

AZERBAIJAN

TRADE AND TRADE FACILITATION REVIEW



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EXECUTIVE SUMMARY

Azerbaijan became independent in 1991, following the collapse of the former Soviet Union, of which it was part since 1922. After independence the country faced a period of long political and economic turmoil, also as a consequence of the war with Armenia for the control of the Ngorno Kharabakh region. The political scene was normalised when Mr. Heydar Aliyev became President of the country in 1993. In 1995 Azerbaijan started a stabilisation programme in cooperation with the IMF, which succeeded in reducing the main macroeconomic imbalances and in stabilising the economy.

Average yearly growth rates have been at 8 percent for the past five years and inflation at 2 percent. The economy is recovering from the severe setback, which followed independence, although in 2000 real GDP was still at 59% of its 1990 value. Growth is driven by hydrocarbons, thanks to the increasing exploitation of existing oil fields (the Azeri-Chirag-Guneshli field) and to the discovery of a new major gas field (the Shah Deniz field). Oil production has been expanding since 1998 and will peak to 1,000,000 barrels a day by 2008, compared to 140,000 a day at present. Gas from Shah Deniz will be extracted starting from 2004. Hydrocarbons accounted for 32.5 percent of total GDP in 2001.

Other sectors have a much smaller role. Agriculture accounted for 18 percent and manufacturing for 5 percent of GDP in 2001. Manufacturing and agricultural activities have been declining since independence. In 2001 the output of industrial machinery was at 12.3 percent of its real value in 1990, agro-processing was at 16 percent, other light industries like textile at 11.5 percent and agricultural crops like cotton at 27 percent.

Exports accounted for 44 percent of GDP in 2001. Hydrocarbons are by far the dominant export activities, up to 91.5 percent of total exports in 2001. The remaining share of exports mostly consists of raw and processed food products, mechanical equipment and chemical products. Manufacturing and agricultural products accounted for a considerably larger share of exports before independence, when Azerbaijan was a large exporter of food processed products and light machinery, mostly to the rest of the Soviet Union

The largest share of imports is made of machinery for the oil industry, food products, other mechanical equipment and luxury consumer goods for the high-income part of the population. Imports have replaced many of Azerbaijan traditional products in the domestic market, as these are unable to withstand international competition.

As for the markets of destination of exports, there is a dichotomy between oil and non-oil products. Oil is mostly exported to Europe, whereas non-oil products mostly cater the regional market, which includes neighbouring CIS countries (mainly Georgia and Russia), Turkey and Iran. A large share of imports originates from

Europe and the US, namely machinery and high quality consumer goods, the rest, including foodstuff, from the region.

Although Azerbaijan has been running a trade surplus since 2000 and exports of hydrocarbons provide much needed foreign resources, the country faces the severe problem of diversifying its structure of production for the domestic and the export markets. This report finds that diversification is hindered by constraints in the trade and in the overall economic environment. Effective diversification will not be achieved unless some of these major constraints are lifted.

Constraints to trade

In principle Azerbaijan has a fairly liberal trade regime. Tariff brackets range from zero to 15 percent, with an average tariff of 7 percent. This compares favourably to most countries, which are considered to operate under free trade regimes. The average tariff is 8.7 per cent for a free trade champion like Korea, it is around 7 percent for the European Union and much higher, up to 32 percent for India. There are limited non-tariff barriers to imports and exports. Only trade of sensitive products, like weapons or narcotics, is restricted. Besides for oil and a few other strategic commodities, there are no restrictions or specific duties on exports.

Azerbaijanis is seeking accession to the WTO, implicitly a long-term commitment to free trade. The first meeting of the working party on the accession of Azerbaijan took place in June 2002. The government is now preparing the sector specific accession documents. Accession is expected by the end of 2003.

Also, Azerbaijan's authority has managed to keep a stable real effective exchange rate, notwithstanding growing net oil revenues which are being sterilised in an off budget oil fund.

However, a detailed analysis of Azerbaijan's trade environment shows that trade is faced by major constraints in the domains of trade policy, hard and soft infrastructure.

Trade Policy. Trade policy in Azerbaijan faces three main shortcomings.

First, there is a bias against imports of components of exported products. Duty free exemptions are only available for companies working in the oil sector under Production Sharing Agreements (PSAs). Bonded warehouses and free trade zones are admitted by the legislation, but they do not exist in fact. Draw back mechanisms of duties and VAT, even though available, take time to be implemented, they are granted on a discretionary basis and they are rarely accessible to small firms. This is a serious impediment to trade, particularly for potential non-oil exporters like agro-processing businesses, as many components are not available in the domestic market and must be imported anyway.

Second, many regulations and procedures are incompatible with WTO standards and will have to be reformed. These include, sanitary and phytosanitary standards; the custom valuation approach when based on the

minimum value; the fact that VAT is computed on the origination principle rather than on the destination principle; the fact that custom fees are set at a fixed percent of custom value instead of reflecting the actual cost of service delivery. Also protection of intellectual property rights is allegedly weak and will have to be strengthened.

Third the trade regime faces severe problems of *implementation*. This is probably the most serious impediment to trade. A contradictory legal and regulatory framework leaves large margins to discretionary behaviour, causing uncertainties when dealing with the administration and widespread corruption.

Hard infrastructure Vast reforms and investments in rehabilitating the transport system are required.

First, the *institutional framework* is weak. There is generally no separation between the regulatory and the operation functions, which are mostly carried out by the parastatal companies operating in the relevant transport sectors. The Ministry of Transport has just been set up, but it is not fully in operation yet.

Second, large *investments* are required in the road systems, railways, ports and airports to bring infrastructure up to international standards. Infrastructure has also a major trans-national dimension, given that Azerbaijan is land locked. As a consequence of political instability the main and essentially only viable trade route is through Georgia and then on to Russia or to the Black Sea. Georgia has very poor infrastructure and its roads are not safe because of political and civil unrest. The Georgian corridor is a major bottleneck for Azerbaijan's trade. Containers travel by rail between Baku and Poti (the main Georgian port on the Black Sea) at an average speed of 20 Kms. per hour, and this is the fastest mean of transportation on this route. However, these constraints only concern trade of non-oil products. Exports of hydrocarbons will soon circumvent transport barriers, because of the construction of two major pipelines. The new Baku-Tbilisi-Cheyan oil pipeline and the Baku-Erzoran gas-pipeline, presently under construction, will reduce drastically the cost of transporting hydrocarbons to Western markets. They have sufficient transport capacity for all the newly found oil and gas.

Soft infrastructure Trade also faces major soft infrastructural constraints, pertaining to the Customs administration and to the broader business environment.

First, Azerbaijan's *Customs* has severe shortcomings in its legal system, in the administrative capacity of its border agencies, it has problems of corruption, clearance procedures, controls are long and discretionary and the infrastructure is poor. According to a survey of trade and transport companies, unofficial payments, mostly arising at Customs, constitute a large share of all transport costs. Although there have been a number of recent improvements in the State Customs Committee and a Customs reform program was outlined in cooperation with the IMF and Price Waterhouse Coopers, major shortcomings are still to be addressed.

Second, soft infrastructural constraints also arise in Azerbaijan's *overall business environment*. Given the weakness of the local economy, trade expansion can only happen as a consequence of new investments and of emerging new activities. In all areas of business environment analysed by this report (namely, law enforcement, incentives and constraints to foreign investors, the financial sector and the protection of property rights) major shortcomings have been found, hindering private sector development. The picture is considerably different for firms working in the oil sector, as their activities are 'sterilised' from the rest of the economy and ruled by ad hoc PSAs, which are virtually parallel pieces of legislation.

Measures for trade facilitation and private sector development

Which measures should be undertaken to lift these constraints? Different measures and reform programs have been proposed by the major aid agencies. It is therefore essential to develop an all encompassing plan for action, coordinating all the specific initiatives in the field. The measures suggested in this report pertain to the trade environment and to the broader business environment.

Trade Facilitating Measures. Most of the suggested measures affect directly the trade environment and fall under the scope of trade facilitating actions.

First, introduce reforms to achieve the compliance with WTO regulation and measures aimed at assisting the country in the final phases of negotiation for WTO accession. These include:

- the convergence of sanitary and phytosanitary requirements to WTO standards;
- the application of *ad valorem* duties on all items;
- the reform of VAT assessment procedures;
- the adoption of a custom fee reflecting the actual cost of service delivery.

Second, reduce the trade related costs of imported components by way of:

- the reduction or the elimination of duties on components;
- the establishment and the implementation of an effective draw-back scheme for duties and VAT charges,
- the establishment and the implementation of Bonded Warehouses and of Free Trade Zones.

Third, reform Customs, on the basis of the plans put forward by the World Bank, the IMF, Price Waterhouse and the TRACECA secretariat. This process of reform should encompass measures related to:

- the legal framework, including the redrafting of the Customs Code, which still allows for large margins of discretion, rent seeking behaviour and corruption;
- the administrative capacity, including a rationalisation of the operations of the State Customs Committee and of pre-processing practices;

- the procedures, including the improvement and the rationalisation of valuation procedures, of documents and goods clearance, of post-entry verification and also the substantial strengthening of the computerisation of procedures, on the basis of standard international practices like Asycuda;
- the infrastructure, including the construction of bonded warehouses.

Fourth, reform the institutional framework concerning transport and invest in transport infrastructure, as part of and beyond the TRACECA project. Specifically:

- reform the institutional framework, aiming at the separation of the regulatory and the operative functions, which are still joint for most of the means of transportation;
- improve the infrastructure of the rail and road transport corridors through Georgia, which is the only viable trade route to the West, at present;
- improve maritime transportations in the Caspian Sea, including rehabilitation and strengthening of the Port of Baku, so as to facilitate trade in the Central Asian Region.

Measures to improve the broader business environment. The report also suggests measures aimed at improving the overall business climate for private sector development, which are also judged to be an essential pre-condition to trade expansion.

Fifth, complete and implement institutional and policy reforms, with the aim of reducing margins for discretion and rent seeking activities. This process should:

- define and implement a stable legal framework;
- strengthen dispute settlement mechanisms;
- ensure effective protection and enforcement of property rights
- promote specific measures to reduce and eradicate corruption.

Sixth, introduce direct measures to promote non-oil activities and companies and to lift some of the major constraints to their activities. These should include:

- financial support;
- fiscal incentives;
- facilities for training and technical assistance.
- examine the extension of the regulatory framework implicit in the Product Sharing Agreements for the oil sector to other economic activities;

A broader strategy for trade facilitation and private sector development: diversify from hydrocarbons

The trade and private sector facilitation measures discussed above should be part of a broader strategy to expand exports and possibly reduce import dependence. The central goal of this strategy is maximising the oil windfall to diversify the economy into non-oil activities. Investments to expand the exploitation of oil and gas fields and the construction of the new pipelines are essential, as they generate much needed resources for the broader development of the country. However, oil activities, despite their GDP share of 32.5 percent in 2001, only account for 2.1 percent of total

employment and have therefore limited effects on the broader working population of Azerbaijan. Specific and targeted measures are consequently necessary to promote non-oil activities. These activities should aim at supplying both the domestic market, in order to reduce import dependence, and the export market. This is a difficult task, given that there are not many activities in which Azerbaijan has an obvious comparative advantage and which would be able to withstand international competition.

Specifically, Azerbaijan's trade expansion strategy should pursue five objectives.

First, strengthen the oil windfall by promoting activities to be developed as a spin-off of hydrocarbons. Besides for using oil revenues to strengthen the broader economy, some activities could be developed as a direct spin-off of oil and gas extraction. The report argues that there is limited scope for the establishment of oil based processing activities, but it is possible to focus on external services to the oil industry which could in the future cater other sources of demand. Among these, we should include mechanical shops, light engineering and services like catering

Second, directly promote non-oil activities. This primary target is shared by the government and some major aid agencies. The most promising sectors are food and agro processing. These activities are hampered by major constraints which are discussed extensively in the report and which must be directly addressed. Transit activities are also important. Their expansion depends on the future development of the regional economy and on the viability of the TRACECA corridor, linking Europe to China through the Caucasian republics. Any measure of promotion will have to be designed to avoid breaching WTO regulations.

Third, reduce the bias against non-oil activities, to avoid the crowding out effects of oil. Crowding out does not just refer to the diversion of financial resources towards the more profitable oil sector, but also and mostly to the lack of interest for policy and institutional reforms concerning non-oil activities. A first fundamental step will be to study how and whether the type of institutional framework envisaged by the PSAs could be extended to non-oil activities.

Fourth, promote a right balance between world and regional markets. Political and military unrest at and beyond Azeri borders limit considerably Azerbaijan's trade flows of non-oil products, forcing them through the Georgian bottleneck. The impossibility of using other trade routes (through Armenia and Russia) likely diverts trade towards the region. Half of the transport costs of a container from Baku to Northern Europe arise in the region. Consequently, very little trade can reach competitively beyond the borders of the region. Gravity models predict a large increase in trade with the US and the EU, if these routes are reopened. However, in the short term, this prediction is unlikely to apply to non-oil activities. These will keep catering the regional market. Even if Azerbaijan is able to develop a viable export sector, it will take time before its products enter the sophisticated Western markets. Russia, in particular, will continue to be the main outlet for the few exportable

Azeri products. Trade is also likely to increase with neighbouring Kazakhstan, as far as oil revenues boost local markets. Thus, regional trade is likely to intensify, even following the normalisation of trade relations with neighbouring countries and the re-opening of trade routes alternative to Georgia. It is therefore important that in the longer term the cooperation with Central Asian and Caucasian states is strengthened, and that infrastructural investments do not crowd out trade routes to regional markets, once they become again politically viable.

Fifth, maximise the benefits from WTO accession. Azerbaijan has a fairly liberal trade regime. It should not try to negotiate higher bound tariffs than those effectively in place, to grant itself some future room for manoeuvre to protect domestic production. This is not a viable strategy and it would anyhow be unwise to reverse the trade liberalisation process at this stage, thereby hampering the reallocation of economic activities, which is actually taking place under this regime. In contrast, Azerbaijan should make sure that by entering the WTO its exports do not lose the preferential market access to industrialised countries, which they now enjoy in the EU and in the US. Azerbaijan should also make sure it is allowed to preserve its free trade agreements with the other CIS countries. Given that effective free trade agreements with CIS countries are only bilateral, if Azerbaijan had to unilaterally renege the agreements it has in place at the moment as a consequence of WTO accession, it would likely be cut off regional trade flows.

1. INTRODUCTION

This study reviews all the main issues concerning the international trade of Azerbaijan. The country, independent since 1991 and formerly part of the Soviet Union, is essentially a net exporter of hydrocarbons, thanks to the exploitation of its large oil and gas fields in the Caspian Sea. Other manufacturing and agricultural products constitute less than 10 percent of total exports. Domestic production of these products is close to nil, at a fraction of what it was before independence, as it was unable to withstand international competition. Azerbaijan, therefore, is also heavily dependent on imports of most products, including foodstuff.

The main concern underlying this study, then, is to understand the major constraints hindering the development of a diversified productive sector and how to use the oil windfall to lift them. Obstacles to trade and to business in general are indeed many, the first one being oil itself. Hydrocarbons generate badly needed foreign resources, but extraction activities are capital intensive, employ few people (2 percent of the total labour force) and generate few spillovers on a backward economy like Azerbaijan. Moreover, given the high margins of these activities, most resources are devoted to them. These do not just include financial resources but also the effort of reforming the overall policy and institutional framework to the benefit of the overall economy. Oil is institutionally sterilised by ad hoc production sharing agreements and the rest of the economy is left in a bit of a shamble.

Other constraints include poor infrastructure, the existence of essentially one viable, albeit shaky, trade route to the West, crossing Georgian territory, and a lack of managerial and technical capabilities to set up viable and competitive activities. Although the Government of Azerbaijan is committed to free trade, it has actually adopted a liberal trade policy and it is seeking membership to the WTO, until these major constraints are lifted, no major changes in the trade prospects of non-oil products are to be expected.

This report begins by reviewing Azerbaijan political and economic background; it then moves to analyse the country's trade performance. It then examines the main trade constraints pertaining to policy, hard and soft infrastructure. It concludes by outlining a broad strategy for trade expansion.

The author of this study benefited from various earlier works, which have addressed different aspects of Azerbaijan's international trade, particularly the World Bank's studies on Trade and Transport Facilitation in South Caucasus, from which various sections of this study draw. Compared to these earlier works, the novelty of this report is to bring together all the different aspects of the trade issue.

2. SETTING THE SCENE: A BACKGROUND REVIEW

2.1. Historical and political background¹.

Azerbaijan is an independent republic since 1991, following the collapse of the former Soviet Union, of which it was part since 1922. It is located in the southern part of the Caucasus Region and on the Western shore of the Caspian Sea. It has common *borders* with the Russian Federation to the North, the Republic of Armenia and the Georgian Republic to the West, with the Islamic Republic of Iran to the South. Part of its territory, the Nakhchivan Autonomous Republic is a separate enclave between Armenia and Iran and has a short stretch with Turkey. Mountains surround Azerbaijan's territory –amounting to just over 86,000 square kilometers–, less than 20% is classified as arable.

The country is *endowed* with petroleum and natural gas, and favourable climatic conditions for agriculture. Unfortunately, in the past, exploitation of such resources disregarded environmental safety guidelines; as a result parts of the country, namely the Apsheron Peninsula and the Caspian Sea, are today among the most polluted areas on Earth.

Estimated *population* in January 2001 was 8,081,000, growing at a 0.38% growth rate. The population is rather homogeneous: about 90% are Muslims and speak the Azeri language. In 2001, about 49% of the population was estimated to live in urban areas, with a slightly increasing trend. The most densely populated area of the country is the Apsheron Peninsula, while the highlands are the least populated region.

