's exports benefit from most-favored nation (MFN) zero-duty status.<sup>58</sup> Duties and non-tariffs controls are not common except for a special tax for oil exports equivalent to 20% between the country and the rest of the world.

The Export regime of the country can be described as relatively open. The Government regulates exports of such strategic commodities as petroleum products, cotton, electric power and non-ferrous metals.

Export Financing and Subsidies. Domestic channels of export financing remain limited. The banking system is at a stage of development. Short-term trade financing is offered by most banks (through letters of credit confirmed by Western banks) with long-term financing being rare. Contracts are authorized only upon advance payment, or opening of an irrevocable letter of credit. Exports in favor of WTO accession are not subsidized<sup>59</sup>.

Restrictions on export operations. According to the Presidential Degree of Rules Regulating Foreign Trade in the AR, these measures do not apply to most goods. There are exceptions for sensitive products, such as weapons, military technology, explosives, pyrotechnic substances, nuclear materials, technology, equipment, radiation sources, narcotics, psychotropic substances and chemical poisons, scientific-technical information; and special types of technology, materials and equipment which could be used in the creation of military technology or arms. These goods cannot be exported on credit, or through consignment<sup>60</sup>.

Being an observer member as of 1997, Azerbaijan is seeking WTO membership and is currently in the process of negotiations. The country has held two WTO Working Party meetings in Geneva in 2008, as well as discussions with the EU and Office of the US Trade Representative (USTR). The World Bank says 'that deeper reforms are necessary including standards, technical barriers to trade and sanitary and phytosanitary agreements

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<sup>58</sup> *ibid*

<sup>59</sup> *ibid*

<sup>60</sup> Azerbaijan Export Control System [www.nti.org](http://www.nti.org)



of the WTO; the custom valuation approach, when based on the minimum value approach does not reflect WTO principles with VAT not operating according to international practices (as it is assessed on an 'origination principle' rather than a destination principle); the Custom fee should instead reflect the actual cost of service delivery<sup>61</sup>.

In domestic legislation a Dispute Settlement mechanism exists, but effective measures of protection, enforcement and rights are not in place. The courts are often weak, judges are inexperienced, progressive tax and other legislative procedures are not often undertaken and well implemented. The Economic Court which is in charge of economic disputes is not transparent and is largely ineffective. The settlement of disputes often occurs through acquiring a powerful local partner.

Protection of Property Rights (IPR) is technically recognized. However, its application is neither effective nor transparent, although the country is working on their enforcement together with the assistance of the World Bank. In the mid-1990s, the country became a member of the World Intellectual Property Organization (WIPO) and started implementing registration and protection of IPR under its guidance. Azerbaijan adopted the Law on Trademarks and Related Rights in 1996, the Law on Patents in 1997 and the Law on Trademarks and Geographic Indications in 1998. It is also a party to several IPR conventions and treaties. For example, the Convention for Protection of Industrial Property ,the Berne Convention for the Protection of Literary and Artistic Works , Geneva Phonogram Convention and acceded to the two WIPO Internet Treaties in 2005. The State Copyright Agency has enacted an anti-piracy commission, but nevertheless pirated software, films, luxury goods and clothes are often found in the country.

In Standardization, the laws are not fully in line with international and European standards. The GOST system that is used in CIS countries is not recognized by major export markets.

In Sanitary and Phytosanitary areas according to the latest ENP Country Report, public health institutions lack funds and qualified personnel for upgrading laboratories in order to provide adequate control and vaccination for animal diseases. The country is a member of the Food and Agriculture Organization (FAO) and World Health Organization (WHO).

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<sup>61</sup> Azerbaijan: Trade Brief. <http://info.worldbank.org/etools/wti/docs/wti2008/brief13.pdf>

Taking into account the above described constraints, Azerbaijan's trade policy needs some adjustments. The real problem is the enforcement and implementation of adopted reforms.

Joining the WTO can bring the country the following advantages: increased transparency and predictability through trade policy forecasting, the number of partners will be augmented, as well as the dispute settlement process and enforcement of IPR rights will run more effectively. Furthermore, better integration into the world economy will be possible in the long-term perspective.

Owing to the fact that the country is facing weaknesses outside its oil and gas sector, in order to facilitate trade, new investments and activities should be put in place. Besides opening Western markets, Azerbaijan should not underestimate its regional trade partners once economic constraints are eliminated.

## **2.4 EU trade policy**

The European Union including all 27 Member States has a common trade policy meaning that they act as a single body in prevailing trade associated issues. The legal bases for the EU Trade policies are the Articles 206 and 207 of Treaty on establishing the EU. Based on which, the European Commission speaks on behalf of the member states consulting; its statements are, however, in line with conclusions of the Trade Policy Committee'. This Committee consists of delegates from each of the State and the European Commissions. The main purpose of the Committee is coordination of trade policy including aspects of trade negotiations at the WTO, export/import regulations in order to guarantee conformity with the policy. All EU trade measures and EU trade agreements are approved by the Council of ministers and by the European Parliament. .

The main goals of the European Common Commercial Policy (CCP) are:

- to serve common interests of the Member States,
- to guarantee balanced trade relations,

- to reduce tariffs and lessen other restrictions.

The trade policy of the EU covers trade not only in goods but also services, commercial aspects of intellectual property, trade related issues such as company law, technical regulations and others<sup>62</sup>.

### **The EU and world trade**

In the table below, we can see that the EU is the largest importer and exporter both in merchandise and commercial services. In 2009 it accounted for 16.2% in exports and 17.4% in imports in world merchandise trade. In services these numbers are even higher: 26.3% in exports and 23% in imports.

**Table 10. Leading importers and exporters in commercial services (excluding intra-EU(27) trade), 2009**

	Exports		Imports	
	Value (bln US\$)	Share of the world trade	Value (bln US\$)	Share of the world trade
EU(27)	652	26,3	543	23
United States	474	19,2	331	14,0
China	129	5,2	158	6,7

Source: WTO. International trade Statistics

<sup>62</sup> <http://ec.europa.eu/trade/about/policy-making/>

**Table 11. Leading importers and exporters in merchandise trade (excluding intra-EU(27) trade),2009**

	Exports		Imports	
	Value (bln US\$)	Share of the world trade	Value (bln US\$)	Share of the world trade
EU(27)	1528	16,2	1673	17,4
China	1202	12,7	1605	16,7
United States	1056	11,2	1006	10,5

Source: WTO. International trade Statistics

**Table 12.EU trade with main partners**

The Major Imports Partners				The Major Exports Partners			
No	Partners	Mio euro	%	No	Partners	Mio euro	%
	Extra EU27	1,501,843.9	100.0%		Extra EU27	1,348,792.4	100.0%
1	China	282,011.1	18.8%	1	United States	242,095.1	17.9%
2	United States	169,467.4	11.3%	2	China	113,117.7	8.4%
3	Russia	158,384.9	10.5%	3	Switzerland	105,433.4	7.8%
4	Switzerland	84,126.2	5.6%	4	Russia	86,508.8	6.4

Source: EU bilateral trade and trade with the world 2011.European Commission

When looking at the statistics above, we can analyze that many countries have high share of trade with the EU. For example, the EU is the largest trading partner with Russia 46.8%, Switzerland 68% and the US 17.8% in their total trade turnover<sup>63</sup>. In practice this can lead to the usage of its commercial privilege as a diplomatic tool. In fact, the previously described European Neighborhood Policy which allows access to European markets including provision of financial aid, economic and other forms of cooperation in exchange for reforms is used to promote the Union's geopolitical interests.<sup>64</sup>

<sup>63</sup> European Trade Commission <http://ec.europa.eu/trade/statistics/2010>

<sup>64</sup> The EU Common Commercial Policy and Global/Regional Trade Regulation. Paola Conconi at

## **Instruments of the Common Commercial Policy.**

From our Trade policy course we know that CCP principles are applied by set of trade policy instruments and agreements. The keystone of the CCP is Article 133 of the Treaty of Rome. These instruments are composed of:

- Tariffs (customs duties on imports and/or exports)
- Non-tariff barriers (quantitative restrictions, antidumping, countervailing measures, technical norms, sanitary, phytosanitary or environmental measures, etc.)
- Subsidies (for example export subsidies )

Tariffs. Since the EU is a Custom Union, Common External Tariff (CET) for all of the 27 members is used outside its borders. The EU identifies between over 10000 individual products at the 8-digit level of the Combined Nomenclature. The tariff average differs on the individual products. There is a big distinction between the tariffs by sector. Although the average EU applied MFN tariff is relatively low (5.3% in 2009), higher tariff rates are imposed on a large portion of products imported to the EU. For example, agricultural products such as dairy, animal products, cereals and sugar have the highest tariffs compared to other segments such as manufacturing<sup>65</sup>.

Non-tariff barriers. In this sense several forms of non-tariff regulations are applied. For the purposes of protection of the local market against dumped prices, antidumping measures are practiced. According to the Article VI of the GATT they refer to “the measures against imports of a products at an export price below its normal value”. There are examples of the EU antidumping measures imposed on textiles and chemicals from China; alcohols and their blends from India, Indonesia and Malaysia; medicines from India and others<sup>66</sup>.

Additionally, the EU can take safeguards and countervailing measures against imports in the case when exporting countries threaten or cause material injury to a domestic industry.

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<sup>65</sup> WTO statistics database.available  
<http://stat.wto.org/CountryProfile/WSDBCountryPFView.aspx?Language=E&Country=E27>

<sup>66</sup> [www.antidumpingpublishing.com/anti-dumping-news](http://www.antidumpingpublishing.com/anti-dumping-news)

Technical barriers are practiced so that imported products comply with EU regulations. They may include health, sanitary and phytosanitary and safety protection. Their use is controlled by the WTO Technical Agreement to Trade (TBT).

Trade policy instruments also include subsidies. This kind of direct financial support is banned for industrial products but extends largely to agriculture, namely dairy, meat and sugar. However they are criticized for the reason that they create problems of trade distortion, and also incentives to overproduce and sell agricultural products at low prices thus damaging developing countries' competitiveness on the world market.

Given the importance of 'knowledge goods' such as patents, licenses, knowhow and designs, Intellectual property rights (IPR) are also covered by the EU trade policy issue. The Uruguay Round negotiations led to the Agreement on Trade Related Intellectual Property Rights (TRIPs), under which parties have to establish minimum standards of IPR protection and extend the traditional GATT principles of non-discrimination to intellectual property.

### **Common Agricultural Policy**

Large territories of the EU countries are land and forests and therefore the agricultural sector plays an important role in the development of rural areas. The EU is the largest producer of food and drinks and their total production is estimated at 675 bln Euro<sup>67</sup>. Although the total share of agrisector is minimal (around 3%), it largely contributes to the development of rural areas and ensures self-sufficiency of primary agricultural goods. Moreover in the countries like France, Italy, Spain, Germany and the Netherlands, it accounts for a significant part of their GDP. Additionally, this sector employs over 15 mio employees<sup>68</sup>.

Besides the EU Common Commercial Policy, the Common Agricultural Policy (CAP) is the strongest policy and represents a large share of the EU budget. It is constantly evolving and has gone through different stages. It was originated in the Treaty of Rome

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<sup>67</sup> European commission EU Agriculture statistics

<sup>68</sup> Ibid

(1957) when 6 member states desired to control their agrisector. The objectives were described as the following <sup>69</sup> :

- to increase agricultural productivity
- to ensure a fair standard of living for the agricultural community
- to stabilize markets
- to promote fair food prices and assure availability of supplies

In order to accomplish these goals, two main measures were introduced: the ''target price'' was used for main farm goods. The imported agricultural goods from outside the EU were subject to '' variable tariffs'' to avoid competition with low price imports.