The capital city of Baku is located on the western shore of the Caspian Sea and with a population of 1.8 millions it is the largest city of the country. It is a major cultural and educational centre, and the basis of its economy is petroleum.

The first Azerbaijan Republic was established in 1918, but two years later the country was invaded by the Red Army and absorbed into the Soviet Union. In the late 1980s, as the Soviet Union began to collapse, a nationalist movement started to develop also in response to the separatist claims of the dominant Armenian population of the Azeri district of Ngorno Karabakh. War broke out and the Armenians of Karabakh took control of a territory amounting to almost 20% of Azerbaijan. In 1994 a cease-fire was signed, but the territory remains occupied and more than 750,000 refugees and internally displaced people are scattered around the country.

Ever since independence, politics in Azerbaijan has been dominated by the Ngorno Karabakh conflict. After much political turmoil, Heydar Aliyev – a former KGB officer, head of Azerbaijan's Communist party and member of the Soviet Politburo – seized

¹ The Sources of much of the information reported in this section are: Economist Intelligence Unit, 2002, Baker and McKenzie, 2002, US Department of Commerce, 2002

power in 1993 and was soon after elected president. Since then, Mr. Aliyev has consolidated his power and established a stable rule of government. Although political pluralism exists and opposition is lively, power is tightly in the hands of Mr Aliyev and his party, the new Azerbaijan Party (NAP).

Azerbaijan's executive power rests with the president (elected by popular vote to a 5-year term), the Prime Minister and the Council of Ministers. The President, with the consent of the National Assembly, appoints the Government. The Legislative branch consists of the unicameral National Assembly, the Milli Mejlis that enacts laws and constitutional laws. The judicial power is implemented through the Constitutional Court, the Supreme Court, the Economic, and general courts; judges are independent from the legislative and executive powers, being only subject to the constitution

Azerbaijan's international relations are tense not only with Armenia, but also with the other countries bordering the Caspian Sea. The issue there is the legal status of the Sea and the rules to be applied to its exploitation. Tensions between the littoral states peaked in July 1991, when the Iranian Navy prevented Azerbaijani ships from surveying the sea.

2.2. Economic background

The *transition* to a market economy, following the separation from the Soviet Union, posed enormous problems to Azerbaijan. During the Soviet era most of industrial exports and about a quarter of agricultural exports were directed to other soviet republics, but when the Union collapsed, with the dramatic economic crisis that followed, these markets became suddenly foreclosed. Furthermore, after independence, the government engaged in very loose monetary and fiscal policies that resulted in a budget deficit, hyperinflation and a depletion of foreign reserves. The country went through a deep socio-economic crisis, and, according to IMF estimates, real GDP contracted by almost 60% by 1995.

Despite all this and the additional problems posed by the conflict with Armenia, some element of a market economy emerged and long-term prospects remained relatively good given the medium term perspective of increasing the exploitation of the substantial energy resources with which the country is endowed.

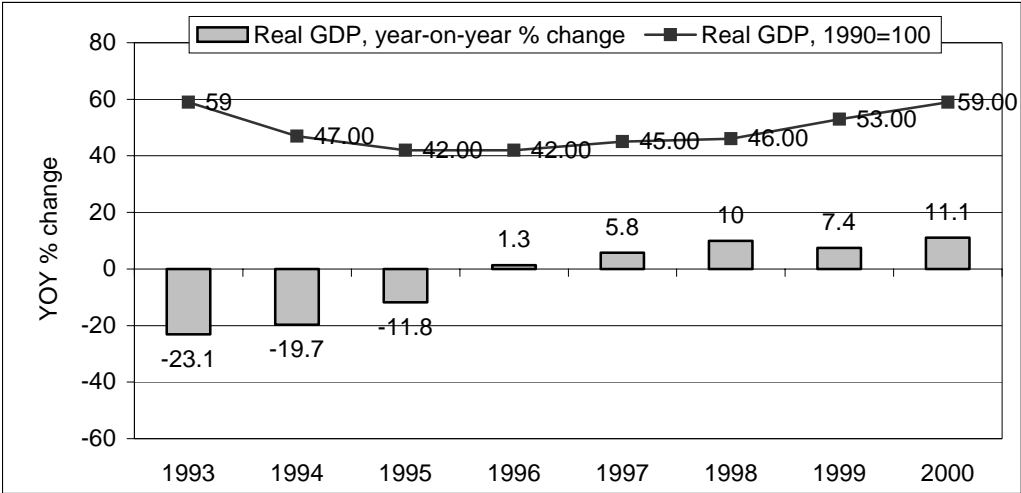
In 1995, Azerbaijan started a *stabilisation programme*, in cooperation with the IMF, the World Bank and the EBRD. As a result recovery began in 1996 and accelerated until late 1998 (real GDP growth rate reached 10% during that year). During the past 5 years, real GDP growth averaged 8% while inflation rate was on average 2%; the exchange rate stabilised as well and actually appreciated in real terms during 1998.

Other important achievements of the programme were price and trade *liberalisation*, small enterprises and land *privatisations*. On the other hand, deep structural reforms, such as large-scale privatisations, regulation of public utilities, reform of the financial sector, have been limited as far as any serious attempt to address the reported rampant corruption. Despite all this progress, incidence of structural unemployment, poverty and civil unrests remain high.

2.3. Output and output growth

Azerbaijan’s nominal GDP stood at 36 billion US\$ in 2000, which implied that real GDP was 59% of what it was in 1990, at the eve of Azerbaijan’s declaration of independence from the Soviet Union. As shown in Figure 1, real GDP kept declining dramatically up to the mid 1990s during the troublesome years that followed independence. In 1996 real GDP was 42% of what it was worth in 1990. GDP started picking up in the mid Nineties as a consequence of the successful political and financial stabilisation, reaching two digits growth rates by 1998 (Table 1). Growth in GDP is essentially driven by increasing oil production, which however cannot make up for the overall collapse of real output which is still at 59 percent of what it was at the eve of independence. Real output will increase further, when the new oil and gas fields reach their full capacity output.

Figure 1: Real GDP 1993-2000



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

Table 1: GDP and GDP per capita

	1995	1996	1997	1998	1999	2000	IX 2001
Real GDP (1995 prices)bill. AZM	10669	10803	11430	12569	13494	14993	
Real GDP rate of growth, (percentage)	-11.8	1.3	5.8	10	7.4	11.1	
Real GDP per capita (1995 prices, 000 AZM)	1388.4	1391.6	1458.2	1588.4	1690.4	1862.8	
Real GDP per capita rate of growth (percentage)	-12.8	0.2	4.8	8.9	6.4	10.2	
Real GDP per capita (US\$, 1995 prices and 1995 exchange rate)	314.5	315.26	330.35	359.85	382.96	422.02	
Nom.GDP per capita (US\$-current prices)	314.5	409.3	505.4	562	574.5	654.5	
Average Exchange Rate (AZM / US\$)	4414	4300	3986	3869	4116	4474	4630

Source: Economic Trends Quarterly Issue., Azerbaijan July September 2001

2.4. GDP by sector

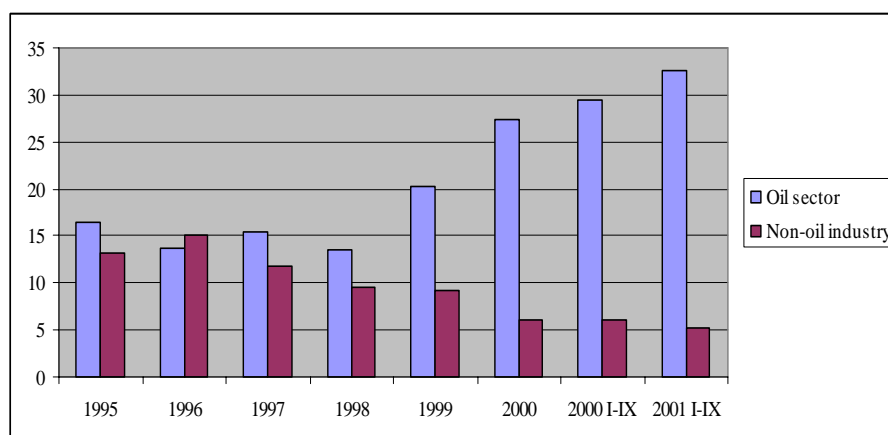
By the mid nineties, Azerbaijan's economy had undergone dramatic changes, whereby most of its agricultural and manufacturing activities, which were essentially catering the captive Soviet Union markets, had been irreversibly lost, and oil was the leading economic activity. Figure 2 shows the rampaging share of oil in total value added, dwarfing the share of non-oil industrial activities. In 2001, oil accounted for 32.5% of GDP. This share had increased considerably since 1998, thanks to rising world oil prices and as new oil fields started being exploited by the Azerbaijan International Operating Company, a joint venture led by BP, including the State Oil Company of Azerbaijan Republic (SOCAR) and other international oil companies. AIOC won in 1994 the right to exploit the Azeri-Chirag-Guneshli (ACG) oil field. The share of oil in the economy will increase steadily up to 2008 when the ACG oil field will be fully exploited with a daily production of 1,000,000 barrel per day compared to 140,000 as of today.

Most of this oil will be exported using a new pipeline. In 2002 Azerbaijan signed a 7 billion dollar deal with an international oil consortium, once more led by BP, to construct the Baku-Tbilisi-Ceyhan –BTC oil pipeline, that will connect the Caspian shore near Baku to the Mediterranean sea, passing through Georgia and Turkey. This pipeline significantly increases Azerbaijan's oil export capacity: while cutting transportation costs, it will also reduce Caspian oil exports (essentially from Azerbaijan and Kazakhstan) dependence from Russia, which so far still conveys a large share of Caspian oil through its pipelines.

Moreover, the newly discovered BP operated gas field of Shah Deniz will start producing in 2004, exporting to Turkey 5 bn. cubic meters per year (the whole field is

500 bn. cubic meters), as soon as the new pipeline from Shah Deniz to Erzerum in Eastern Turkey is completed.

Figure 2: Estimated share of oil sector and non-oil industry in total value added



Source: Economic Trends Quarterly Issue., Azerbaijan July September 2001

The oil windfall is a great opportunity for the country, but it poses serious problems for the future, unless the economy undergoes dramatic restructuring. As clearly shown in Table 2 oil extraction accounts for 75 % of industry GDP in 2000 (the total industry share is 32%). Note also that the share of processing declines from 21.4 percent to 16.9 percent between 1999 and 2000, the only two years for which these data are available.

Table 2: Structure of GDP by main sectors

	1995	1996	1997	1998	1999	2000	2001-IX
Industry	27.3	25.8	25.2	22	28.2	32	29.1
Of which							
Extraction	...	...	...	...	65.57	75.32	...
Processing	...	...	...	...	21.40	16.89	...
electricity, gas and water	...	...	...	...	13.03	7.79	...
Construction	3.7	9.3	11.7	13	10.9	4.4	2.9
Agriculture	25.1	24.7	20	17.9	18.4	18.1	33.2
Transp. & Comm.	17.4	10.2	10.5	12	10.7	14.4	14.9
Trade	4.8	5.2	5.8	5.9	7.1	6.1	5.2
Others	14	14.6	19.5	25.1	20.8	21	9.9
Indirect taxes	7.7	10.1	7.4	4.1	4	4	4.8
GDP	100	100	100	100	100	100	100

Source: Economic Trends Quarterly Issue, Azerbaijan July September 2001. International Monetary Fund, Azerbaijan Republic: Selected Issues and Statistical Appendix.

This trend is consistent with real output production indices, as reported in Table 3. Consider some of the Azerbaijani's key industries under the Soviet Union. In 1997 machine building's real output (Azerbaijan was the most important producer of machinery for oil extraction) stood at 20.4 percent of its level in 1992 to decline to 12.3 percent in 2000. Agro processing (Azerbaijan has nine climatic zones and was a net exporter of processed and unprocessed food products) output is stable around 16 percent of 1992 output. Other light industries like textile fare equally badly: from 26.8 percent in 1997 to 11.5 percent in 2000.

Things do not fare much better in agriculture. After independence, the government initiated a program of privatisation and land reform that led to the free distribution of over 1.3 million hectares to the rural population. The productivity of the sector, though, remains very low both because of an inadequate infrastructure for irrigation and because land plots allocated to the farmers are exceedingly small. The share of agriculture in nominal GDP declined from 25.1 percent in 1995 to 18.1 percent in 2000. Real output of export crops, like raw cotton, was at 27.2 percent of its 1992 levels in 2000.

Unfortunately oil, which is a fundamental earner of foreign currency for the country, is not a labour intensive industry. Despite its 32.5 percent share of GDP, in 2001 oil only accounted for 2.1 percent of total employment (total industry accounts for just 6.2 percent). In contrast, agriculture accounted for 41 percent, an explicit sign of how little productive is this sector (International Monetary Fund, 2002). This also explains the low level of income per capita of Azerbaijan. To exit from poverty a fundamental restructuring of the economy will be necessary. Even though oil will generate more or less permanent spillovers to non oil sectors, it is absolutely vital that its windfalls are also used to diversify Azerbaijan's economy into non-oil activities with a broader employment basis like light manufacturing.

Table 3: Production Indicators, 1997-2001. Index of real output, 1992=100

	1997	1998	1999	2000	2001 I
Total industry	44.5	45.5	47.4	50.3	52.7
Energy	73.2	78.3	82.4	83.9	82.6
<i>Electricity</i>	70.5	74.7	75.8	78.2	80.2
<i>Oil and gas</i>	74.5	80.1	85.7	90	88
Metallurgy	9.7	4.4	7.1	17.8	9.5
Machine building	20.4	14.2	6.3	12.3	15.9
Chemical and petrochemical	33.4	29.6	32.2	93.7	30
Construction materials	15.6	12.1	9.5	13.4	20.7
Light industry	26.8	15.6	9.3	11.5	11.7
Textiles	27.4	15.3	10	12.3	7.8
Agro-processing	15.7	15.3	15.9	16.2	17.8
Agriculture	66.4	70.5	75.4	34.5	98.2
Grains	84.3	71.1	82.1	115.2	153.6
Cotton	37.1	33.6	28.2	27.2	26.7

Source: International Monetary Fund, Azerbaijan Republic: Selected Issues and Statistical Appendix.

2.5. Trade and Foreign Direct Investment

Azerbaijan has been running large current account deficits for most of the 1990s. The situation was particularly grim in 1998 (US\$ 1,364.5 million deficit) due to declining commodity prices, low export demand for non-oil sector products and increased imports to fund investments in the oil sector (Table 4). In 1999, there was an improvement in the trade balance up to a reversal in 2000, because of increasing export revenues generated by increasing oil prices and output. In fact, Azerbaijan exports have been rising since 1998, to reach almost 50% of GDP in 2001. Oil products account for more than 90 percent of the country's export share. Far behind oil are exports of food, mainly processed fruit, cotton and textiles. Europe is the main market of destination for oil, whereby Russia and Turkey are the two most important export outlets for non-oil products. The country imports are mostly composed by machinery for the oil sector and food products.

Table 4: Balance of Payments: US\$ million 1997 to 9/2001

Main indicators	1997	1998	1999	2000	9/2001
A. CURRENT ACCOUNT	-915.8	-1364.5	-599.7	-124	-8
Trade balance	-566.9	-1046.2	-408.2	319.3	329
Exports (fob)	808.3	677.8	1025.2	1877	980
<i>Of which: oil</i>	<i>454</i>	<i>450</i>	<i>801</i>	<i>1598</i>	<i>885</i>
Imports (fob)	1375.2	1723.9	1433.4	1539	651
Services	-384.2	-369.1	-228.3	-224.7	-186
<i>Of which: oil sector imports</i>	<i>-310</i>	<i>-246</i>	<i>-189</i>	<i>-154</i>	<i>-129</i>
Incomes	-9.5	-13.3	-45	-310	-182
<i>Of which: profit of oil consortia</i>	<i>0</i>	<i>0</i>	<i>-23</i>	<i>-293</i>	<i>-162</i>
Net transfers	44.8	64	81.8	73.1	31
B. CAPITAL & FINANCIAL ACCOUNT	1072	1313	743	460	122
Net Direct investment	1115	1023	510	119	12
<i>Of which: oil companies</i>	<i>844</i>	<i>831</i>	<i>349</i>	<i>-16</i>	<i>-31</i>
Public sector capital	58	58	215	239	59
Other	-101	232	18	102	51
Errors and omissions	-6	-10	8	-56	-9
C. OVERALL BALANCE	150	-61	151	281	105

Source: IMF, 2002, 'Azerbaijan Republic: Selected Issues and Statistical Appendix', IMF Country Report 02/41

Foreign Direct Investment has been an important source of foreign financing of the country's investments. As shown in Table 5, they peaked in 1998 to 1.5 billion dollars, accounting for more than 20 percent of Azerbaijan's GDP and for 65.9 percent of gross capital formation. As shown in Table 6, this share is high compared to other developing and transition countries. FDI then declined between 1999 and 2001, but they are bound to rise again as more than 9 billion US\$ of new investments

will be undertaken for the next phases of exploitation of the new gas and oil fields and for the construction of the Baku-Tbilisi- Ceyhan oil pipeline and the Baku-Erzerum gas pipeline. The largest share of FDI is in the oil sector (91 percent in 2001), with the remaining share mostly in infrastructure.

Table 5: Foreign Direct Investments (FDI) in Azerbaijan 1994-2001 (Millions of US dollar).