The formation of CAP has lessened the dependence of European markets on imported agricultural goods.<sup>70</sup> The farmers were paid directly in the form of subsidies. This has led to high budget costs which have been seen negatively by European taxpayers. Besides that, developing countries have considered them as trade distorting measures lowering world market prices and reducing their competitiveness.

Since those days the CAP has been substantially reformed: support prices were reduced, overproduction was prevented by introducing production limits. Special measures of restructuring and promotion of ecofriendly production became very popular. Export subsidies were diminished as well as the agricultural budget being cut. The European farmers receive financial aid to compensate for natural disasters and animal diseases; ensure food safety, farm hygiene and preservation of natural landscapes. Consumers have become more sophisticated and concerned about the quality of the agricultural products they buy. Consequently, all products must contain clear labels of ingredients, country of origin and the methods by which they are produced.

### **EU System of trade preferences**

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<sup>69</sup> Treaty of Rome .Article 39 .Available at [http://ec.europa.eu/economy\\_finance/emu\\_history/documents/treaties/rometreaty2.pdf](http://ec.europa.eu/economy_finance/emu_history/documents/treaties/rometreaty2.pdf)

<sup>70</sup> The EU Common Commercial Policy and Global/Regional Trade Regulation. Paola Conconi

The EU has developed an extensive system of trade preferences. Below we can distinguish different levels of its expansion.

The highest belongs to the membership in the Union. This is the deepest level of liberalization. All of the members are characterized with the principle of 'four freedoms', which is a free movement of labor, capital, goods and services, as well as number of common policies and have common external tariff (CET). The EU has substantially increased in number of states as of 2004 and presently consists of 27 countries, 17 of which have common European currency –Euro. Additionally, there are five EU candidates: Croatia, FYROM (Former Yugoslavian Republic of Macedonia), Montenegro, Turkey and Iceland.

One level lower than that is the European Economic Area (EEA). This agreement links the EU and three members of the European Free Trade Association (EFTA) - Norway, Lichtenstein and Iceland but not the fourth, Switzerland. There are two major differences between the EU and EEA. Firstly, the EU is a custom Union and has a Common External tariff but the EEA is a free trade area which means that the EU as a single member and other three states maintain their own different tariffs. Secondly, although the EEA is obliged to adopt all EU single market legislation, this does not extend to agriculture and fisheries.

One level below that, there is the Customs Union which the EU enjoys, for example, with Turkey, and is aimed at promoting trade and economic relations. The Customs Union is a single trading area where all goods circulate freely no matter if they are produced within the EU or outside its borders. The Customs Union has quite a large coverage but does not apply to agriculture, services and public procurement. Like in previous level, Turkey and the EU reserve the right for charge different tariffs for non-members.

Further below lie free trade agreements between the EU and different countries. These agreements are at different stages of their implementation. For example, agreements with countries like South Korea, Chile, Mexico and South-Africa are already in place. Several others, for example, including Ukraine, India, Malaysia and Singapore are in the process of negotiation. These agreements are designed in favor of further liberalization. Traditionally, liberalization of trade implied reduction of tariffs but nowadays, the EU



looks to move beyond this level, for example, in such areas as restrictive regulations and technical barriers.

Next, we can see non-reciprocal preferences namely Generalized System of Preferences (GSP) and Everything But Arms (EBA). Under GSP, the EU can grant non-reciprocal tariff-free access to industrial and agricultural products to the developing countries. Azerbaijan is one of the countries which benefits from this program along with other developing states. Apart from GSP, there is another scheme called 'GSP plus' which is additionally designed for environmental protection and support of transparent, stable governance for the most vulnerable states.

Under EBA, which is formally a part of the GSP specifically adopted for the 49 least developing countries, all products except arms and ammunitions enjoy tariff-free access without any quantitative restrictions (with the exception of bananas, sugar and rice for a limited period).<sup>71</sup>

In conclusion to what was said, we can see that first - the level of the EU integration with the developed countries is of a larger-scale against the same for the developing ones; and the second - even within the group of the developing the preferences, granted on grounds of bilateral and compliment multi-lateral agreements, are not always equally distributed and some developing countries may seize a preference-set of a greater scale than the others, being held of a greater interest of the EU and relative integration processes.

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<sup>71</sup> European Trade Commission [www. ec.europa.eu/trade](http://www.ec.europa.eu/trade)

### 3 SWOT Analysis of the Future Development of Relations EU-Azerbaijan

In this chapter, a SWOT analysis of the future development of relations between the EU and Azerbaijan outlines the key internal factors: strengths and weaknesses, as well as external opportunities and threats. The aim of the analysis is to show how these factors can influence the relations between the two parties. In the table below all of these factors are presented in a short summary.

**Table 13.SWOT analysis**

<b>Strengths</b>	<b>Weaknesses</b>
Favorable location and the EU's biggest trade partner in the South Caucasus	High dependency on hydrocarbons exports and its implication
Macroeconomic stability and energy resources	Political challenges
	Weak infrastructure
	Business constrains
	Widespread corruption
<b>Opportunities</b>	<b>Threats</b>
Place of the country in Europe's energy diversification plans	Energy resources related threats
Accession at the WTO	Nagorno-Karabakh problems
International focus on Eurovision contest	

Source: Author

#### 3.1 Strengths

- Favorable location and Azerbaijan being Europe's biggest partner in the Caucasus

The port of Baku is the largest on the Caspian Sea operating all year round and is an important transit point for Europe-Asia. The port's capacity is growing and can deliver

up to 15 million tons of liquid bulk and 10 million tons of dry cargo.<sup>72</sup> Azerbaijan has direct maritime links to other countries in the Caspian basin (namely Russia, Iran, Turkmenistan and Kazakhstan). The Volga-Don Canal provides access to the Black Sea and the Baltic-Don Canal - to the Baltic Sea. These conditions facilitate trade and movement of goods among the countries. Most imported merchandise from Europe comes across Turkey through Georgia. The Georgian ports of Poti, Batumi and Supsa on the Black Sea and Ceyhan on the Mediterranean part of Turkey serve as important maritime connections.

Currently, the EU's turnover with Azerbaijan is over €12 billion with annual growth of 13%. This is much larger than with other countries in the South Caucasus region.

- Overall macroeconomic stability and substantial endowments of oil and gas

The country's economic growth averaged 20% per year in 2003-2008, due to its oil and gas production. GDP growth in 2009 was 9.3% but shrank by 3.7% in 2010.<sup>73</sup> Azerbaijan has low external debt equal to 7% of GDP in 2010, large current account surplus with 30% and sizeable foreign exchange reserves at USD6.3bln without considering energy receipts in the State Oil Fund. The country has not experienced a significant slowdown during the economic crisis. The reason for that is its limited involvement in the global economy, revenues from natural resources and measures undertaken by the National Bank of Azerbaijan (NBA) to minimize its impact. As a result of high growth rates, Azerbaijan has entered the global downturn with a strong economic base. The NBA has allocated around \$1.1 billion of direct financial support to banks facing liquidity problems, softened monetary policy to stimulate economic activity. The lending rate fell from 10% to 8%<sup>74</sup>. The reserve requirements on deposits were reduced from 12% to 0.5% and the refinancing rate fell from 15% to 2%. This reduction in interest rates has allowed commercial banks to keep lending at the same level. Finally,

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<sup>72</sup> <http://www.bakuseaport.az/eng.html>

<sup>73</sup> [www.cia.org](http://www.cia.org) World Factbook. Azerbaijan

<sup>74</sup> [www.eurasianet.org](http://www.eurasianet.org)

the maximum amount of deposit insurance was increased 5-fold, which helped to strengthen public confidence in the country's banking system.<sup>75</sup>

Owing to its oil and gas fields, the country was able to attract foreign investment, increase its foreign exchange revenues and improve standards of living. The oil and gas boom has improved the country's position both inside and outside its borders. Energy resources remain the main interest for European companies and their share in exports has increased during the last several years.

### **3.2 Weaknesses.**

- High dependence on energy exports and its implications

Given its natural resources, Azerbaijan is becoming more and more dependent on its energy exports which slows the diversification of its economy and crowds outside the non-oil trade sector. Recent studies of resource rich countries show that increasing dependency on oil can be negatively correlated with the economic and political performance of the states<sup>76</sup>. This phenomenon has taken place in countries such as Nigeria, Iran and Venezuela.<sup>77</sup> Civil wars and protest actions against authoritarian regimes in the Middle East and Africa are recent signs of poor governance in resource rich countries. Political leaders that control wealth have no incentive to share power, which leads to non-democratic political systems and causes violent conflicts.

In addition, oil brings high revenues but it does not create employment, which brings social and economic problems on one side and causes currency appreciation on the other. Moreover, this resource is non-renewable. British Petroleum estimates proven oil reserves at 7 mio barrels and 44.99 cubic trillion cubic meters of natural gas to be exhausted by 2024 and bring \$21-58 bln depending on oil and gas prices<sup>78</sup>.

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<sup>75</sup> <http://www.regionplus.az/en/articles/view/1074> The Azerbaijani economic model and the global crisis

<sup>76</sup> Schubert R.S.''' Revising The Oil Curse: Are oil rich countries really doomed to autocracy and inequality?'' Oil and Gas Business, 2006

<sup>77</sup> Open Society Institute. Caspian Oil Windfalls: who will benefit? Joseph E. Stiglitz, 2003

<sup>78</sup> [www.bp.com](http://www.bp.com), Statistical Report of World Energy 2011

Therefore, diversification of the country's economy and adequate management of its resources are among current priorities. This could be done, for example, through re-investing revenues from natural resources in other labor-intensive and productivity-oriented industries.

- Political challenges

According to the IMF, good governance is “an effective and transparent management of public resources, and a stable economic, regulatory and legal environment conducive to sound management and efficient use of private and public resources.”<sup>79</sup>

Unfortunately, the decision-making process in the country is highly centralized and consolidated within the political elite. Notwithstanding, this is not the only difficulty. The country has held several elections since its independence, which have occurred with many irregularities. The current president, elected in 2003, Ilham Aliyev is the son of previous president, Heydar Aliyev. In 2009, a constitutional referendum allowed the president to stay in power indefinitely; attempts to silence the opposition, the most disappointing imprisonment of youth activists (with the most internationally known case of Adnan Hajizadah and Emin Milli who were sentenced for 2 and 2,5 years respectively ) and journalists on fabricated charges are several examples of the current authoritarian regime. There is a huge gap in the distribution of wealth between the rich and the poor. Despite the fact that the country has democratic institutes, it is regarded by the Freedom in the World Survey 2011, which measures political freedom and democracy, as “not free”<sup>80</sup>. The latest Press Freedom report places Azerbaijan in 152<sup>nd</sup> place out of 178 countries. That being said, the increasing usage of Internet which is supported by the intentions to raise the development of ICT sector in the country has led to some concerns in government opinions. The Internet is being used among the opposition, journalists and bloggers as an important source of political communication. Meantime, there are some indications that restrictions on content may arise in the future. Websites that criticize the ruling party's policies have emerged; consequently the government has considered introducing a law that will impose restrictions on Websites with antinational content. The