	1994	1995	1996	1997	1998	1999	2000	2001
Total FDI	150	218	540	1155	1480	937	692	900
FDI in the oil sector	22	140	417	780	944	553	574	820.5
FDI by country of origin								
Turkey	40	52	73	118	204	103	63	70.6
USA	3	61	208	383	416	166	170	371.4
United Kingdom	6	28	81	184	230	163	169	161.5
Germany	1	1	4	27	38	7	57	13.9
Russia	3	15	44	85	8	47	32	34.6
Italy	-	-	-	13	20	38	12	25
Japan	2	5	17	42	67	13	97	58.7
France	1	-	-	14	22	44	70	62.9
Norway	1	12	35	69	115	63	47	35.5
Saudi Arabia	2	2	7	12	15	6	14	-
Arabic Emirates	-	1	2	8	16	8	3	0.7
Spain	-	-	-	-	-	-	-	4.77
Netherlands	-	-	-	-	-	-	-	31.7
Canada	-	-	-	-	-	-	-	0.5
Switzerland	1	1	4	20	20	15	2	8.3
Iran	0.6	1	1	9	41	24	16	7.7
Others	90	39	64	101	194	240	203	12.9

Source: Ministry of Economic Development, Azerbaijan State Statistic Committee

Table 6: Inward FDI flows as a percentage of gross fixed capital formation

	1998	1999	2000
Azerbaijan	65.9	32.1	9.2
Turkmenistan	4.9	5.9	7.7
Georgia	30	20.1	29.8
Korea, Republic of	5.7	8.3	7.1
India	2.9	2.2	2.3
China	12.9	11.3	10.5
Poland	15.89	18.4	23.4
Romania	26.5	16.5	14.7
Russian Federation	5.7	11.9	6.7

Source: UNCTAD, 'World Investment Report 2002: Transnational Corporation and Competitiveness'

2.6. Price liberalization, privatisation

Privatisation has always been on the government's agenda and important reforms have been implemented in this area with the backing of the IMF, the World Bank and other donors.

In year 2000 the official *private sector's contribution to GDP* reached 68 percent, compared to 29 percent in 1994, although, according to US Department of Commerce, 2002, independent observers estimate that the private sector's share of GDP is between 50 and 60 percent. The official share in 2000 was at 44 percent in industry, 98 percent in agriculture, 52 percent in investments, 85.6 percent in transports, 98 percent in trade, 38 percent in education, 38 percent in medicine, and 79 percent in municipal services (Republic of Azerbaijan, 2001). The share of people employed in the private sector and self-employed is on average lower, at 51 percent. Large and inefficient state owned companies are still major employers in the country.

The *privatisation process* was planned in two phases. In the first phase, the focus was on the privatisation of small-scale enterprises through mass privatisation. This phase was quite successful: 29,000 small and 1,000 medium and large state owned enterprises were privatised through check and cash auctions, closed subscriptions and auctions (US Department of Commerce, 2002). Today virtually all the small enterprises are privatised.

In contrast, the second phase, centred on medium and large scale divestments, is still lagging behind: 80% of medium and large enterprises has yet to be privatised. Nevertheless, according to the acts of government, the process is apparently gaining new ground. In August 2000 a Presidential Decree was issued, approving a 'Second Program for Privatisation of State Property' and in March 2001 the Government identified several hundred enterprises to be privatised.

Most prices are no longer controlled. Exceptions are: energy, gas, oil, railway, telephone, posts, and housing rent. There is at present a serious problem concerning the price of utilities, especially energy. According to the IMF, 2002, 'Azerbaijan continues to suffer from an extensive circuit of non-payments and arrears, with the energy sector at its hart'. This implies an implicit subsidy from the budget to end users and leaves room for non transparent and discriminatory practices in the pricing of utilities.

2.7. Outlook

Real GDP growth forecasts for 2003 are around 7.5% (Economist Intelligence Unit, 2002b). The main assumptions underlying this forecast are an increase in oil prices and oil production and large FDI inflows into the oil and gas sector up to 2006.

Oil prices will likely decrease as tensions in the Middle East and in Iraq lessen, although this effect will partly be compensated by the expected increase in oil output. The communication and construction sectors will still benefit from growth in the oil

sector, but other sectors of the economy are likely to still lag behind, given the strong bias of the economy in favour of hydrocarbons.

Although prospects are good in the short to medium term, because of the extreme dependency of external and internal balances on oil business, the economy is and will be exceedingly vulnerable to oil prices' fluctuation. In the longer term there are also concerns that oil reserves will come to an end. According to BP's predictions, actual reserves in the already discovered fields will be almost exhausted in 20 years. The ACG field will reach its peak production in 2008 at one million barrels per day, but output will decline steadily thereafter up to near exhaustion in 2020. The sustainability of the oil boom crucially depends on the discovery of new oil fields. No major discoveries have been made since the start of the new exploration wave in the mid nineties, besides for the Shah Deniz gas field, and apparently companies are getting more reluctant in carrying out new explorations.

If new discoveries do not materialise, Azerbaijan's future rests on the country's ability to diversify its economy. The other reason to diversify is that the welfare impact of oil is limited, unless targeted distributive policies are put unto place. Oil is a capital intensive industry, and as argued above it accounts for just 2.1 percent of total employment in the country.

The real problem is that the rest of the economy is being crowded out by the oil sector. Crowding out may be caused by different sets of reasons. The first one is the standard Dutch Disease effect, whereby the oil surplus induces a real appreciation of the Manat, thus hampering the competitiveness of potential non-oil exports. The second effect is that the increase in domestic demand induced by the oil revenues may generate an increase in prices and wages, again reducing the competitiveness of non-oil exports. Both these effects are less likely to materialise if the government sticks to its very conservative policy in the use of the oil resources. Oil revenues are in fact channelled to an off balance oil fund in foreign currency. A very small share of the fund is used to finance domestic expenditure. However, this policy will likely be challenged, as a large share of the population lives in conditions of extreme poverty and the country infrastructure is in desperate need of upgrading

The third source of crowding out is that investment resources are more likely to be attracted by the lucrative activities in the oil sector or connected to it, rather than in alternative initiatives with bleaker profit prospects. Activities catering to the oil industry, like light mechanical engineering may generate permanently new skills and sources of activities, but the evidence is that the oil industry generates small spillovers to local economies in developing countries, particularly because its demand of high tech goods and services can rarely be fulfilled competitively by local producers.

Finally, there is an institutional crowding out, in that little attention is devoted to institutional reforms outside the oil sector. The activities of the oil companies are regulated by 'Product Sharing Agreements' (PSAa), that besides for defining the sharing rule of oil profits between the foreign companies and the government, they set all the privileges and rules governing oil extraction. This institutional sterilisation provides oil companies with the right institutional framework to operate, but in the

meanwhile, as we will discuss below, the rest of the economy has to live with what at the moment is still a bit of an institutional shamble.

The restructuring of the economy and the completion of the program of privatisation is likely to have large social costs in the short term, as at present a large share of the labour force is in works in inefficient state owned companies and it is in fact disguised unemployment.

3. TRADE PERFORMANCE

Azerbaijan's exports account for a large share of GDP, 44 percent in 2001. The export orientation of the Azerbaijani economy is however almost fully explained by oil exports, which account for 91.5% of total flows in 2001. Agriculture and manufacturing output and export have been shrinking since independence.

The country's problem, at least in the medium term, is not the generation of foreign currency, but, rather, how to use the oil windfall to diversify its economic structure and exports. At the same time, Azerbaijan has strong import dependence for most consumption and investment products. It therefore also faces the problem of supplying competitively the domestic market, even in sectors like agro-processing where it holds an obvious comparative advantage. As discussed in this report, at present the diversification of the economy is hindered by various supply and demand constraints that can partly be tackled by means of policy and investments in infrastructure. In what follows, we first report and discuss the structure of trade flows and then how these are related to terms of trade. In the following chapters we will discuss trade policy and hard and soft infrastructural constraints.

3.1. Composition, direction and volumes of trade

3.1.1. Trade by sector

Exports. The growing predominance of oil exports clearly emerges from Table 7, which reports the sectoral composition of exports between 1995 and 2001. Oil in 1995 accounted for just 58.6% of total exports to climb up to 91.5% in 2001. This trend is explained by an increase of both output and oil. The first stage of exploitation of the ACG field by the AIOC consortium boosted total crude oil production and export from 9 million tons a year in 1997 to 14 million tons in 2001. On top of this, oil prices went up from 12.5 in 1998 to nearly 25 in 2001 (Economic Trends, 2001). Even though this trend is partly due to artificially high oil prices in the midst of international political instability, a possible reversal of this trend will anyway be compensated by the perspective dramatic increases in oil and gas extraction, following the full exploitation of the ACG oil field and of the Shah Deniz gas field.

The increase in the export share of oil is not only explained by increasing oil production and prices, but also by the decline or the stagnation of the other export items. Total non-oil exports declined from 265.3 million dollars in 1995 to 200.7 in 2001. 116.8 million dollars of raw cotton made up 18% of the country's export in 1995. In 2001 there were virtually no exports of raw cotton.

The lack of non-oil exports is the reflection of the broader output constraint problem faced by Azerbaijan. Firms that are exporting or can do so in non-oil sectors are very few. Given the small size of the domestic market – no more than one million people

with some purchasing power - the export market is the main potential outlet for manufacturing and also agricultural production. Azerbaijan's 'pseudo' export market was captive and it was the Soviet Union. Azerbaijan was a net exporter of raw and processed fruits and vegetables, of machines for oil extraction, of cotton. The collapse of the Soviet Union left Azerbaijan and the other Caucasian countries without export markets and with huge excess capacity. Although most small and medium size enterprises were privatised, this was not enough to boost export supply. GTZ, the German aid agency carried out a survey of the many privatised agro processing firms to find out that only are still in production, a minority of which could think to have any chance of competing in the export market. Thus, when discussing the country non-oil export potential, we should bear in mind that the non-oil export sector at present does virtually not exist.

Table 7: Exports by sector (US\$ million)

	1995	1998	1999	2000	2001
Total	637.199	606.151	928.620	1,744.900	2,314.282
Food products and animals of which:	38.532	46.734	60.181	56.709	55.535
Animals	560	274	598	462	290.6
Vegetable products	13.277	16.619	22.664	28.458	20.736
Vegetable and animal oils and fats	277	1.624	3.380	3.606	2957
Food products, drinks, alcohol, tobacco	24.418	28.217	33.539	24.183	31.551
Mineral products, of which:	373.115	418.732	730.602	1,485.341	2,117.907
Petroleum products	371.882	392.926	704.414	1,465.535	2,113.595
Chemical products	19.618	11.292	22.766	36.196	21.629
Plastics	13.639	11.986	13.105	20.524	13.821
Textiles	124.549	56.037	26.583	40.775	18.721
Unprocessed cotton	116.834	49.335	21.742	36.542	15.190
Metals and metal articles	17.543	13.371	24.726	32.032	18.959
Machinery equipment and mechanisms	39.422	33.438	34.655	30.684	38.075
Other	10.782	14.560	16.004	42.640	29.635

Source: Economic Trends Quarterly Issue, Azerbaijan July September 2001. Statistical appendix. Annex 7.5; Ministry of Economic Development. Azerbaijan State Statistic Committee

Imports. The value of imported goods in current US dollars almost doubled between 1995 and 2001 (Table 8). This increase is essentially explained by the rising demand of machinery for oil exploration and by investments in infrastructure. This is quite paradoxical, given that Azerbaijan was the most important producers of machinery for oil extraction in the Soviet Union. The oil industry imports all of its required machinery, and just use local mechanical shops for repairs. It is however quite unlikely that the country's oil machinery industry has any chance to be brought back to life, besides for basic engineering, given the size of the investments and the technological speed characterising this type of activity.

Table 8: Imports by sector (US\$ million)

	1995	1998	1999	2000	2001
Total	667.657	1,077.169	1,033.469	1,172.069	1,430.867
Food products and animals, of which:	277.145	175.329	207.496	221.817	234.031
Animals and animal products	74.301	31.247	26.543	31.629	34.542
Vegetable products	51.537	97.458	115.975	119.488	116.808
Vegetable and animal oils and fats	54.484	4.882	12.710	11.242	12.976
Food products, soft alcohol drinks, tobacco	96.823	41.742	52.268	59.458	69.706
Mineral products, of which:	100.832	85.599	89.767	115.180	248.021
Petroleum products	88.055	27.915	20.816	21.896	216.342
Products of chemical industry	61.321	79.366	57.556	84.126	68.716
Plastics and articles of plastics	11.577	23.991	17.732	22.769	29.729
Paper pulp, waste and scrap of paperboard	15.188	16.114	9.492	18.458	24.454
Articles of stone, plaster and cement	7.961	31.546	19.762	17.709	20.706
Metals and articles of metal	42.024	129.696	111.143	123.416	132.124
Machinery equipment and mechanisms	82.884	348.276	342.200	362.781	353.809
Transport, aircraft and water facilities	36.615	87.068	90.362	100.005	198.583
Other	32.110	100.185	87.959	105.808	120.693

Source: Economic Trends Quarterly Issue, Azerbaijan July September 2001. Statistical appendix. Annex 7.5; Ministry of Economic Development; Azerbaijan State Statistic Committee

Import data also reveal Azerbaijan's dependency on imported food products, another sector where Azerbaijan had a comparative advantage. In 2001, food products accounted for 16.3% of total imports and the trade balance for the food sector was negative by 187.5 million dollars.

Reducing import dependency is not simple. Though local producers could cater part of domestic demand, particularly in 'easy sectors' like agro-processing and light engineering the local market is in fact small and completely fragmented. Of the 8 million inhabitants of Azerbaijan, only little more than one million have some purchasing power. Most of these are high-income people who demand only luxury imported products. In a country with average income per capita of 700 US \$, it is quite striking to notice luxury cars in large numbers and shop windows showing the best of top western brands. The lack of a middle class is at the moment a major constraint to expand a domestic demand for local products.

3.1.2. Trade by origin and destination

Exports. Also the geographical destination of exports (Table 9) has changed significantly in the Nineties, as a consequence of the oil boom. If we look at total exports (oil and non oil products), we see that in 1995 CIS countries accounted for 44.7% of total exports. In 2001 their share had declined to 9.6%. Indeed most of crude oil is sold to the European market, after refining in Italy.

Table 9: Main Trading Partners by Export/Import Value (US\$ Million fob)

	Import value (Mill USD)				Export value (Mill USD)			
	1995	1998	1999	2001	1995	1998	1999	2001
Turkey	140.5	220.1	142.4	148.2	26.4	135.8	69.0	67.4
Russia	88.3	193.8	225.8	153.0	100.2	105.7	83.0	77.6
Georgia	18.9	25.2	9.5	4.9	45.3	76.9	71.7	103.2
Iran	80.3	42.5	47.4	55.4	186.1	44.4	22.6	9.1
Ukraine	33.5	92.9	38.4	39.3	33.6	12.0	23.6	6.8
United Kingdom	9.3	68.9	67.0	54.0	48.6	40.3	10.8	35.4
Germany	43.8	46.7	46.0	72.8	3.9	5.5	7.6	12.9
USA	13.3	39.7	82.9	230.9	1.1	13.8	29.8	13.6
Italy	2.5	9.0	8.2	24.7	26.4	45.0	31.0	1324.1

Source: Ministry of Economic Development., Azerbaijan State Statistic Committee

The picture is radically different if we just focus on non-oil exports. The distribution of non-oil exports by country of destination is reported in Table 10. CIS countries are increasingly the main destination of Azerbaijani products. Their share was around 44% both in 1995 and 2001. Other major non-oil export markets are Turkey and Iran. The share of the developed economies is very small. Thus Azerbaijan faces a dual export market. Oil products are sold to the industrialised economies, whereas non-oil exports essentially cater the regional market.

Table 10: Distribution of non-oil exports by country of destination (US\$ million)

	1995	1996	1997	1998	1999	2000	2001
Turkey	26445	38106	27344	39426	25835	34977	18820
Russia	83984	87415	115791	75261	74720	94204	69164
United Arab Emirates	1576	3-53.9	1084	2968	8890	7091	6298
Iran	34724	11149	8758	3114	11297	6967	9143
Georgia	10595	14105	20018	5427	8725	10342	9439
Germany	3872	2855	6172	5572	7623	7901	11832
Ukraine	12032	9149	15803	7660	4319	4876	5067
Italy	566	499	672	1481	1530	3940	1423
Kazakhstan	7444	11198	5751	7821	2554	4400	4783
Switzerland	28232	1612	6646	10677	12982	14464	166
Israel	1	4	7	389	110	1320	393
France	117	406	140	1410	372	284	1658
USA	1113	2178	2082	3587	5205	8001	6319
UK	47623	127	427	8052	9189	5112	6210
Total by main partners	258374	181857	210695	172845	173350	203879	150714
Total export (incl. oil products)	547360	631246	781310	606151	928620	1744900	2314282

Source: ASSC (Azerbaijan State Statistic Committee), Ministry of Economic Development

Imports. Also a large share of Azerbaijan's imports originates in the regional market. CIS countries saw their share decline just marginally from 31% between 1995 and 2001. In contrast, there was a sharp decline in the share of Turkey and Iran that went from 33% to 14% (Table 9). The ability of CIS countries to preserve their market share in Azerbaijan, coupled with the decline of Turkey and Iran, can partly be explained by a process of trade diversion induced by the implementation of a free trade area with Russia, Georgia, Ukraine and Kazakhstan – see below.

The share of both the EU and especially the US increased considerably from 14% to 33%. This reflects purchases of sophisticated machinery for the oil industry and an increasing demand for high quality consumer goods by the top income brackets of the population.