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<sup>79</sup> [www.imf.org](http://www.imf.org) The role of the IMF in Governance Issues: Guidance note 1997

<sup>80</sup> [www.freedomhouse.org](http://www.freedomhouse.org). Freedom House annual Report, 2010

political section of the most popular online forum (<http://www.day.az/forum>) in Azerbaijan was removed around 20 days before the presidential elections in 2008. The popular opposition Web blog Tinsohbeti.com was blocked in March 2008 after it published an article detailing the political and economic problems in Azerbaijan. Earlier, in 2006, the same Website was blocked because it posted satirical cartoons of the president. The FM broadcasts by the British Broadcasting Corporations, Voice of America and Radio Free Europe/Radio Liberty were banned in the country in 2009.<sup>81</sup>

President Aliyev , who has been in power since 2003 ‘‘ holds a firm grip on power with control over the police and security, the state monopoly on the oil resources, and the political support of the ruling YAP party’’ says Leyla Aliyeva , president of the independent Center for National and International Studies in Baku, Azerbaijan<sup>82</sup>.

The above named problems represent significant challenges for conducting business with European and other foreign parties. Legitimacy, transparency, public participation in the management of resources and enforcement of democratic institutions in order to bring social wellbeing is an obvious step, which should be undertaken.

- Weak infrastructure

Among Azerbaijan’s other obstacles is its poor infrastructure, especially considering its specific geographic location. The country is at the crossroads between the East-West Trans-Caucasian route, a route potentially linking Europe to China and a North-South route linking Russia to Iran. Weak infrastructure, natural barriers such as the mountains, heavy-going roads, politically unstable neighbors represent significant challenges.

The infrastructure problem has two dimensions: ‘‘national’’ within the country’s borders and ‘‘international’’ in the neighboring countries through which trade flows, for example in Georgia.<sup>83</sup> Domestic infrastructure has been improved thanks to the construction of pipelines in the region and recent road building, but it is still insufficient. According to World Bank around 56% of the main roads remain in bad conditions and 30% need to be

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<sup>81</sup> <http://www.eurasianet.org/node/62309> Azerbaijan : Baku State Apparatus Takes Aim at Pro-Opposition Media

<sup>82</sup> Leyla Aliyeva .European Union Institute for Security studies’’ Azerbaijan’s presidential elections: do oil and democracy mix’’ October 2008

<sup>83</sup> Trade and Trade Facilitation Review. ADB, March 2003

repaired .Azerbaijan railroad are not able to operate at full capacity. The public water, energy and electricity supply have been improved lately, particularly in Baku area, but still face temporary shutdowns.<sup>84</sup> The railroad, although being quite dense, is inherited from Soviet times and requires reconstruction. The same applies to the existing infrastructure in Georgia. The remaining physical transport is not enough good, lacking an institutional framework, good governance, maintenance, investment and related supply.

- Business constraints

Among the indicators in the Doing Business ranking 2010, Azerbaijan scores the lowest in Trading across the borders (177), Dealing with Construction Permits (160) and Paying Taxes (103) due to its burdensome customs system, weak regulatory policy, labor force and other factors discussed in this chapter. The time to export (43 days vs. Europe and Eurasia which average 26) and a cost per container is 80% higher than Europe and Eurasia on average. There are many formal and informal charges, insufficient computerization and little usage of up-to date technology inspections at the customs.

High entry regulations can prevent new firms from entering the market, limit competition and increase production costs. This will make goods or services uncompetitive and more expensive. Whether a country wants to trade or become a transit area, its business constraints need to be abolished thus making goods or services more competitive.

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<sup>84</sup> Azerbaijan country memorandum .A New Silk Road: Export-led Diversification. Poverty Reduction and Economic Management Unit Europe and Central Asia Region December 2009.Document of the world bank

**Table 14. Selective indicators of doing business in Azerbaijan**

<b>Rank</b>	<b>Doing business 2011(out of 181)</b>
Ease of Doing Business	54
Starting a Business	15
Dealing with Construction Permits	160
Registering Property	10
Getting Credit	46
Protecting Investors	20
Paying Taxes	103
Trading across Borders	177
Enforcing Contracts	27
Closing a Business	88
	<b>Global Competitiveness Report(out of 134)</b>
Higher education and training	77
Goods market efficiency	93
Technological readiness	70

Source: AZE Doing Business report 2010 and Global Competitiveness Report 2011

In the labor market, despite a generally good standard of education inherited from Soviet times, the country is facing the following challenges. Firstly: corruption, lowering value of diplomas; secondly: due to underinvestment into the education system (3.9% of GDP compared to 5.2% for the OECD countries) and thirdly: graduates often do not meet the requirements of the labor market and lack vocational knowledge.<sup>85</sup> Additionally, the teaching methods and materials used in higher education are out of date and have very theoretical approach. In the capital Baku, being a major centre for higher education in the

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<sup>85</sup> Azerbaijan country memorandum .A New Silk Road: Export-led Diversification. Poverty Reduction and Economic Management Unit Europe and Central Asia Region December 2009.Document of the World Bank



country, there are virtually no dormitories for the students coming from other towns. Those few ones, built in the Soviet times, are in poor conditions and often being used as homes for refugees. Investment in adequate education matching markets needs, raise of salaries in education sector, technological upgrade of schools, construction of student campuses, additional trainings ,for example, of English language or IT skills of both students and teaching personnel, will not only boost employment and reduce poverty but also improve graduates' job opportunities. As a result general productivity and competitiveness of the country will be increased.

- Widespread corruption

This is another obstacle for European entrepreneurs. Anti-corruption laws adopted in 2005 and the National Strategy on Increasing Transparency in Combating Corruption is in place, but its enforcement is necessary. Bribery is found in all spheres of life, from Officials at the lowest ranks to the top, thereby any transactions or contracts lack overall transparency. According to the Transparency International 2010 Report, the country's corruption perception index is 2.5, so it is in 124<sup>th</sup> place out of 163 countries (compared, for example, to the Czech Republic at 53<sup>rd</sup> place with a rating of 4.6).<sup>86</sup>

State-controlled television, partially press and internet resources which do not always reflect reality have become important tools of the government to control the opinion of the population and increase pro-government propaganda. Data which can be obtained from the official sources can be different to those from independent ones, like the World Bank, the IMF and the OECD, is often not fully accurate. Moreover, the share of black market (estimated at an average 28-43 in percentage of GDP) and unreported economy is high which again proves the non-transparency of local institutions and the lack of accountability of authorities.<sup>87</sup>

### 3.3 Opportunities

- The country's place in Europe's energy diversification plans

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<sup>86</sup> [www.transparency.org](http://www.transparency.org) Transparency International Annual Report 2010

<sup>87</sup> Ibid

One of them is the Nabucco pipeline which is expected to bring natural gas from the Caspian Shelf, the Middle East and Egypt to European markets to ensure energy security and supply diversification bypassing Russia, the current and largest gas supplier to Europe. Lately widely discussed, Nabucco as a part of the Southern Corridor is projected to begin in 2013 and the first gas will flow in 2017. When operating at full capacity, Nabucco will transport 1,550 bcm to Europe over the next 50 years. This means that an economy the size of Germany could be supplied solely with Nabucco gas for over 16 years<sup>88</sup>. The EU has started to promote this alternative, after Russia cut off gas supplies several times with the most recent cuts in supply during winter 2009 causing gas shortages in several European countries. Other possible pipelines are Italy-Greece as a part of the ITGI (Interconnector Turkey-Greece-Italy) and the Azerbaijan-Georgia-Romania pipeline. Realization of these pipelines is still under review.

In order to extend gas supplies and keep the costs down, the EU has proposed a merger of the Nabucco and ITGI. This combination could be realized in two parts — firstly, the “Southern Corridor Phase I” to Greece and Italy, and then secondly a “Southern Corridor Phase II” to Austria.

In May 2009 during the Southern Corridor Summit held in Prague during the Czech Republic’s presidency of the EU, participants expressed their interest in energy cooperation with coordination within a common progressive strategy and the establishment of a necessary framework to encourage trade, exchange of know-how, technologies and experience.<sup>89</sup>

The Nabucco project can be mutually beneficial: on one side, it will strengthen European energy security; on the other, it will ensure the demand for Azerbaijani gas. For Azerbaijan, Europe represents a reliable and transparent market for energy resources. Additionally, European principles of trade such as fair competition, predictability and others are highly appreciated in the world as well as Azerbaijan. It is estimated that demand for gas will increase especially after some European countries have refused to use nuclear energy following explosions in Japan and the danger they represent. For

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<sup>88</sup> [http://www.nabucco-pipeline.com/portal/page/portal/en/press/Facts%20\\_Figures](http://www.nabucco-pipeline.com/portal/page/portal/en/press/Facts%20_Figures)

<sup>89</sup> [www.eu2009.cz/en](http://www.eu2009.cz/en) Prague Summit ”Southern Corridor- New Silk Road

instance, Germany has already closed 9 nuclear plants and plans to completely shut down its remaining nuclear power plants by 2022.<sup>90</sup> Whereas, despite close historical and geographical links of Azerbaijan and Russia, conflicts with Russia can turn into a real war, as in the case of Georgia in summer 2008, and numerous energy conflicts with Ukraine and Belarus.

‘Azerbaijan is also looking to the EU for support on the long-standing conflict over Nagorno-Karabakh, an Azerbaijani enclave held by Armenia with Russian backing, as well for visa concessions’ says UK based M & C Business News<sup>91</sup>.

Nevertheless, there are certain obstacles that need to be overcome before the gas reaches its destination. Firstly, it is a long distance for the gas to run into European markets, added to which is the cost (estimated at 8 bln Euro) and time (over 4 years) before the pipeline construction is finished. Second, there is no united stance because some countries in Eastern Europe are more interested in Nabucco than others in Western Europe, such as France and Italy. Besides that, Turkmenistan, which has 6 times as much gas reserves as Azerbaijan, is likely to export to China and Russia rather than Europe, as well as concerns about the country’s non-democratic regime and government regulations in energy segments; the increasing importance of Turkey for transit of energy to Europe and safety issues related to the Turkish South East region; political instability in the Middle East; continuing talks on dividing the Caspian Seabed and other constraints for its realization.

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<sup>90</sup> Germany: Nuclear power plants to close by 2022". BBC Article 30 May 2011. <http://www.bbc.co.uk/news/world-europe-13592208>.

<sup>91</sup> M & C business news. January 2011 [www.monstersandcritics.com](http://www.monstersandcritics.com)

**Image 1: Nabucco Gas pipeline route**



Source: Azerbaijan State Oil Academy

- Accession to the WTO

The country's accession to the WTO can facilitate trade between the EU and Azerbaijan through its further liberalization. Especially giving the fact that the number of countries included in the Union has risen in 2004 and is moving further to the East thereby bringing them closer in geographical distance. Azerbaijan's long history in entrepreneurship and trade can positively influence growth with increasing number of the EU countries. Transparent and simplified tariff structures can bring the country closer to the EU market but requires it to conform to the policies of the WTO.