4. TRADE POLICY FRAMEWORK

4.1. The Constitutional and Legal Context

The Constitution of Azerbaijan - adopted with a universal referendum on November 12, 1995 - provides for a unicameral parliament (the National Assembly, or Milli Mejlis), a president and a Prime Minister. The Constitution instituted a system of government based on the principles of separation of powers: legislative, executive and judicial².

4.1.1. The Executive Authority

In compliance with article 99 of the Constitution, the President of the Republic, elected for five-year term by popular vote, implements the executive power. The supreme body of the executive power is the Cabinet of Ministers, whose members are appointed by the President of the Republic, with the consent of the National Assembly

4.1.2. The Legislative Authority

According to article 81 of the constitution, the legislative power is vested in the National Assembly that enacts the constitutional laws, laws and regulations in term of its competence. There are 125 members to the National Assembly, elected on the basis of a majority and proportional electoral system for five-year terms

4.1.3. The Judiciary Authority

The judicial power is vested in the independent courts: Constitutional Court, Supreme Court and High Economic Court and lower-level general and specialised courts. Under Article 126 of the Constitution, Judges are independent and subordinated only to the Constitution and Laws of the Country, they are limited in their right participate in political elections and cannot be affiliated to political parties. The Constitutional Court deals with settlement of disputes relating to the division of power between Legislative and Executive branches and gives interpretation of the Constitution and the Laws. The Supreme Court is the highest judicial body in civil, criminal, administrative cases. The Economic Court is the highest law court for settlement of economic disputes

² "The new constitution of Azerbaijan was adopted in November 1995 by a flawed referendum. Although it proclaims Azerbaijan a democratic republic, it has not prevented the president from assuming wide-ranging powers. Parliament is a rubber-stamp body packed with government supporters. The constitution proclaims the principle of the separation of powers, but all are in practice subordinate to the president". Economist Intelligence Unit Country Profile on Azerbaijan.

4.2. Trade Policy Formulation

The April 30, 2001 Decree of the President of the Republic Azerbaijan abolished the Ministry of Economy, the Ministry of State Property, the Ministry of Trade, the State Committee for Antimonopoly and Entrepreneurship Support, the Agency of Foreign Investments and established the Ministry of Economic Development on their basis.

The Ministry of Economic Development is the central body for formulation and implementation of state policies regarding the socio-economic development, trade, investment, international cooperation, development of entrepreneurship and competition, privatisation and management of state property in Azerbaijan. Operations of the Ministry are based on the Constitution, laws, decrees and resolution of the President of the Republic and Cabinet of Ministers, as well as its regulations, established in the above mentioned decree.

As far as trade policy is concerned, the Ministry of Economic Development main functions are

- to provide proposals on the rates of duties and taxes in trade to the Cabinet of Ministers, based on the recommendations of the Tariff Council (see below)
- to draft international treaties regarding legal, tariff and other actions in the field of transportation, transit of goods, and participate in negotiations and implementation of such treaties
- to formulate and implement measures aimed at ensuring export of Azeri goods and services as well as measures of protection of domestic markets
- to supervise the compliance of industrial trading and catering enterprises with existing norms and rules as well as with quality and safety of goods.
- to apply measures of non-tariff regulation of foreign trade activities
- to issue licenses for export and import in cases provided by the legislation, issue certificates of origin if necessary
- to establish and manage economic and trade representations of Azerbaijan with foreign states, international and trade institutions. In particular, arrange cooperation with the World Trade Organisation
- to formulate proposals on safety measures
- to formulate rules on border zones and border trade, and creation of border markets, organise work on establishment of free economic zones
- to participate in design and implementation of regulation of foreign exchange.
- to define the directions for utilisation of centralised foreign exchange reserves

The newly created Tariff Council should approve all changes of tariffs and duties. The document ruling its activities is the 'Regulations of the Tariff Council' issued in January 2002. Changes in tariffs or duties are normally proposed by the State Custom Committee; the Tariff Council then examines the proposed changes also by requesting information from state agencies or experts; successively it will then make its recommendation to the Cabinet of Ministers for final approval.

The State Customs Committee is the law-enforcement agency for tariff policy.

Other entities involved in the formulation and implementation of foreign trade policies are: the National Assembly, the President of the Republic, the Cabinet of Ministers, the National Bank, and the State Customs Committee and the Ministry of Taxes. Trade Laws and Regulation

4.2.1. Import Regulations

Foreign trade regulation in Azerbaijan are primarily based on the decree "On Further Development of Foreign Trade Regulation", issued on December 17 1996, which replaces earlier regulations.

Import Tariffs. Tariff laws implemented successive changes in 1997, 1999 and 2001. Today, imports are subjects to ad valorem duties at uniform rates at 0.5, 3, 5 and 15 percent of declared customs value (World Bank, 2002a). Some goods are granted duty free entry. The average tariff was 7.35 percent in 2000.

In order to avoid under-invoicing, some products are subject to specific tariffs defined as a fixed amount per unit of quantity or volume and they are set at levels consistent with a maximum ad valorem tariff of 15 percent. As specific tariffs have recently been extended to a wider number of goods, the average tariff increased to 7.9 percent in 2001 (World Bank, 2002b).

In the context of the WTO accession process and of cooperation with the IMF, the government has committed to bring the average import tax to 6.5% by 2005 and significantly reduce the use of special tariffs (Government of Azerbaijan, 2001). A non-exhaustive list of tariff schedules is provided in the appendix.

Importers are also subject to a minimum custom processing fee of 16,500 AZM or equal to 0.015 percent of the declared custom value, if larger. This fee, which is payable independently of whether the goods are exempt from customs duties or VAT, is apparently not applied at all port facilities in the country (US Department of Commerce, 2002).

Tariff Preferences. According to Chapter 6 of the "Law of Azerbaijan Republic on Customs Tariff", reduction of duties for preferential treatment applies to import originating from countries that established customs union or free trade zone with Azerbaijan or from developing countries enjoying national system preferences. Such privileges are established by decision of the Cabinet of Ministers.

Azerbaijan signed an agreement on the establishment of a free trade zone with all other CIS countries in 1994, but this agreement was never implemented. It also signed seven bilateral agreements with seven CIS countries, abolishing duties, taxes and charges on exports and imports. Allegedly, at the moment, only imports from Russian Federation, Georgia, Kazakhstan and Ukraine are duty free³. Imports from other CIS countries are treated like imports from any other country and are subject to normal VAT rates if the partner country applies a reciprocal regime on exports from Azerbaijan (World Bank, 2002a).

Tariff Exemptions. Pursuant to Article 34 of the law on “Customs Tariff”, a duty free import regime applies to medical equipment and medicines, humanitarian goods and some products for military use. It also applies to property contributed by foreign investors to the equity capital of joint ventures and for goods for official use by diplomatic missions and international organisations. In addition, customs duties are not applied on good imported under bilateral free trade treaties.

Special provisions for imports by companies working in the oil sector are an integral part of Product Sharing Agreements. Goods, tools, equipment, supplies and services necessary to carry out production under Product Sharing Agreements are generally duty free and they are also exempt from VAT. This regime is also extended to foreign firms registered in Azerbaijan providing services to contractor parties and foreign sub-contractors participating in Product Sharing Agreements (US Department of Commerce, 2002)

Apart from the oil sector, there are no other duty free-exemptions from custom duties for imports used as factors of productions for export products. This creates a serious impediment to exports in the non-oil sector, particularly because many components need to be imported.

Import Quotas and Prohibitions. Azerbaijan has established import quotas on ethyl alcohol, alcohol beverages and tobacco products; according to the government, such restrictions have the purpose of safeguarding public health.

Import Licensing. Licensing presents obstacles for all firms in Azerbaijan: many requirements are imposed, the application of relevant regulation is inconsistent, non-transparent and time consuming. Import of alcohol, alcoholic drinks, and tobacco are subject to licensing under concession of the Ministry of Economic Development. Food products of animal origin are also subject to licensing. Large communication equipment must be authorised by the Ministry of Communications⁴.

Import Documentation. Documents that must be submitted to Customs Authority by importers are: import contract, customs declarations, invoice, bill of lading, sales

³ Russian Federation, Georgia, Kazakhstan, Ukraine, Moldova, Turkmenistan, and Uzbekistan

⁴ Source: “Doing Business in Azerbaijan. Azerbaijan Country Commercial Guide FY2002”

invoice, certificate of origin, certificate of quality, and permission from relevant ministry of imports if imports include pesticides, medicines or weapons.

Domestic Taxes on Imports. The sale of goods, works and services in Azerbaijan is subject to Value Added Tax (VAT) as well as excise tax. The new tax code reduced VAT from 20 to 18 percent for most goods. Goods and services exported and in international transit are exempt from VAT. VAT paid on imported goods, works or services is treated as input VAT and it is creditable against output VAT.

A draw back scheme is in existence to recover VAT on goods imported for processing and then re-exported: when processing is completed, a draw back procedure can be initiated, but no formal procedure for submitting an application has been defined. The time for processing and re-export is established by the custom, and it is usually within two years (US Department of Commerce, 2002). According to a recent World Bank study the availability of these draw back schemes is discretionary and beyond the reach of smaller firms (World Bank, 2002b).

Anti-Dumping Regime. Anti-Dumping rules are established by article 8 of the law on “Customs Tariffs”: if commodities are imported to Azerbaijan at a price lower than the production cost and this damages local production, the anti-dumping duties are applied. Such regulation has not been ratified yet, and no anti-dumping duties are applied.

Countervailing Duty Regime. The countervailing duty regime is described in article 9 of the law on “Customs Tariffs”: if subsidies were used in the production of imported commodities that caused damage to local production, then compensatory duties are applied.

Safeguard Measures. Article 2 of the law on “Customs Tariffs” provides for special duties to be applied as protective measures when quantity or terms of imports damage local producers or as retaliatory measures.

Rules of Origin. Chapter V of law on “Customs Tariffs” provides criteria applied in the identification of the country of origin. Such rules, based on prevailing world standards, concern commodities completely produced in a country and those that processed in more than one country.

The main commodities that qualify as completely produced in one country are minerals, vegetable and animal products, recycled resources and wastes. When many countries take part in production of a commodity, its origin is established in accordance with the criteria of sufficient processing; this means that a commodity can be regarded as originated in a specific country when the commodity has undergone significant production and technological operations in that country.

4.2.2. Export Regulations

Registrations Requirements for Export Operations. For unlisted goods, an entity may export on a credit or consignment basis after filing a contract with the Ministry of Foreign Economic Relations or the local customs agency. No export will be allowed without either full advance payment or the opening of an irrevocable letter of credit at a designated bank for the full export value unless specific instructions are provided in the text of the contract (consignment, barter, credit exports).

The government regulates exports of some strategic commodities like petroleum products, cotton, electric power and non-ferrous metals. The State Commission on Supervision of Foreign Economic Relations must approve exports of such commodities.

Export Duties. The export regime is relatively open. Duties and non-tariffs controls are uncommon; a special tax applies to oil exports, equivalent to 20 percent of the difference between domestic and world prices.

Quantitative Export Restrictions, Including Prohibitions, Quotas and Licensing Systems. Export of works of arts, weapons, explosives, radioactive materials and wastes, narcotics, and psychotic drugs are prohibited. In addition, exports of strategic commodities produced in Azerbaijan are restricted; such commodities include: petroleum products, cotton, electric power and non/ferrous metals.

Export Licensing. Apart from commodities subject to export restriction, exports are not subject to licensing.

Export Documentation. Documents that must be submitted to the State Customs Committee by exporters include documents verifying legal status of exporting entity and its code, copy of contract, certificate of origin, document issued by an authorised bank on pre/payment or letter of credit, sales invoice, customs declaration, permission of the Cabinet of Ministers if exporting restricted materials.

Export Financing, Subsidy and Promotion Policies. Local sources of export financing available to foreign firms are limited. The banking system is fairly rudimentary at present; while short-term trade financing is offered by most banks (through letters of credit confirmed by Western banks), long term financing is rare. Contracts are authorised only upon advance payment or opening of an irrevocable letter of credit.

The government, according to WTO accession documentation, is not involved in subsidising exports.

Import Duties Drawback Schemes. Goods imported into Azerbaijan for processing and then re-exported are subject to normal duty and taxes but a drawback scheme is

available to recover import duties; as seen for draw back schemes for VAT, procedures are unclear and recovery of duties is *de facto* not available for the majority of firms.

4.2.3. Other Policies Affecting Trade

Technical Norms and Standards. The framework of Azeri norms and standards is quite confusing; in general, local regulation follow standards established by the former Soviet Union, but these will be abandoned and replaced with standards that should comply with the international ones. A new committee will be responsible for such issues.

Certification is required for a number of products. Food and agricultural imports are the most regulated, with standards updated from those of former Soviet Union and under the control of the Ministry of Agriculture. Labels on food and agricultural products must be in Azeri or at least in Russian; if they are in English then information in Azeri must be provided as well.

Sanitary and Phytosanitary Measures. Sanitary protection measures on food and agricultural imports are currently regulated by the “Law on Food products”, the “Law on Veterinary Medicine”, the State Veterinary Committee and State Plant Quarantine Inspection within the Ministry of Agriculture.

Animal products are required to be inspected at retail and wholesale level; Azerbaijan also banned the addition of certain antibiotics to animal and poultry feeds as well as imports and production of certain genetically modified seeds and other products. State Plant Inspection and Quarantine inspect agricultural products for pesticides; contaminants are inspected by Republican Toxicology Control Agency. Lastly, Azerbaijan set standard for imports of poultry seeking a reduction in imports of inferior poultry products.⁵

Sanitary and phytosanitary measures are not in line with those requested by WTO agreements, and Azerbaijan does not seem to be close to compliance.

Protection of Intellectual Property Rights. Azerbaijan began to implement a national system for protecting intellectual property rights, covering all rights to industrial property, copyright and related rights. Current law pertaining to intellectual property includes the “Law on Copyrights and Related Rights”, the “Law on Trademarks and Geographic Names” and the “Law on Patents”. There is no single authority for property rights; the Cabinet of Ministers authorizes the state agencies to register and protect property rights in their areas. Copyright protection is normally granted -on works of science, literature and the arts, computer programs and databases- without registration requirements.

⁵ USDA 2002 “Republic of Azerbaijan, Food and Agricultural Import Regulations and Standards Country Report 2002”

Azerbaijan has also undertaken the implementation of a property rights protection framework by signing various international agreements. These agreements provide a substantial framework for protection of personal and proprietary rights of authors, trademarks and appellation of origin.

Enforcement of intellectual property rights regulation – carried out through court regulation – is still weak, also because of the weaknesses of the judicial system. Indeed, pirated cassettes, videotapes, software and clothes can be easily found in the local market (US Department of Commerce, 2002). All in all, current intellectual property rights protection is deemed to be insufficient, thus posing a serious obstacle to international trade. Enforcement of property rights protection will have to be strengthened in view of the accession to the WTO.

State–Trading. There are no privileged entities in trade operations (such as marketing boards), except for state-owned enterprises in the energy sector.

Free Zones and Free Economic Areas. The Azerbaijan Customs Code provides for the establishment and operation of bonded warehouses within Foreign Economic Zones but none are operating at present.

Regulation of Transit Trade. Transit goods under the control of customs are exempt from custom duties. Customs registration and cargo declaration fees are levied at the customs border, with some exceptions for which no customs registration fee is levied.

4.3. Trade Agreements

4.3.1. Bilateral and Multilateral Agreements

Bilateral Agreements. Azerbaijan signed an agreement on the establishment of a free trade zone with all other CIS countries in 1994, but this agreement was never implemented. It also signed seven bilateral agreements with individual CIS countries, abolishing duties, taxes and charges on exports and imports. Allegedly, at the moment only imports from Russia, Georgia, Kazakhstan and Ukraine are duty free. Imports from CIS countries are treated like imports from any other country and are subject to normal VAT rates if the partner country applies a reciprocal regime on exports from Azerbaijan (World Bank, 2002a).

In July 1999, Azerbaijan signed a Partnership and Cooperation Agreement with the European Union that aims, among other things, at establishing a greater compatibility between legislation of the two. With this agreement, Azerbaijan also gained most favoured nation status with the EU and the United States (US Department of Commerce, 2003). A Bilateral Investment Treaty between the United States and Azerbaijan has also been signed.

Multilateral Agreements. Azerbaijan is seeking membership into WTO and it is currently completing the procedures for accession. Accession was requested in June 1997 and the Memorandum on the Foreign Trade Regime was filed in April 1999 (WTO, 1999). Questions have been presented by other member countries and the first meeting of the working party on the accession of Azerbaijan took place in June 2002. The government of Azerbaijan is now preparing the sector specific accession documents and accession should take place by the end of 2003. According to the World Bank, the main issues raising concerns from other member countries and that will require explicit reforms are the following: standards do not always comply with the technical barriers to trade and sanitary and phytosanitary agreements of WTO; the custom valuation approach, when based on the minimum value approach does not reflect WTO principles, although the Government in the Question and Answer accession document (WTO, 2000) argues that their custom valuation system complies to the general principle of world practice; VAT does not operate according to an international practice as it is assessed on an 'origination principle' rather than a destination principle; the Custom fee, now set at 0.15 percent of custom value, should instead reflect the actual cost of service delivery (World Bank, 2002b).

4.4. Terms of trade and the real exchange rate

Azerbaijan has a liberal exchange system, and, in general, there are no restrictions on converting or transferring funds associated with an investment. Conversion is carried out through the Baku Interbank Currency Exchange Market and the Organized Interbank Currency Market. Cash exchange is carried out at numerous currency exchange points. Additional requirements relating to the disclosure of the source of currency transfers have been imposed in an attempt to reduce illicit transactions.