- International focus on Eurovision stimulates public protests

The role of social media and internet can be helpful to raise international awareness about Azerbaijan to improve the situation regarding human rights and democracy. The country expects around 60000 visitors and thousands of top journalists in connection with the 2012 Eurovision Song Contest taking place in Baku. Even if this contest has little cultural significance as one might think, it presents certain challenges in the sphere of social changes in the country. International media coverage of the contest in Europe is pretty high. Given this, civil society activists are already launching a campaign dubbed 'Freedom songs in a non-free country', a protest against hidden authoritarian regime. Activists aim to draw attention to the cases of political prisoners (a number of Azerbaijani opposition

activists have been jailed for up to three years over an antigovernment protest in Baku in April this year), and the increased usage of social networks is giving a louder voice to those who are trying to help secure their release. The civil rights advocates are also targeting the encouragement of political pluralism on public television, the liberalization of bureaucratic visa regulations (as of 2010 it is no longer possible to obtain visa at Azerbaijani borders for the majority of European and other states), guarantees for freedom of assembly and the promotion of greater official respect for property rights.<sup>92</sup> Nevertheless, the real impact and changes it could bring will be known upon the successful completion of the event and in latter times next year.

### **3.4 Threats**

- Energy resources related threats

There are several threats for Azerbaijan-EU relations which arise from the energy sector of the country. The opening of the Central Asia-China and the South Stream pipelines are seen as an attempt to end the viability of Nabucco with the latter one increasing Russian presence in the European energy markets.

Another pipeline- Nord Stream bringing Russian natural gas from across the Baltic Sea to Germany is currently under construction.

Moreover, Russia has proposed to buy Azeri gas at a record price of \$350 per 1000 cubic meter in order to minimize its delivery to the European markets. Russia's largest gas exporter, Gazprom has signed an agreement with the State Oil Fund (SOCAR) to buy 2 bln cubic meters in 2011 and even more from 2012 for further export.<sup>93</sup> From which Azerbaijan will benefit based on purely commercial reasons.

''Russia is purposefully missing out on \$360 million a year by paying market prices for Azeri gas. The idea is to prevent Europe from buying the gas so it cannot diversify its

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<sup>92</sup> [www.eurasianet.org](http://www.eurasianet.org) Azerbaijan:

Eurovision More than Just a Song Contest for Activists

<sup>93</sup> <http://uk.reuters.com/article/2010/09/03/russia-azerbaijan-gas>

supplies away from Russia,’’ said Mikhail Korchemkin, head of East European Gas Analysis.<sup>94</sup>

- Nagorno-Karabakh problem

This conflict was described in detail in chapter 1. The latest negotiations took place in June in Kazan (Russian Federation) between Ilham Aliyev, the President of Azerbaijan and Serzh Sargsyan, his Armenian counterpart, which failed to bring any progress in the Nagorno-Karabakh peace process.<sup>(5)</sup> The Azerbaijani President has repeatedly announced that Azerbaijan’s “territorial integrity will be restored by any means.” A potential military solution could bring problems to both sides and further deepen economic and political imbalances in the region, which in turn may negatively influence Azerbaijan’s position in the international arena. Besides that, internally displaced people from both sides and the isolated enclave are obvious obstacles for reducing poverty and further economic growth.

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<sup>94</sup> *ibid*

## Conclusion and recommendations

In the conclusion of my thesis we can analyze that whilst Azerbaijan continues development and becomes richer in the short and medium term the economy outside the hydrocarbon sector must be encouraged to create further growth.

The first chapter of my thesis is focused on the beginning of transition of Azerbaijan to the market economy. Firstly, in the early years of its formation, the country went through a large-scale economic downturn but later following the stabilization program under the supervision of the IMF and the World Bank and undertaken series of privatization, trade liberalization and land reforms was able to improve its position.

The following chapter describes the latest economic achievements. Despite fast economic expansion, Azerbaijan is facing many challenges and much work still needs to be done. That is to say:

- reduction of poverty and the improvement of the welfare of refugees and IDPs including better access to healthcare and education in the rural areas in order to raise their living standards and diminish the difference between the rich and the poor. The population below the poverty line in 2009 was 11% (in population terms this represents around 1 mio out of a total of 9 mio). That is still higher than in neighboring Kazakhstan which has 8.2% for the same period<sup>95</sup>.
- upgrading of infrastructure and the business environment. These factors have been largely discussed in previous chapters and remain major constraints for doing business. Addressing these issues could increase the potential in the service sector and other areas of the economy
- enforcement of anticorruption legislation and the transparency of institutions
- building a strong human capital base that meets the labor market needs through a higher quality of education, an upgrade of the current methodologies used coupled with computerization and improved training of teaching personnel .

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<sup>95</sup> [www.nationamaster.com](http://www.nationamaster.com) Statistics of Population below Poverty line by country

- another important challenge for the country is to effectively manage current revenues to transfer them into non-oil sector given the short term nature of the energy boom and volatile fuel prices. This can in turn transform a small resource-rich country into successful globally and regionally integrated one.
- the country must be aware of Dutch Disease effect, an economic overdependence on energy exports. Consequently, diversification outside the energy sector is crucial for generating jobs and equity. For example, for stimulating the development of SMEs and the agricultural sector, the government must be more effective in the implementation of key reforms, privatization of state enterprises and strengthening the financial sector. In another example, the country can use western practices of subsidies and other means of support agriculture in order to ensure its sustainable development and competitiveness that leads to higher productivity, lower prices and better quality of products.
- identification of the competitive advantages of the different regions can be used to increase their specialization and attract more investment. Furthermore, investment not only refers to financial means but there are also new technologies, innovations and experience that can increase efficiency of the regions and raise the added value of products. This is valid for tourism, food processing and agriculture throughout the country
- maximize the advantages from the accession to the WTO. By entering the organization Azerbaijan must keep preferential access which it already enjoys with the EU and US and maintain its free trade agreements with the CIS countries taking into consideration the importance and proportion of trade with them
- political development towards democracy, human rights ,fundamental freedoms and equal distribution of revenues
- peaceful settlement of the Nagorno-Karabakh problem has critical importance for the prosperity of the country and a better quality of life for its citizens. The conflict is still not resolved. This slows down not only the country's but also regional trade flows,



prevents greater inflow of foreign direct investments and re-opening of the second (after Georgia) alternative corridor through Armenia.

In the final chapter, I have analyzed the country's major opportunities for further cooperation with the EU using SWOT analysis tool.

The study finds that on one hand, the profits generated by export of energy resources represent large opportunities to realize the country's economic transition to a market economy and build a modern and successful state. But on the other hand, many scholars argue that current energy boom has had a negative impact on the country's development in the spheres of democratic reforms and human rights. In my SWOT analysis I have provided some aspects of current non-democratic regime and its consequences. Foreign investors, who are interested in high revenues from energy resources, support the present political regime for the sake of continuation of oil and gas projects. In fact, many companies have established close political relations with the government to pursue their goals and continue to ignore the real economic and political situation.

Since the beginning of Azerbaijan's independence the EU has played an important role in the transition of the country to a market economy. Firstly, in the beginning of the transition in the early 90s, the EU has participated through different programs and technical assistance such as TRASECA, INOGATE and TACIS. Later, in 1999 Azerbaijan enlarged its cooperation with the EU in the framework of Partnership and Cooperation Agreement which serves as a political and legal basis for mutual cooperation. In 2004, the country has increased its participation by enrollment in the European Neighborhood policy and adoption of the Action Plan two years later. By doing so, the two parties have committed themselves to strengthening bilateral economic and political cooperation. Launched in 2009, the EU Eastern Partnership agreement aims at establishment of closer integration of the country with the EU including signature to comprehensive free trade agreements and simplification of the visa process.

Currently, the EU and Azerbaijan are working on a wide range of projects such as transport, education, human rights and freedoms, aviation, culture etc. Today, the EU has become Azerbaijan's main trade and investment partner.

Consequently, the implementation of the Action Plan requires deeper reforms from Azerbaijan especially in promoting civil society, strengthening democratization and the rule of law in order to make the best out of it. To be able to benefit from further trade liberalization and greater market access, deeper reforms to comply with the WTO rules are required. This can in turn generate further growth and increase employment outside the hydrocarbon sector.

Presently, the majority of the EU-Azerbaijan economic cooperation is driven by EU energy needs. In the structure of Azerbaijani foreign policy, the EU is one of the key economic partners given its 500M+ population and tremendous economic leverage. The realization of deliveries of oil and gas to Europe has strategic importance for both sides. On European -its plans to diversify its energy imports and reduction of dependence on Russia. On Azerbaijani –to secure a stable demand for its energy resources and become a potential secure transit route for the countries in the Caspian basin and Central Asia. However, unlike previous successful completion of the pipelines bringing Azerbaijani fuels and those from other countries in the Caspian basin to the European markets, the Nabucco pipeline is full of controversial opinions and dilemmas.

Nevertheless, along with the EU, regional trade with neighboring countries of the CIS and Turkey especially taking into account the close political and economic ties with the latter remains of high importance. That being said, the country's major pipelines lie through the territories of these states; the countries are bound by close historical relations and the share of trade with the CIS countries is the highest after the EU at 17% of the total turnover. Turkey was the first country to recognize Azerbaijan's independence in the early 90s and support its territorial integrity in the conflict with Armenia.

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## Annex

**Table : Structure of Azerbaijan 's imports by commodity (in thousands USD) 2010**

	<b>Sections of commodities</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>
	<b>Total</b>	<b>6372165.0</b>	<b>6058222.3</b>	<b>47756040.2</b>	<b>14701358.8</b>	<b>21360210.2</b>
	of which:					
0	Food and live animals	228016.1	407581.0	408473.7	404438.0	415118.7
1	Beverages and tobacco	38894.4	28402.1	22762.1	16568.2	21972.2
2	Crude materials, inedible, except fuels	203967.4	107076.5	83402.9	31570.7	22949.5
3	Mineral fuels, lubricants and related materials	5390285.9	4931210.5	46362868.4	13639469.0	20110120.4
4	Animal and vegetable oils, fats and waxes	52795.5	67010.7	98769.4	103655.4	154862.1
5	Chemicals and related products	134507.4	98113.3	174428.5	90237.0	130179.2
6	Manufactured goods classified chiefly by material	175511.6	221049.6	408466.8	171256.1	170847.9
7	Machinery and transport equipment	121830.1	147357.5	174163.2	200975.6	217765.1
8	Miscellaneous manufactured articles	26356.6	50421.1	22705.2	32177.1	34604.9

Source: Statistical Committee of Azerbaijan  
www.azstat.org



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Source: Source: Ministry of Economic Development of Azerbaijan. Available at <http://www.economy.gov.az/eng>

Chart 4.Foreign investment by country directed to fixed capital 2010 (Mio AZN) Source:

Source: Ministry of Economic Development of AR [www.economy.gov.az](http://www.economy.gov.az)

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2011.Available at [http://devdata.worldbank.org/AAG/aze\\_aag.pdf](http://devdata.worldbank.org/AAG/aze_aag.pdf)

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Table 3.Structure of Imports of Azerbaijan Source: Azerbaijan Statistics Committee

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Source: World Bank .Azerbaijan and EU bilateral trade and trade with the world 2011

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Table 5 .Azerbaijan main trade partners 2010

Source: World Bank .Azerbaijan and EU bilateral trade and trade with the world.

Available at <http://ec.europa.eu/trade/creating-opportunities/bilateral-relations/regions/south-caucasus/>

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Source: Eurostat. Azerbaijan-EU bilateral trade and with the world. 2011 Report.

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