Azerbaijan was very effective in stabilising its international relative prices in the second half of the Nineties. The macroeconomic program of financial discipline initiated by the government in 1995 ended hyperinflation and stabilised the exchange rate. Inflation, which had reached 1,660 percent in 1994, started declining in 1995 and it was down to 3.7% in 1997. Two years of deflation followed, partly engendered by very tight financial conditions and by the Russian crisis, till prices stabilised in 200-2001 at a 1.7-1.8 percent inflation rate. The Azerbaijan National Bank (ANB) was also effective in controlling the exchange rate and avoiding a Dutch disease effect induced by the trade surplus in the oil sector.

Since 1994 the Manat is the legal tender in Azerbaijan and its exchange rate can be defined as a managed floating one. This essentially implies that the authority try to keep the real effective exchange rate stable. Following a nominal appreciation *vis a vis* the US dollar of 9% in 1998, the AZM started depreciating to nominal values which are now 20% lower of what they were at the beginning of 1999. The exchange rate appreciated until 1998 and then depreciated back to 1995 nominal levels. In fact, oil revenues are being sterilised in a foreign oil fund to avoid the Dutch disease effects that would be induced by a real appreciation of the exchange rate (Table 11).

Table 11: Average AZM/US\$ exchange rate.

	1995	1996	1997	1998	1999	2000	2001
Average Exchange Rate (AZM / US\$)	4414	4300	3986	3869	4116	4474	4630

The devaluation of the nominal exchange rate coupled with stable, even declining prices led to a decline in Azerbaijan's terms of trade and to consequent gains in export competitiveness. As reported in Figure 3, the bilateral real exchange rates have been depreciating since 1998, relatively to the country's western trading partners and also to Turkey and Iran (not reported in the figure). Russia and the Ukraine (and shortly Georgia) are exceptions, as a consequence of the nominal devaluation of the rouble following the Russian financial crises. As a consequence of the real appreciation of the AZM towards the rouble and of the increase in oil prices, the effective real exchange rates, both import and export weighted, have been stable in the period (Figure 4).

These trends deserve some comments, especially concerning their implications for trade. The starting point is that the large oil revenues and the small short term capital flows give Azerbaijan the option, rare for a small open economy, to effectively manage its exchange rate. Indeed, the AZM has a managed floating exchange rate, which in principle is determined by the ANB as a weighted average of the value of the AZM in currency transactions carried out in the domestic currency market in the previous year (Azerbaijan Economic Trends, 2001)⁶. The oil revenues are sterilised in a foreign oil fund, and only a small share of them is effectively transferred to the country. Hence, the possibility of devaluing gradually since 1998.

Given that Azerbaijan can control its exchange rate, and taking for granted that the authorities should avoid a real appreciation of the AZM, we should discuss the merits of a real devaluation towards the main Western currencies. The country's main export good is oil. As Azerbaijan is a price taker in the international market of oil, the devaluation has no effects on the quantities exported, although oil revenues in national currency increase. Moreover, the structural weakness of the country's non-oil sector hinders any shift from non-tradable to tradable, possibly induced by the devaluation. Hence, imports are more expensive with no possible supply response from national producers. Finally, there is no real devaluation towards Russia, Azerbaijan traditional non-oil export market. Thus, although in principle devaluing is a useful step to enhance the country's competitiveness, its short run effects are unlikely to be welfare improving.

⁶ According to many observer, there is however a large discretionary component in the fixing of the AZM exchange rate.

Figure 3. Real bilateral exchange rates

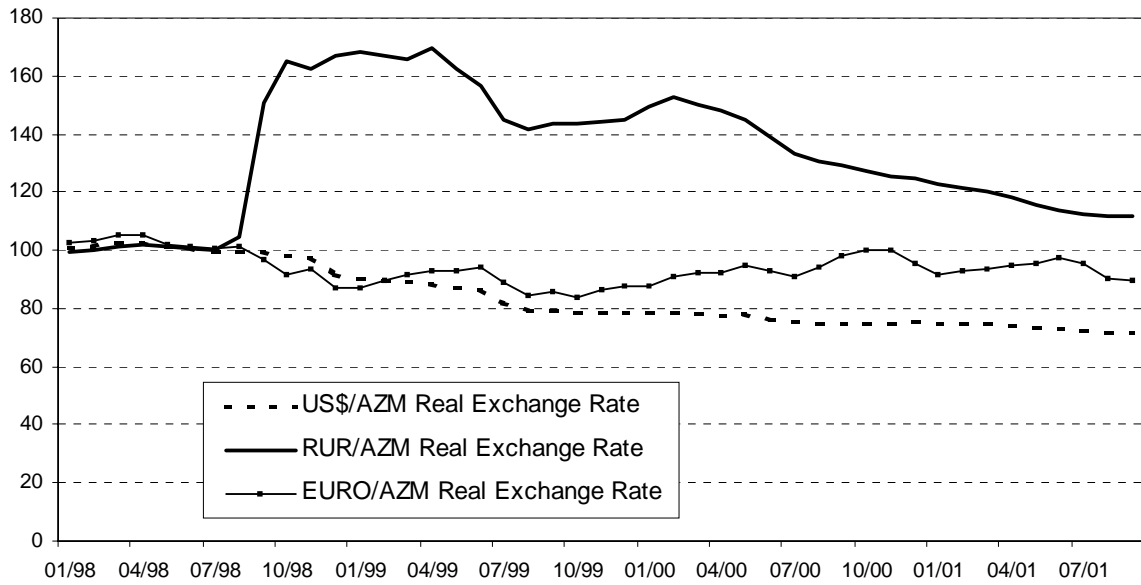
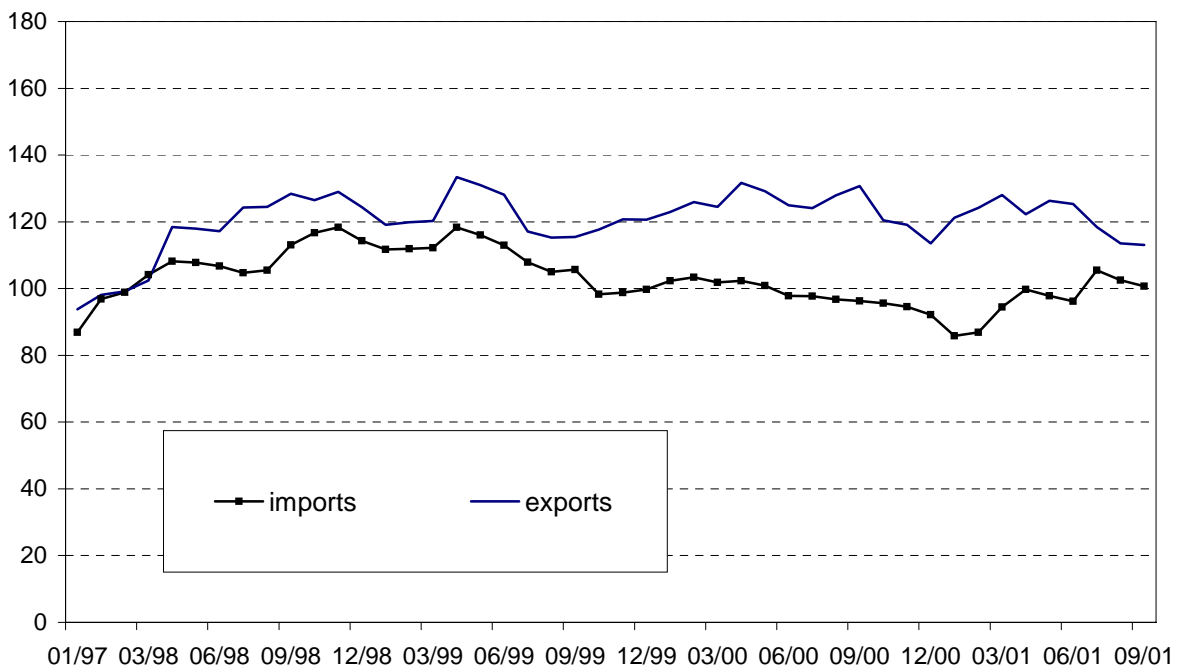


Figure 4. Real effective exchange rates (import and export weighted)



Source: ANB (Azerbaijan National Bank), ASSC (Azerbaijan State Statistic Committee), CIS (Interstate Statistics Committee), AET calculations in Economic Trends Quarterly Issue, Azerbaijan July September 2001.

5. KEY OBSTACLES TO TRADE FACILITATION

This section discusses obstacles to trade facilitation. It will be based on a broad definition of trade facilitation, encompassing hard infrastructural problems that characterise transport through, to and from Azerbaijan, and soft infrastructural problems pertaining to both custom procedures and the overall investment environment of the country. Earlier studies actually found that in terms of impact on trade, trade facilitation may be just as important as trade liberalisation—if not more (Wilson, J., C. Mann, Y. Woo, N. Assiane, I. Choi, 2002).

Besides for specific transport costs, a recent paper, shows that the time of transporting goods from origin to destination accounts for a considerable share of the total cost of the goods delivered, because of interest payments, the loss of potential customers, the interruptions in the production process and so on (Hummels, 2001). Hummels estimates that every day of delayed delivery costs to the average American importer 0.3 percent to 0.5 percent of the value of the good delivered. Thus, making trade speedier through infrastructural investments and increased efficiency of custom procedures has a very large impact on trade costs.

The infrastructural problem is key in Azerbaijan, particularly considering its very special geographic location. Azerbaijan is at the crossroad between the East-West Trans-Caucasian route, a potential corridor linking Europe to China and a North South route linking Russia to Iran, down to the port of Bandar Abbas. Unfortunately, natural barriers, politically unstable neighbours and poor infrastructure clog both routes.

As already discussed, also soft infrastructure is a fundamental constraint to trade flows. Thus, notwithstanding a fairly liberal trade policy regime, limited implementation and some other major institutional constraints are yet a major challenge to trade. In what follows we will discuss hard and soft constraints in turns. Much of our discussion will be based on a recently completed study on trade facilitation by the World Bank (World Bank 2002a and c)

5.1. Hard infrastructure

Azerbaijan's hard infrastructural problem has two main dimensions: a *national dimension* for what concerns infrastructural facilities and transportation within the country; an *international dimension* for what concerns the infrastructure in the countries through which any trade flow into, from or through Azerbaijan must transit, mostly Georgia. This second aspect is especially important, because the country is land locked (besides for trade with the other Caspian states), and because transit trade may become important in the future, given Azerbaijan's location at the crossing between major East-West and North-South routes.

5.1.1. Domestic infrastructure

Transport has been growing at a yearly rate of 12% since 1998, because of increasing oil transit from the Caspian Sea and imported equipment for the oil fields. In 2000, the country exported 8 million tons of goods. Of these 30 percent went by rail, 65 percent by pipeline and 3 percent by road. As for imports, eighty percent came by rail and 14 percent by road (imports from Iran are mostly by road) (World Bank 2002a, from TRACECA database). The physical transport infrastructure is in poor conditions, lacking an institutional framework, maintenance and new necessary investments. The World Bank has recently carried out a major study on trade facilitation in Azerbaijan, which discusses thoroughly infrastructural constraints (World Bank 2002c). What reported below mostly draws on this study.

Institutional aspects Although the Ministry of Transport was recently established, the separation of the regulatory and operational functions in transport activities has not been implemented yet. Also, there is a lack of coordination in the issuance of licences and permissions, particularly for combined transports.

In the road sector the majority of transport operations were privatised but the former parastatal company Azeravtonaglyyyat, which is also involved in operations, handles the regulatory activities. In the maritime, rail and aviation sectors this division of roles has not taken place yet. Quite the contrary. Thanks to a recent Presidential Decree (2000), Caspian Shipping has all the authorities of the Ministry of Transport with respect to shipping, although it keeps operating. All the rail transports and regulations are managed by the State Railway Company of Azerbaijan (ADDY), which as an independent government entity reports to the Council of Ministers. Baku International Airport is owned and operated by Azerbaijan Airlines (AZAL), which is a self-regulating entity and an operating airline, with no vertical separation of the two functions

In principle, once it starts functioning, the Transport Ministry should define the overall transport policy. The administrations and authorities governing each transport mode should be responsible for the implementation of regulations and legislation under the supervision of the Ministry. Parastatal companies like ADDY, AZAL and Caspian Shipping should strictly focus on operations.

Roads. Most roads need repair, because the State Road Construction Company – the responsible institution– lacks the resources for road maintenance. According to the 1996 Road Conditions Survey, 56% of the main road network is in poor conditions. The average maintenance budget is just 470 US\$, compared to 625 in Georgia and US\$ 4,000 in Baltic countries.

Rail. This is the most important means of transport for both imports and exports (for the latter excluding pipelines). The rail system, built during the Soviet Union era, was mostly conceived to connect Azerbaijan with Russia. Given that now most trade flows transit through Georgia and that the direct Russian route is scarcely viable, railways need major restructuring and re-orientation. As a result of decreasing trade with CIS

countries and of the worsening of the physical conditions of railroad, in 2000 freight by rail was less than 10% of its level previous to independence. About 1000 Km. of rail trucks (30 percent of the total) require reconstruction.

ADDY's priority for infrastructural investments is the Trans-Caucasian line to improve its international links to the Black Sea. It also suffers from a shortage of oil tankers, which is a major constrain, given that this is an important transit route for oil from Kazakhstan. The railway also suffers environmental problems at refuelling points because of leakage. The EBRD is now financing a large project to improve the Trans-Caucasian Railway route.

Pipelines. There are two oil pipelines at present, the Baku-Supsa Pipeline, which goes through Georgia (70% of pipeline exports) and the Baku-Novorossisk pipeline, which is controlled by the Russian State and conveys the remaining 30 percent of oil exports. The Russian route has higher transit fees and entices a dilution of quality as the high quality Azeri oil is often blended with lower quality oil at the Russian terminal. These two pipelines, combined with rail transport, are enough to export the present oil output, but they will no longer be enough once the new oil field of Azeri Chirag Guneshli will start producing. A new major export pipeline, the Baku-Tiblisi-Ceyhan is now under construction and will connect Baku to Georgia and the Mediterranean coast of Turkey. It will also be partially used to transport oil from Kazakhstan. A gas pipeline will also be constructed to transport the newly discovered gas of the Shah Deniz field to Erzerum in Turkey. These new pipelines will provide cost efficient ways to transport hydrocarbons to their markets of destination.

Ports and maritime transports. Azerbaijan has direct maritime connections to other Caspian states (Iran, Russia, Turkmenistan and Kazakhstan). It has also access to the Black Sea, via the Volga-Don canal, which is however in bad need of rehabilitation. The port of Baku is the largest port on the Caspian Sea and it handles around 5 million tons per year; it has both a ferry and a container terminal but there is no free trade zone inside its area. 90 percent of its traffic is transit, mostly of oil. A ferry terminal will be reconstructed, funded by an EBR 16.2 US\$ million loan. A key condition attached to this loan is the vertical separation of operations and regulation in maritime transports. At present, Caspian Shipping has a de facto monopoly in the port as it also holds the right of issuing of licenses to other fleets to use the port facilities.

Airports and aviation. Baku International Airport is owned and operated by Azerbaijan Airlines (AZAL). Although Baku has some international flights to CIS countries, Turkey and some European destinations, high handling charges in the airport induced some airlines to stop their services in 2000. The other two Azerbaijani international airports of Gyandzha and Nakhichevan are in need of reconstruction and repairs

Telecommunications The state of technology is behindhand and it makes it difficult to cope with increasing traffic volumes. The telephone system is mostly inadequate:

the majority of telephones are in Baku and other urban areas. The Soviet infrastructure is still serviceable for international calls, but a satellite connection through Turkey is also available. The Ministry of Telecommunications regulates the sector but it is also a major shareholder in most telecommunications enterprises. Current fixed lines penetration is estimated at 20 percent of the population. Two mobile phones companies operate in the country. They are both international joint ventures including the state owned company Azertelecom.

Energy. Energy is controlled by Azerenerji, which is a state owned company, merging the activities of generation, transmission and distribution. Power generation includes nine thermal and five hydroelectric power stations. The sector needs urgent structural reforms and investments, and 30 percent of the power generation equipment should be replaced as soon as possible (European Bank for Reconstruction and Development, 2002). Also, the sector suffers from an extensive circuit of non-payments, arrears undermining its financial viability. Pricing policies and arrears in payments generate an implicit subsidy from the state and the state oil company SOCAR to end users of gas and energy. According to the IMF, in 2000 this subsidy amounted to 27 percent of GDP (International Monetary Fund, 2002). All the same, end users, particularly small companies, suffer from shortages of energy supplies, which need to be compensated at the not small cost of setting up an independent generator.

5.1.2. International trade route and the cross-country dimension of the infrastructural problem.

Because of the country's geographical location, Azerbaijan's trade is affected by infrastructural problems, well beyond its national borders. This is clearly shown in Figure 5, which reports the main trade routes through the country.

Figure 5: The TRACECA Trade Routes



Trade through Georgia. Azerbaijan's trade with Western markets is landlocked. The Caspian sea only gives access to Turkmenistan, Kazakhstan, Russia and Iran. All of Azerbaijan's trade with the West must necessarily go through Georgia. From Georgia it either proceeds via the Black Sea or by land through Turkey. The alternative western route through Armenia is not viable because of the long-standing and yet unresolved Ngorno Karabakh conflict between the two countries. Also much of trade to and from Russia transits through Georgia, as the direct routes cross Daghestan and Chechnya and are therefore not safe.

Consequently, the conditions of infrastructure in Georgia have fundamental implications for Azerbaijan's trade. At the moment Georgia is definitely a bottleneck: infrastructure, particularly rail, needs rehabilitation badly. Goods travel under a constant threat of civil and political unrest and trucks only transit in escorted convoys. Transporting a container between Baku and Poti, the Georgian main port on the Black sea, costs 1.37 US\$ per km, against 0.92US\$ between Baku and Moscow and 0.53US\$ between Baku and Bandar-Abbas. Although these costs include various official and unofficial handling charges (see below for details), they do not include the implicit cost of the time spent travelling. The speediest mean of transportation between Baku and Poti is the railway. Containers travel on this route at an average speed of 20 Kms. per hour (including stops at the border). Although this does compare favourably to the 13 Kms. per hour of rail transport to Moscow and to the 8 Kms. per hour of road transport to Poti, it is certainly not hart warming.

The ports of Poti, Batumi and Supsa can handle most of general, bulk and liquid cargo, but the handling of containers appears to be inefficient.

Transit trade and the TRACECA corridor. The cross-country dimension of trade costs is also relevant because transit activities are an important component of Azerbaijan's trade and could become even more so. Azerbaijan is strategically located at the cross-road between the East West Transport Corridor Europe Caucasus Asia (TRACECA), linking Europe to China and the North South corridor, linking Russia to Iran and then the Arabian peninsula, India and Pakistan through the port of Bandar-Abbas. According to World Bank 2002c, each ton of general transit cargo generates between US\$ 20 to 40 of direct economic activity. If Baku were to succeed in becoming a regional logistic centre for the region, other value added creating activities like various ancillary services, re-labelling packaging and light processing could emerge.

For political reasons, the North South corridor is not viable at the moment. In contrast, the governments of the Caucasian countries, backed by the European Commission, are devoting much effort and resources to the TRACECA corridor. Trade between Azerbaijan and Kazakhstan is bound to increase, particularly if local markets develop as a consequence of the oil boom. As shown in Figure 5, TRACECA is also the shortest transport route between China and Europe not transiting through Russia. The alternatives are the Trans-Siberian to the North and the sea route through the Indian Ocean and the Suez Canal. Moreover, the TRACECA corridor has also political value, as it provides a Euro-China corridor, which does not cross Russian territory.

The TRACECA initiative was launched in 1993 with the aim of enhancing the capacity of the countries located along the corridor to access European and World markets; to encourage regional co-operation between the Central Asian and the Caucasians republics; to link the TRACECA route to the Trans-European route. The project entices infrastructural investments and broader investments in trade facilitation, like the harmonisation of custom procedures. Since 1993, the European Commission, invested 115 million US\$ in the Traceca. These were supplemented by 700 US\$ million of investments in infrastructure funded by International Financial Institutions like the EBRD and the World Bank and by another billion of US\$ financed by the Japanese government.

Although this is a very important program for the countries involved, both for economical and political reasons, excluding oil a limited amount of goods transits through the TRACECA corridor. This shows that TRACECA still faces severe challenges ahead. *First*, the success of this trade route depends crucially on smoothening the Caucasian bottleneck. As argued above, transit through Georgia is not easy and it would be essential to open a second corridor through Armenia. This is unfortunately unfeasible at the moment, given the state of conflict between Azerbaijan and Armenia and given Armenia's strained political relations with Turkey. *Second*, the number of borders that needs to be crossed to reach Central Asia through the Caucasus, and all the official and unofficial handling costs involved in each crossing are severe impediments to the success of this trade route. It is therefore vital to smoothen as much as possible handling procedures at crossing. *Third*, the infrastructures of the countries part of the corridor have often incompatible standards. For example, the Former Soviet Union did not adapt its internal transport system for containers to the parameters of the International Standard Organisation (ISO). Consequently transport systems in the TRACECA countries are ill equipped to handle 40-ft ISO containers or any of the other intermodal methods commonly in uses in throughout the EU such as Swap Bodies (European Union, 2000). *Fourth*, according to World Bank, 2002a, disbursements with no conditions attached have sometimes prevented deeper institutional reforms. Also, the choice of the projects financed has often been driven by the delicate political balance of a multinational initiative, rather than on the bases of allocative efficiency criteria.

Table 12: Transport Costs and Time by Road and Rail of a Container between Northern Europe and Baku

Expenditures	Road			Rail		
	Payments (USD) Official	Unofficial |	Time Hours	Payments (USD) Official	Unofficial |	Time Hours
Transport & handling						
Azerbaijan						
Terminal to final destination, Baku	50		2	50		2
Handling charges, terminal, Baku	50		2-4	50	10-20	3-4
Azeri Transport leg	700		12-24	350		24-48
Road toll to enter Baku	25				5	
Georgia	700	350-500 ⁸	12-24	350		24-48
Georgian transport leg	175	10-20	24-48	175		24-48
Handling charges, Poti port	925		480	925		480
Other						
Ocean leg ⁷						
Cross border processing			2-4			4-6
Georgian/Azerbaijani Border guards		10				
Customs inspection		100-150			30 – 50	
Phyto-sanitary		10-20				
Clearance procedures in						
Azerbaijan	8	10-50	1	50	50	1
Terminal fees	28	10-50	1	28	50	1
Declaration completion			1			1
Valuation			2			2
Inspection						
Total logistical cost	2925	500-800	539-591	1978	145-175	566-641

Source: World Bank 2002c. and 2002c

Quantifying broader transport costs to and from Northern Europe. When trying to assess transport costs, it is important to take into account all the logistical costs of trade movements. These have been estimated by World Bank 2002a and 2002c on the basis of a survey of forwarders, and we report here the main results of this analysis. According to this study, the total logistical costs of moving a consignment include: the pure transport costs for the domestic and international part of the consignment, the official and unofficial facilitation costs, the costs of accessing the relevant information, and the costs due to diseconomies of scale engendered by small volumes and small markets.

⁷ Assuming 20 days from Poti to Rotterdam. This can be reduced with a higher shipping fee.

⁸ This sum includes an unnecessary official fee of USD 300, additional transit insurance in Georgia, in contravention of the TIR convention, together with the demands of the traffic police in Georgia.

Table 12 reports all official and unofficial logistical costs for one container shipped from Rotterdam to Baku, via the Georgian port of Poti. The two most noticeable findings are that the Caucasian part of the journey (Georgia and Azerbaijan) constitutes by far the largest share of transport costs and that unofficial handling costs are a considerable share of all official costs. The cost of the international part of the journey is roughly 25 percent of all transport costs by road and 43 percent of total transport costs by rail, although it represents 80 percent of the travelling time. The unofficial charges are roughly 27 percent of official costs for road transport and 9 percent for rail transport. Note that most of these unofficial charges are generally not related to the transport activity per se, but mostly to custom clearance. In the next section we discuss in details the main constraints arising from soft infrastructure and particularly custom

5.2. Soft Infrastructure

Besides for hard infrastructure and strict transport costs, Table 12 shows that there are various other official and unofficial cost elements that seriously affect total trade costs. To understand these other costs better it is useful to look at Table 13, which describes all the steps a truck driver has to go through when delivering goods to Azerbaijan. Most of the official and unofficial costs the truck driver incurs are related to the handling of goods at custom and to custom clearance. Thus Customs constitute a fundamental component of soft infrastructure. In what follows we discuss the working of Azerbaijan's customs at length.

There is however another component of soft infrastructure to trade, pertaining to the broader cost of doing business in Azerbaijan, which of course impinges on the ability of firms to exploit trade opportunity. Also this component of soft infrastructure will be discussed at length.

Table 13: The official and unofficial costs of importing to Azerbaijan

1. **Arrive at the border** – The vehicle is stopped by the border guards, who check the driver's passport and visa. Drivers from CIS Countries and Iran do not require a visa. **This step usually requires an unofficial payment of USD 10**
2. **At Customs** – All the documents relating to the cargo and the vehicle are checked, and the seal on the trailer is inspected. The appropriate page of the TIR carnet is taken, and a stamp applied to the next page. The CMR and invoice are also stamped (as required by Baku Customs House), and the details of the consignment are entered into the Customs internal network. **The unofficial fee averages USD 100 for Azeri trucks and USD 150 for foreign vehicles.** The latter also pay the official transit fee of USD 180.
3. **Phyto-Sanitary Checks** – The main concern of the phyto-sanitary service is the importation of foods and dangerous commodities, as they need a special license. However, all cargoes are checked and this stage can **result in an unofficial demand for USD 10-20.**
4. **Police** – The police repeat many of the same documentary checks undertaken by the Border Guards and Customs, and **also seek an unofficial payment of USD 20.**
5. **The Transport Inspection** – checks the technical passport of the vehicle and the transport permit. If there is no permit, then an official charge of USD 100 is imposed. After this stage the vehicle is free to continue.
6. **On the Road** – Trucks that entered the country from Iran and Georgia are stopped at the Sangachal (approx. 45 km. South of Baku) Customs Post. The trucks coming from Russia are stopped at Nasosni Customs Post. All the original documents are taken by the customs officers: invoice, CMR, TIR Carnet., and Customs issues an Order (Assignment) under which the truck has to go to the Terminal specified in this order. Usually all trucks that entered the country from Iran and Georgia sent to Sabail Terminal (Southern Entry of Baku) and those of from Russia sent to Binagadi Terminal (Northern Entry of Baku). The official fee for entrance to Baku is USD 25. The original documents are taken by Customs to Baku Customs House.
7. **At the terminal** – The vehicle and driver process to the inland terminal, and an official charge of 40,000 AZM is imposed for parking (approx. USD 8) and the documents and goods are inspected. The Customs officer informs the client, who writes a letter to Customs requesting permission to clear customs.
8. **At Baku Customs House** – The documents are checked by each of the relevant departments – tax and duty, and the goods valued and the relevant duties paid. The official fee for the declaration is 140,000 AZM (approx. USD 28), and the **unofficial fees total USD 50 per truck on average.** The order is issued by Customs, which provides the client with the authorization to clear the consignment.
9. **At the terminal** – The order is provided to the terminal and after checking the documentation, the consignment is released. The parking fees are paid, and **unofficial gratuities totaling USD 50** are provided.

Source: World Bank, 2002a, page 32

5.2.1. Customs⁹

A survey of 60 trade and transport companies reveals that Azerbaijan's custom is affected by major weaknesses in its legal system, in the administrative capacity of its border agencies, corruption, bureaucratic clearance procedures and control, and poor infrastructure. Although part of these deficiencies is attributable to the Custom administration in Georgia, most of them also concern Azerbaijan's Custom. On the positive side, according to the World Bank, there have been a number of visible improvements in the State Custom Committee. Moreover, the Presidential Decree of September 10, 2002 on additional measures for State Support to Business Development in Azerbaijan and the Customs reform program outlined in cooperation

⁹ The main shortcomings and problems affecting Customs in Azerbaijan have been thoroughly analysed by the World Bank study on Trade and Transport Facilitation in South Caucasus, World Bank 2002a and 2002c. Thus, also much of the discussion in this section will be based on these reports.

with the IMF and Price Waterhouse Coopers are expected to address some of the main shortcomings in view of the Country accession to WTO. The main proposed elements of this reform are: (i) a bonded warehouse system; (ii) a licensed Custom broker program; (iii) a bond and guarantee program for goods under a suspense regime for vehicles not covered by the TIR carnet; (iv) Customs valuations based on WTO rules; (v) an improved information system.

The assessment of custom can be carried out at four levels: the legal framework; the administrative capacity; the procedures; the infrastructure. We discuss each of these issues in turns.

Legal framework. The Customs Code of the Azerbaijan Republic of 1997 provides the legal framework for Customs. This complies broadly with the Kyoto Convention and forms a basis for an effective custom regime. However, according to the review of the code carried out by Price Waterhouse Coopers, the code has major weaknesses, which do need reforms. These weaknesses leave large margins for discretion and encourage rent-seeking behaviour. They include the unclear definition of Customs reporting responsibilities; the restricted legal authority of Customs regarding the post import control of intermediaries involved in trade; the duplicated, and sometimes not matching, description of customs offences and sanctions in the Administrative and in the Customs Codes; the absence of provisions in the Code to deal with bribery and corruption of Customs officials.

Moreover, the Customs Code does not allow for bonds and guarantee system to cover transit, inland processing and temporary imports and for guarantees from Custom brokers. Instead it permits high personal allowances for travellers, and thus room for smuggling. .

Finally, processing time frames and required documents are often unspecified and Customs charges are defined in separate normative acts. According to World Bank 2002c, 'there is no single document defining the rates of all custom charges'. Access to information is a challenge also for other areas of Customs legislation and regulation. The absence of official documents in foreign languages leaves much scope for discretionary decision and corruption.

Another major problem is a lack of an independent arbitration service. Although, as discussed below, this concerns the broader business environment in Azerbaijan, it is a key factor preserving the discretionary power of the custom authority. Disputes with Customs are very frequent: 45 percent of the 60 trading and transport firms have had a dispute with Customs at least once a month.

Administrative capacity. The State Customs Committee (SCC), an independent body, organised in 12 regions and which employs a staff of 1,600 people, manages customs and processes 70,000 import and export declarations per day. SCC is committed to reforms and trade facilitation and senior officials admit openly the existence of unethical practices in the administration.

Custom performance is not far from standards in South East Europe, as shown in Table 14, and it could easily be improved further through rationalisation and computerisation.

Table 14: Customs productivity figures in the South Caucasus compared with Southeast Europe.

	Azerbaijan	Georgia	Armenia	Southeast Europe		
				Average	Minimum	Maximum
Revenue collected/Customs staff	113,019	94,650	188,047	308,668	85,597	745,548
Total Customs cost/Revenue collected	2.30%	2.90%	1.10%	1.50%	1.20%	5.80%
Salaries/Revenue collected	0.80%	1.20%	0.60%	0.90%	0.50%	2.60%
Trade volume/Staff (US\$ million)	2.4	0.78	1.2	2.8	1.1	7.2
Declarations/Staff	44	45	40	250	80	422
Cost per declaration	59	61	50	28	11	49
Average monthly staff cost	73	91	81	362	194	757

Source: National Customs Administrations and World Bank calculations in World Bank 2002c

However, actual processing time considers only part of the hurdles faced by traders, those arising once processing has already started. Estimates of users' impact show that by just considering processing time the actual delays importers and exporters have to face are underestimated. Much of these delays are due to pre-processing practices. Waiting time to initiate processing at some crossings, like the Red Bridge towards Georgia, extend to several hours, whereas processing takes 20-30 minutes.

A second major problem is that corruption is quite widespread. According to the most recent World Bank /FIAS Investment Climate and Administrative Cost Survey corruption ranks as the fifth largest factor inhibiting business and trade. At Customs the problem is especially serious given the low Customs officials' average salary of US\$73 per month, including social charges, which is not sufficient for decent family living and it is one fifth of the salary of a junior secretary in the private sector. Selections for appointments are apparently another weak spot of Azerbaijan's Customs. The selection process is not sufficiently based on quality, motivation and commitment of potential candidates.

Procedures. Some major weaknesses have been found in Customs procedures. Valuation procedures must be improved in conformity to the agreement on custom valuation (formally the Agreement on the Implementation of Article VII of GATT). Specifically procedures based on the minimum value approach will have to be abolished. A strengthening of the valuation unit is also required. Documents and goods clearance should take place in just one place and not at different locations, a terminal and the Customs house, as done at present. A post-entry verification mechanism, one of the most important mechanisms of ex-post verification of firms'

declarations is not in place and it is badly needed. Computerisation is insufficient at present and needs to be completed and upgraded. This is necessary to speed up entry, control transit, using intelligence and develop databases. It would be important to install a system like Asycuda, with international track record and compatible to those adopted by Azerbaijan's trade partners. Finally Customs officials and Customs brokers need for training.

Infrastructure Specific infrastructural investments are necessary at border crossings. Bonded warehouses are considered to be especially important.

5.2.2. Other soft infrastructure constraints affecting trade.

Soft infrastructure also pertains to the overall business climate of the country. Given the weakness of the local economy, besides for the oil sector, trade expansion can only happen as a consequence of new investments and of emerging new activities. Thus, any trade expansion program must clearly bear in mind the overall business environment. In this section we deal with the following key aspects: law enforcement, specific incentives and constraints to foreign investors, the financial sector and the protection of property rights.

Law enforcement The major problem of law enforcement in Azerbaijan is probably the constant evolution of the legal framework and the often arbitrary implementation of existing laws. Many factors make compliance with current legislation difficult and give room to arbitrary application of laws and corruption. Among these, unavailability of information on decisions regarding implementations of laws and regulations, scarce co-ordination between Governmental branches, persistence of some Soviet laws, and complex bureaucracy.

Another major deficiency is the extremely weak dispute settlements mechanisms. Despite some improvements, effective protection and enforcement of property rights and contractual rights are not still assured. According to the Azerbaijan Commercial Guide issued by the US Department of Commerce, the court system is weak, judges are often inexperienced, progressive new tax and other economic legislations are poorly understood. The Economic Court which has jurisdictions over commercial disputes is weak, often regarded as corruptible, and its decisions are often inconsistent (US Department of Commerce, 2002).

Azerbaijan became a party to the 1958 United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards in May 2000. This made arbitration a potentially more effective mechanism to settle disputes. However, an arbitration tribunal responsible for the resolution of commercial disputes has not been established yet; therefore, for the time being, commercial disputes have to be resolved through arbitration sites in London or Stockholm – a very time consuming and expensive procedure.

Azerbaijan's bankruptcy law does not function adequately, and it is being revised as part of the IMF's Poverty Reduction and Growth facility Program

Taxes and tax administration. The first codified digest of tax laws is the Tax Code, which became effective on July 2002. The tax code describes powers and duties of the tax authorities, provides penalty for non compliance, set out procedural rules for appeal of tax payers against decisions of the tax authorities and addresses general issues of tax payments and collection. It also defines each of the taxes applied in the country, including the corporate profit tax, the income tax of individuals and the VAT (Baker & McKenzie, 2002). Notwithstanding a clear legislative framework, allegedly the implementation of the code is still non transparent and discretionary.

Foreign investment's regulations and incentives From a regulatory standpoint, the government of Azerbaijan has taken significant steps to provide protection for foreign investments. The legal framework for foreign investments is defined principally by the "Law on Protection of Foreign Investments" (1992), the "Law on Investment Activity" (1995), the "Law on Privatization of State Property" and a the presidential decree "On Approval of the Second Program of the Privatization of State Property" (August 10, 2000).

Under Azerbaijani law, foreign investors are permitted to participate in any activity open to domestic investors, except for activities regarding national security and defense. In key sectors like energy, telecommunications are controlled by the government and foreign entity can only enter in joint ventures with state companies. In general, foreign investors must be treated by the government in a manner "not less favored" than local investors; they may invest in Azerbaijan through joint ventures with local companies, with owned subsidiaries, or with representative offices and branches. The law also provides for the repatriation of profits and revenues after application of relevant Azerbaijani taxation. Generally, foreign investors are not required to purchase from local sources or to export a certain percentage of their output. However, investors participating in the privatisation of state enterprises are sometimes required to assume specific obligations. There are no specific incentives to foreign investors, besides for those provided by the PSAs in the Oil and Gas sectors (US Department of Commerce, 2002, Baker & McKenzie, 2002)).

Lastly, foreign investors are protected against nationalization and requisitions by the law, which identifies exactly the circumstances under which nationalization can occur and establishes that, under such event, the investor is entitled to prompt and adequate compensation. Namely, nationalization and requisition can be enacted to prevent damage to the population or to state interest. Foreign citizens may lease land, but not own it.

In practice, though, there are some major deficiencies in the enactment of this legislation. The "not less favored" principle, for example, is not really applied. *Firstly*, because the procedure of enterprise registration at the Ministry of Justice is not always transparent, which gives room to discretionary choices and screening of foreign investors. *Secondly*, because the state strictly controls many key sectors and often the only viable choice for foreign private investments in Azerbaijan is to establish joint ventures with a state partner.

In general terms, according to various entities and independent observers, doing business in Azerbaijan can be quite problematic as government bureaucracy, weak legal institutions and predatory behaviour by politically connected monopoly interests hinders investments outside the energy sector (US Department of Commerce, 2002).

Foreign investments in the energy sectors are ruled by specific *Production Sharing Agreements*. “A Production Sharing Agreement (PSA) is a contract pursuant to which the state entrusts the investor to conduct exploration and or extraction of mineral resources in a defined subsoil area on a compensated basis and for an established time period” (Paliashvili, 1998). Under such contract, the State transfers to the contractor the right to use exclusively the subsoil area for a defined period of time and under compensation. The investor, in the other hand, carries out the activity at its own risk and makes the payments for the use.

In the context of frequently changing laws, a PSA offers the investor significant protection against possible conflicts of interest between the state public function and its role in the agreement, because it is a civil law agreement between legally equal parties, and the rights and responsibilities of both parties are exhaustively defined within the contract itself. In a license agreement outside a PSA, for example, the State has an administrative-authoritative role determined outside the agreement itself. As such, it could change the framework within which the license agreement is enacted.

A PSA also offers implicit fiscal advantages: taxes and other mandatory payments imposed on the investor can be partially or entirely substituted with shares of production (hence, production sharing agreements). Overall, therefore, PSAs offer clear benefits to both the State and the investor. For the former, a PSA is an occasion to attract investments without employment of financial resources. For the latter, as explained above, the PSA offers fiscal incentives and protection against changes in the legal and fiscal systems.

Azerbaijan has signed over twenty product sharing agreements with foreign oil companies. By nature of the agreement, adoption of PSAs has been limited so far to the energy sector. However, foreign investments in other sectors would probably increase considerably if contracts offering similar protection were devised.

Financial Sector. The banking sector comprises 58 banks, as a consequence of a consolidation program and an increase in the minimum capital requirements. It is dominated by the International bank of Azerbaijan (IBA), which is 51 percent state owned. Three other nearly bankrupt state banks have been recently merged to form the United Universal Bank. Private Azerbaijani's banks are mostly illiquid and under capitalised. Foreign banks are present in the country, but still face significant restrictions in obtaining licenses. A sign of how difficult is the environment for foreign bank is the recent decision of HSBC, the largest foreign bank in the country, to stop its operations

New bank licensing and prudential regulations were issued in 1996-97, but only recently the National Bank of Azerbaijan has taken adequate step to ensure an

appropriate supervision of the banking system (World Bank, 1999 and European Bank for Reconstruction and Development, 2002).

Overall, the banking system in Azerbaijan is underdeveloped, weak and plays a very limited role in the economy, which mainly functions on cash. Long-term loans are virtually unavailable, and short-term loans, generally one year, exceptionally two years long, are difficult to obtain. Credit is also expensive, 15-20 percent interest rates on dollar denominated loans. Small firms cannot afford such conditions and anyway cannot provide the collaterals needed to obtain a loan. Rural credit is not available at the moment. This absence of credit poses a critical limitation to private sector development (US Department of Commerce, 2002).

5.3. An example: key obstacles to trade facing exporters of agro-processing products

To summarise the trade policy and infrastructural constraints facing potential exporters, it is useful to summarise the main impediments a producer of agro-processed products faces to start exporting. Agro-processing is among the most promising non-oil industries with export potential. These constraints are summarised in Box 1. They range from a lack of upstream and downstream domestic activities, to insufficient basic infrastructure, to bureaucratic hassles. Upstream, the agricultural sector needs deep reforms and restructuring: land plots are too small and farmers are insufficiently trained to introduce international technological standards and to start production on an extensive scale. Downstream, there is no local production of packaging products and there are very few packaging facilities. Most inputs need to be imported but import duties on packaging materials are at fifteen percent, and very inefficient drawback and suspension schemes are available to circumvent such costs. Duty free imports from Russia are not an option because of the poor quality of the packaging facilities there. Credit, particularly for SMEs and small farmers is rarely available, and if so it is generally short term and expensive (15 to 20 percent interest rates or more). Basic infrastructure is not up to standards. Shortages of electricity are a major constraint. Supplies are intermittent, a problem that can be overcome at the substantial cost of implanting a generator or of a generous 'facilitating' fee (equivalent to 15 to 20 percent of production costs). Transports to European or Russian markets are very slow and expensive, as extensively discussed above. Western quality standards are difficult to achieve and implement, ISO 9000 has not yet been introduced in the non-oil sector in the country. Finally, firms operate in a sort of institutional vacuum on different fronts, from the implementation of taxes and custom fees to the broader legislative framework and therefore they are reluctant to undertake new investments.

Although much has already been achieved since 1995, much more needs to be done to construct an overall environment conducive to the development of an export oriented business sector. In the next chapter we describe the main areas for intervention to reduce trade impediments.

BOX 1...Constraints facing exporters of agro-processing products

- Lack of efficient packaging facilities in the country
- Fifteen percent tariff on imported packaging
- Land plots too small for intensive high quality cultures
- Farmers uneducated, unorganised and unable to provide high quality standards
- Credit expensive
- Poor and expensive energy supplies
- High transport costs to markets of destination
- Poor standards and regulations
- Broad institutional uncertainty

6. AREAS FOR TRADE FACILITATION

This section of the report outlines the main policy and regulatory changes required for trade facilitation and for an environment conducive to private sector development. It also underlines the importance of implementing a clear policy and regulatory framework along with the adoption of any specific policy. As discussed above, the unpredictability of the policy environment and the lack of implementation of existing regulations is probably the most severe impediment to trade and business development. Recommendations first focus on policies and regulatory reforms required for trade facilitation and then on policies required to foster the overall policy environment. Given the weakness of the economy outside hydrocarbons, trade expansion can only be achieved if new investments take place and new activities get started. For this reason, any trade facilitation strategy should also take into account broader constraints in the economy.

6.1. Recommendations on policies and regulations for trade facilitation.

6.1.1. Reform trade policy and regulations to comply with WTO rules.

To comply with entry into the WTO changes in trade policy and regulation will have to be introduced. There are several areas where interventions and reforms are needed.

- Norms and standard are still based on those established by the former Soviet Union and they do not comply with the technical barriers to trade and sanitary and phytosanitary agreements of the WTO. International standards like those developed by the ISO are not applied, besides for the oil sector and will have to be introduced. A national enquiry point on local standards and regulations will have to be set up.
- The custom valuation approach, when based on the minimum value approach, entails a lot of discretionary power and will have to be reformed. Valuation will have to be consistent with the procedures of the Agreement on the Implementation of Article VII of GATT.
- The application of *ad valorem* duties to all products has been negotiated with the IMF as part of the conditions attached to the Poverty Alleviation and Growth Facility and as part of the entry process into the WTO. Specific tariffs based on a fixed amount per unit of quantity or volume will have to be abolished. This measure is expected to reduce the average tariff to 6.5 percent by 2005;
- VAT will have to be reformed so as to be assessed on the basis of the 'origin principle', as of international practice, and not on the basis of a 'destination principle', as done at present;

- Finally, the Custom fee now set at 0.15 percent of custom value should instead reflect the actual cost of service delivery. In its documents for accession (World Trade Organisation, 2000 and 2001), Azerbaijan has committed to introduce these reforms but it is not clear when they will actually be implemented.

6.1.2. Reduce the trade cost of imported intermediates.

Many components and intermediates in the production of non-oil goods need to be imported. Many of these components are subject to a fifteen percent tariff that adds to production costs. An example are packaging materials imported for food processing, like glass bottles. They are not produced domestically and those that could be imported duty free from Russia are of poor quality. The available suspension schemes and drawback mechanisms are unable to reduce such costs for exporters and should be reformed. Thus, the tariff schedules paradoxically protect a non-existent domestic production of components and add costs to exporters. To avoid this anti-export bias different measures can be adopted. Specifically:

- reduce or even eliminate tariffs on intermediates, unless suspension schemes and drawback mechanisms become available for exporters and get applied automatically and with no delays.
- establish Bonded Warehouses and Export Processing Zones (EPZ). Bonded warehouses could be set up in various locations of the country and grant access to duty free imports by exporters, even allowing for some limited re-processing and packaging. Export processing or Free Trade Zones, instead, would entice a broader de-regulated framework where to carry out light processing activities for exports.

The establishment of Export Processing Zones has been recommended by the World Bank (World Bank 2002a, 2002b and 2002c), particularly considering Azerbaijan's growing role as a transit economy in the Central Asian and Caucasians Regions. More generally, Export Processing Zones are also shortcuts to a broader process of reform and they isolate exporters from various sources of anti-export biases. This proposal certainly warrants further investigation, given how difficult the adoption and the implementation of broad based reforms is in this country. However, Export Processing Zones should not strengthen the process of institutional crowding out already induced by PSAs, whereby no reforms are undertaken in less strategic parts of the economy. This is especially important for exports of resource-based products, like agro-processing products, the competitiveness of which depends on the functioning of the overall economy.

6.1.3. Reform Customs

This should follow the Custom Reform Program of the Azerbaijan Government, outlined in cooperation with the IMF and Price Waterhouse Coopers, as also discussed by the World Bank (World Bank 2002a and 2002c). It should also take into account the rehabilitation efforts carried out by the TRACECA secretariat. There are four areas where reforms need to be carried out.

- Revise the legal framework. Reform the Customs Code, which still allows for large margins of discretion, rent seeking behaviour and corruption. Introduce a bonds and guarantee system to cover transit and inland processing for re-export. Specify processing time frames and required documents. Introduce an independent arbitration system covering disputes with Customs.
- Strengthen the administrative capacity. The operations of the State Customs Committee need to be strengthened and rationalised to speed up operations, including the pre-processing phases. Selection and rewards of officials should be reformed to reduce scope for corruption.
- Improve the procedures. Valuation procedures will have to be reformed to conform to WTO rules. Documents and goods clearance should be rationalised and strengthened. A system of post-entry verification should be introduced. Computerisation will have to be upgraded on the basis of standard international practices like Asycuda.
- Improve the infrastructure, including the construction of bonded warehouses.

6.1.4. Implement and enforce trade policies and reforms.

It has been discussed above that whatever reforms are adopted, the real issue is their implementation and enforcement. At present, Azerbaijan's trade policy is fairly liberal and it requires some but not major adjustments. The problem is that such regime is poorly implemented and enforced. Uncertainties in the regulatory and policy framework leave large margins for discretion. These are exploited by the authorities to pursue rent-seeking objectives, often by way of unpredictable means. Uncertainty and discretionary behaviours are sources of strong anti-trade and anti-competitive biases. They raise entry costs and 'facilitating' lenient behaviours is costly and often beyond the means of small and medium enterprises. The envisaged custom and other trade reforms will increase automation of procedures and reduce considerably margins for discretion. Still, it will be difficult to ensure full implementation until the system of rewards and incentives in the economy and in the public administration changes.

6.1.5. Invest in infrastructure and reform its institutional framework.

Azerbaijan needs hefty reforms and investments in the infrastructural sector, particularly for what concerns transports. The starting point is the reform of the institutional framework to achieve the separation between the regulatory and the operative functions. Some steps have been undertaken in this direction, particularly with the creation of the Transport Ministry, but the Ministry is barely functioning at present and regulatory procedures and bodies at lower hierarchical levels are still to be set up. It is therefore necessary to introduce the appropriate regulatory bodies. Parastatal companies, presently covering both functions, should focus on operations and release their monopoly control on transport routes and vectors whenever possible.

As for investments, these are badly needed to upgrade railways, roads, airports and ports. The transport problem has already been addressed for hydrocarbons, as the

new pipelines under construction should be sufficient to export all the newly found oil and gas reserves and even part of the Kazakh oil. Investments in the rest of transport infrastructure are vital to expand exports of non-oil products.

Given the landlocked geographical location of Azerbaijan, the infrastructural problem needs to be addressed cross-country. Unilateral upgrading of infrastructure is likely to be of little use. Consequently it is important to define strategic priorities concerning trade routes and corridors. At present all national and international investments are focussed on the TRACECA corridor, crossing the Caucasus through Azerbaijan and Georgia. We argued above that this route faces severe bottlenecks, particularly in Georgia and that it will be important to set up alternative routes as soon as politically viable. There is no embarrassment of riches at present, as both the eastward route through Armenia and the Northward route to Russia are either completely foreclosed (Armenia) or transited at high costs and risks (Russia through Daghestan). Still planning to diversify corridors should be a primary objective. As discussed below, this transport strategy is related to the country's broader trade strategy and to the importance of regional markets *vis a vis* other export markets outside the region.

The country has other severe infrastructural problems in electricity and telecommunications. These also need to be addressed but their discussion is beyond the scope of this report.

6.2. Recommendations on measures for private sector development

6.2.1. Pursue institutional reforms: reduce margins for discretion.

The institutional framework governing many aspects of the business environment, beyond those strictly related to international trade needs reforming. This report finds major shortcomings in all areas analysed. Reforms are necessary to improve law enforcement and dispute settlements. The tax authority should be reformed to make sure the recently approved tax code is enforced in a transparent and non discretionary manner. Legislation on foreign investments should be reformed and properly enacted. Protection of intellectual property rights should become effective. These reforms, the discussion of which is beyond the scope of this report, are necessary to reduce margins for discretion in the administration and to provide a predictable and understandable frame for action to companies. PSAs provide a viable institutional framework, which has worked well to attract investments in the oil sector. Regulations defined in PSAs are actually implemented and enforced. The strong bargaining power of oil companies is an important reason behind the actual enforcement of PSAs. It would however be fundamental to use the PSAs experience to extend this framework to the rest of the economy, therefore offsetting the 'institutional crowding out' of non-oil activities.

Besides for the enforcement of the policy framework, it would also be necessary to take direct measures to reduce corruption, which is a major constraint to the

functioning of Azerbaijan's economy. In June 2001, this country ranked 84th on 91 countries surveyed by in a corruption perception index by Transparency International (US Department of Commerce, 2002). The Government is aware that corruption is a serious problem. The President issued a decree in the year 2000 aimed at curbing corruption. Two working groups have been set up to propose anticorruption legislation, albeit with little results at the moment.

6.2.2. Support the non oil sector

Promoting the non-oil sector is a primary target for Azerbaijan. This target is shared by the government and some major aid agencies. Studies to identify sectors with export and domestic market potential are presently underway and they are being carried out by multilateral and bilateral agencies, like the World Bank and GTZ. The Government too has a master plan to develop non oil-exports, but the plan has been implemented just partially at the moment. A list of the project presently being undertaken to promote the non-oil sector is in the Appendix

As made clear above by the example of agro-processing, the expansion of a viable non-oil export sector requires direct measures of support and interventions beyond the broad regulatory and policy framework. These activities, particularly when resource based, are strictly intertwined to other sectors of the economy and they need efficient interlinkages with upstream and downstream activities. New investments require financial resources, and the backing of an efficient financial sector. Entering foreign markets requires standards and procedures that need to be learned and acquired. Technologies and the labour force will have to be upgraded through training, schooling and technical assistance. Consequently, there is a need for broad based interventions to improve the business climate and foster private sector development. As reported in the Appendix there are many on-going projects carried out by various multilateral and bilateral aid agencies. These include activities as diverse as sector studies and assessments, technical assistance, rehabilitation of firms and financial support.

7. A BROADER STRATEGY FOR TRADE AND PRIVATE SECTOR DEVELOPMENT

7.1. Nest trade facilitation into a broader strategy to diversify from non-oil activities

The trade facilitation measures discussed above should be related to a broader trade expansion strategy, based on the assessment of the country's economic potential. The lack of a clear trade strategy is the side effect of 'easy' natural resources like oil. Since the country's political framework and the economy were stabilised in 1995-96, all efforts have been directed to strengthening the oil sector. New foreign investors came and provided the financial resources for the required investments. The exploitation right of existing fields (the Azeri-Chirag-Guneshli field) was granted to the AIOC consortium, allowing for a dramatic expansion of oil production. The rights for the exploration of new oil and gas fields were also granted. The new explorations were not fully satisfactory, but the large Shaz Deniz gas field was discovered, boosting perspective gas exports. Also, infrastructural problems, related to the transportation of oil and gas to Western markets, were addressed by launching the major projects of the Baku-Tbilisi-Cheyan oil pipeline and of the Baku-Erzurum gas pipeline. Finally, ad hoc institutional frameworks and incentive schemes for foreign companies operating in the energy sector, the Production Sharing Agreements, were defined, virtually sterilising the activities of these companies from the laws and regulations ruling the rest of the economy.

Focussing on oil has been the right strategy in the short term and it will keep providing badly needed resources for broad based development. In the longer term, however, Azerbaijan must define a strategy on how to use the oil windfall to expand its non-oil exports and in-house production for the domestic market. There is an increasing awareness that this is a key development objective, now shared by all major donor agencies and by the Government. In what follows, this report discusses the main areas of Azerbaijan's trade potential and the specific objective that a broad strategy for trade and private sector development should pursue to exploit such potential.

7.2. Trade potential: markets and factor costs

7.2.1. Demand: where are Azerbaijan's potential export markets?

Once more, when discussing Azerbaijan's actual and potential export markets, it is necessary to distinguish between hydrocarbons and other products. As argued earlier, the destination of oil exports is essentially the European market, gas will be sold to Turkey, as soon as the Shah Deniz field starts producing, whereas non-oil products cater regional markets.

The issue of potential export markets is twofold: *first, whether* the present allocation of export would persist if major infrastructural and policy constraints with potential trade diverting effects were lifted; *second* which are the most promising markets for Azerbaijan's non oil exports in case non-oil products are sufficiently competitive for the international market.

Lifting trade diverting constraints.

A recent study (Polyakov, 2001) examines the impact of transport constraints on the export flows of non-energy products for the Caucasian countries. As discussed extensively before, the only viable trade route for Azerbaijan's exports is through Georgia as the other routes (South to Iran, South West to Armenia, North to Russia) are either closed or extremely unsafe. Even the road through Georgia is not fully safe, and trucks must travel in convoys. Polyakov estimates that if these transport constraints were to be lifted, trade costs would be reduced considerably and there would be a reallocation of trade flows, partly within the region and partly towards western markets. According to a gravity model of South Caucasian trade, there would be an expansion of exports to the EU and the US and a reallocation of intra-regional trade, from Turkey and Iran towards Russia.

Besides for transports, other factors affecting in a discriminatory way the geographical allocation of trade flows are bilateral or regional trade agreements. Indeed, Azerbaijan has four bilateral agreements establishing free trade areas with Russia, Georgia Kazakhstan and Ukraine. It is difficult to evaluate how far these agreements cause trade diversion. Possibly, they hinder trade with other regional economies like Turkey and Iran, but to the best of our knowledge a rigorous estimate of trade diversion induced by these bilateral agreements has not yet been carried out.

The problem of trade diversion essentially concerns non-oil products. Oil and gas have captive markets. The issue is really how to transport them more cheaply rather than whether a reduction in transport costs could affect their geographical distribution. Once the Baku Tbilisi Cheyan and the Baku Erzerum pipelines are completed, transport costs for oil and gas will decline drastically. The Baku Tbilisi Cheyan pipeline will also cater Kazakh oil, and Azerbaijan will gain in transit fees.

Which markets for competitive non-oil products?

The predictions of the gravity model just discussed probably over-estimate the competitiveness of Azerbaijan's non-oil products. It will take a long while before these products achieve quality and cost standards sufficient to compete in the sophisticated western markets, even when transport costs become competitive. Rather, these products would more likely cater the less demanding regional markets, particularly, the national one and Russia. The importance of the regional market for non-oil exports should therefore not be under-estimated. Although short term prospects are not very good, and trade with other countries in the region, besides for Russia and Georgia, is namely little more than non-existent, in the longer term regional demand is likely to increase, as income per capita will rise in oil producing countries like

Kazakhstan. Another promising market for Azerbaijan is of course Turkey, particularly taking into account the close economic and political ties between the two countries.

The dependence from the regional market is made more likely by the fact that Azerbaijan is also not in the likely position to become the supplier of labour intensive components to firms located in high income countries.

7.2.2. Factor costs: what can Azerbaijan produce cheaply and effectively?

In the previous sections it was discussed extensively how the supply of non oil products is hindered by major constraints: it is unlikely that Azerbaijan's potential in non-oil products becomes real both in the domestic and in export markets, unless these constraints are lifted.

However, assuming that this does indeed happen, where does Azerbaijan's potential lie? Answering this question requires a thorough and focussed study of the non-oil sector, and the World Bank is presently carrying out such a study (World Bank, 2002b). In the meanwhile, it is all the same possible to discuss broad areas where Azerbaijan is likely to face better prospects. This task is made easier by the fact that Azerbaijan had indeed a viable export sector when the former Soviet Union was its main and captive market. These activities are now in total shambles and few of them are still in operations. Considering that many transition economies changed completely their export basket and markets of destination when they moved to a market economy, this exercise is possibly not very useful. However, this happened mostly to those economies like the Visegrad countries that were near the European market and which rapidly became outposts for labour intensive European manufacturing activities. Azerbaijan does not benefit from such a proximity to a major high-income market and its labour cost, albeit cheap for Western standards (US\$ 100 per month in industry in 2001 – IMF, 2002), is not as cheap as in other developing countries, from North Africa to India and China. Thus, the processing of labour intensive products, like clothing, is not really viable for Azerbaijan. It is therefore likely that Russia and the region (including Azerbaijan itself) will still be the major outlets for Azerbaijani products and that these products will be based on the country's natural resources. Three activities appear to have good prospects: light engineering and mechanical works catering the oil industry, food and agro processing and transit.

Spinoffs from hydrocarbons.

Spin-offs from the extraction of hydrocarbons are not so obvious. The experience of most oil producing developing countries show that very few economic activities develop as a spin-off of oil. For Azerbaijan, nor local refineries neither the production of petrochemical products would likely be competitive, given that these activities already exist in the markets of destination of oil, in Europe and in Russia. There are no clear arguments of why it would be more efficient to carry out these activities in Azerbaijan than in these other locations.

More promising is the development of viable and efficient light engineering and mechanical activities catering the oil sector. Azerbaijan was the leader in the Soviet

Union for the construction of machinery for the oil sector. This industry has completely disappeared in the aftermath of the collapse of the Soviet Union, but the little left behind could constitute a viable initial base to rebuild some of these activities, like shops for repairs and the building of low tech spare parts and components. Also services to the oil industry, like catering, could well have a scope beyond serving hydrocarbon activities.

Food and agro-processing.

Other opportunities are in the agro-processing industry, which could exploit Azerbaijan's tradition in farming and its many climatic zones. Azerbaijan and Georgia were the main suppliers of fruits and vegetables to the Soviet Union. A wide variety of crops are grown in this country, such as fruits (persimmons, berries, currant, pomegranates, grapes citruses etc.), vegetables, grains, tealeaves and nuts (Department of Commerce, 2002). However, the expansion of this sector is hampered by various constraints, as highlighted earlier. Out of 43 canning factories, only 2 survived independence and privatisation. Modern packaging facilities do not exist in the country, and all packaging material is imported. The agricultural sector is inefficient: land allotments are too small for intensive farming and peasants would need to be fully retrained to produce high quality crops for exports.

The export prospects of these products to the European and US markets may also be affected by the severe explicit or implicit trade restrictions applying to agriculture. Thus, here too the regional market would be important, at least for a start. A good example of an attempt to exploit local natural resources for the regional market is the recent opening of a factory producing Buffalo Mozzarella, as the same buffalo milk available in Italy is produced in Azerbaijan. This product will cater the high income segments of the regional market. Less promising, are the export prospects for raw cotton. Apparently, Azerbaijani's quality is not sufficient to stand the competition of other major producers like India, Egypt and China.

Transit

Given the very special geographical location of Azerbaijan, at the crossing of North-South and East-West trade corridors, transit activities may become important for the country. Each ton of general cargo transiting by rail generates between US\$ 20 and US\$ 40 of direct economic activity. There are also other ancillary activities that could emerge, like re-labelling, packaging, light processing, consolidation and redistribution of goods to other Central Asian and Caucasian countries (World Bank, 2002c). If regional trade were to expand, Baku is in the ideal position of becoming the central logistic centre of the region.

Besides for the broader trade impediments affecting Azerbaijan, the expansion of transit activities crucially rests on the reduction of trade costs from the Central Asian Republics and through Georgia and the Black Seas.

7.2.3. A shortcut: are FDI strategies to jumpstart trade viable?

Given the relative weakness of Azerbaijan's domestic economy, a possible way to jumpstart trade could be to exploit FDI. The role played by multinational companies in the oil sector might suggest that this is a viable strategy also for non-oil activities. FDI already accounts for a very large share of the Azerbaijan's gross capital formation, even compared to other economies.

However, FDI are attracted either by the availability of natural resources (which explains FDI in the oil industry) or by cheap factors of production (European FDI in Eastern Europe) or by the proximity of large markets (US investments in Ireland). Besides for hydrocarbons, Azerbaijan has none of these conditions at present. Labour is not cheap compared to other potential locations for FDI, the domestic market is small and the access to regional markets is still constrained for various reasons. FDI could start flowing if the regional market actually expands, but even in this case Azerbaijan should make sure to compete successfully with other potential locations in the region.

The case for FDI is slightly stronger for agro-processing as this is a natural resource based industry. But again, this option rests on the lifting of the overall constraints affecting this sector, on the likelihood of reducing transport costs to the West or on the possible expansion of regional markets.

Thus, FDI could be of help to strengthen the trade potential of Azerbaijan, but only once the broader factors constraining its economy at present are lifted.

7.3. Summing up: specific objectives of a broad trade and private sector development strategy

It is now possible to summarise the key objectives that a broad strategy for trade and private sector development should pursue in Azerbaijan: i) strengthen the oil windfall and eliminate the bias against non-oil activities; ii) pursue the right balance between regional and world markets; iii) maximise the benefits from WTO accession.

7.3.1. Strengthen the oil windfall and eliminate the bias against non-oil activities.

Investments aimed at expanding the exploitation of oil and gas fields and the construction of the new pipelines are essential, as they generate much needed resources for the broader development of the country. It is however essential to diversify the economy into non-oil activities and exports.

In this context, the first step is to reduce the crowding out effects of oil. The major aspect of crowding out is not only the diversion of financial resources towards the more profitable oil sector, but also the lack of interest for policy and institutional reforms concerning non-oil activities. It should be envisaged how and whether the type of institutional framework envisaged by the PSAs could be extended to non-oil activities.

Secondly, non-oil activities are also hampered by major constraints concerning their specific domain and the broader business environment. The Government of Azerbaijan and donors must pursue active policies to reduce the domestic bias against them. This implies tackling major constraints like: a poor institutional framework, the lack of financing for small firms, infrastructural problems like energy supply, the lack of cheap domestically produced or imported intermediates, an inefficient and low quality agricultural sector and an inefficient financial sector.

Third, oil revenues should be used to directly promote non-oil activities, starting from those catering for the oil industry (e.g. mechanical repair and spare part shops, catering services), and then moving on to other promising sectors like agro-processing and transit

7.3.2. Promote a right balance between world and regional markets

Another major issue for Azerbaijan is the role it should assign to the regional market, essentially to Turkey, Iran and other CIS countries. We have seen above that political and military unrest at and beyond Azeri borders limit considerably Azerbaijan's trade flows, forcing them through the Georgian bottleneck. These clogged trade routes appear to reduce and divert trade. It is likely that exports of non-oil products will keep catering the regional market, even if these artificial trade barriers were to be removed. It will take time before Azeri products enter the sophisticated Western markets. Russia, in particular, will continue to be the main outlet for the few exportable Azeri products. Trade is also likely to increase with neighbouring Kazakhstan, as far as oil revenues boost local markets.

Thus, regional trade will intensify, even following the normalisation of trade relations with neighbouring countries and the re-opening of trade routes alternative to Georgia. Although it is essential that Azerbaijan gains easy access to the rich Western markets, the role of the regional market for non-oil exports should not be underestimated and undermined. For example, infrastructural investments should not crowd out trade routes to regional markets, once they become again politically viable. For the same reason bilateral trade agreements with CIS countries should be preserved, even after accession into the WTO. Rather, they should be extended to other countries in the region and/or already signed regional agreements should finally be implemented.

7.3.3. Maximise the benefits from WTO accession.

One major challenge facing Azerbaijan in the near future is its accession to the WTO. As discussed earlier, in order to comply with WTO rules, the country will have to introduce changes in various aspects of its trade policy and regulation (standards and regulations, the custom valuation approach, the Custom fee, VAT charges etc.). These are not major changes, and Azerbaijan could probably apply and obtain a transition period after accession before making them effective (Michalopoulos, 2000).

At present Azerbaijan has a fairly liberal trade regime. Consequently, one question of concern is whether Azerbaijan should try to negotiate higher bound tariffs than those

effectively in place, to grant itself some future room for manoeuvre to protect domestic production. In general it is unlikely that a small country like Azerbaijan would be allowed to negotiate higher than actual bound tariffs, and it is not obvious that this strategy would be viable. Also, it would be unwise to reverse the trade liberalisation process at this stage, thereby hampering the reallocation of economic activities, which is actually taking place under this regime. A reversal of this policy would also give new ground to rent seeking interests that may benefit from a more protectionist stance.

In contrast, Azerbaijan should make sure that by entering the WTO its exports do not lose the preferential market access to industrialised countries, which they now enjoy in the EU and in the US. Note that the WTO membership would allow for a permanent and unconditional MFN status, which is at present granted voluntarily by partner countries and which could be easily suspended. For example, Azerbaijan only recently got MFN status from the US. This was not granted earlier as retaliation for the Ngorno-Karabak war. Moreover, Azerbaijan should also make sure it preserves its free trade agreements with the other CIS countries, as regional trade, particularly with Russia and Kazakhstan is likely to increase in the near future. Given that the broad regional area was never implemented and that effective agreements are only bilateral, if Azerbaijan had to unilaterally renege the bilateral agreements it has in place at the moment, as a consequence of its WTO accession, it would likely be cut off regional trade flows.

APPENDICES

APPENDIX 1. BILATERAL AND MULTILATERAL AGREEMENTS ON FOREIGN TRADE SIGNED BY AZERBAIJAN:

- Free trade agreements with CIS member states
 - Bilateral Agreements on free trade with CIS countries: Russian Federation (1992), Ukraine (1995), Uzbekistan (1996), Republic of Kazakhstan (1997), Georgia (1996), Turkmenistan (1996), and Moldova Republic (1995)
 - Bilateral and multilateral agreements on foreign trade: Establishment of Eurasia Union on Coal and Steel (1993, not ratified), on control of getting permission for re-export and re-import of goods (signed 1994, put into force in 1996)
- Agreements on Economic Integration, Customs Union and Free Trade Zones
 - Economic Union of CIS
 - Economic Cooperation Organisation (ECO)
 - Establishment of Free Trade Zones (signed on 15 April 1994 and put into force on 8 December 1996).
- Azerbaijan is a member of the following economic organisations¹⁰:
 - International Labour Organisation (ILO), International Fund for Agricultural Development (IFAD), United Nations Food and Agricultural Organisation (FAO), United Nations Development Programme (UNDP), The World Bank, The International Monetary Fund (IMF), European Bank of Reconstruction and Development (EBRD).
 - World Customs Organisation, United Nations Conference on Trade and Development (UNCTAD), Economic and Social Commission for Asia and the Pacific
- Azerbaijan has a status of observer in World Trade Organisation (WTO)

¹⁰ Information also available on <http://www.president.az/azerbaijan/az2.htm>. The country is a member of other organizations as well.

APPENDIX 2. MAJOR TRADE-RELATED STUDIES AND PROGRAMS IN THE NON-OIL SECTOR

Sponsor	Activity	Timing
World Bank	Analysis of trade facilitation and transport in southern Caucuses	Draft completed
World Bank	Private sector development assessment (for the Poverty Assessment)	Draft underway
FIAS	Analysis of foreign investment climate	Draft completed
IFC	Development of supply and other linkages in the oil and gas and agribusiness sectors	Design underway
IFC	Foreign investors conference in Baku	Scheduled in March 2003
IMF	Evaluation of the State Customs Committee	2002
UNDP	Assessment of a free zone in Sumgayit	1996
UNDP	Employment strategy for Azerbaijan	2002
ITC (UNCTAD)	Assessment of the Azeri Information and Communications Technology (ICT) industry	Draft completed
ADB	Greater Silk Road Initiative	Design underway
USAID	SME development in various regions of Azerbaijan undertaken by NGOs, including entrepreneurship and business development	On-going
USAID	Private sector assessment	2001
USAID	Rural Enterprise Competitiveness project	Design underway
US Trade Development Agency	Support for WTO accession	Projected to be initiated soon
TACIS	Assistance in WTO accession and the Partnership and Cooperation Agreement between Azerbaijan and the European Communities	Scheduled to end August 2002
TACIS	Assessment of soft drinks, textiles, food processing, credit, machine building industries (done through the Small and Medium Enterprise Development Agency)	2001
EU	Trade and transport facilitation program in Central Asia and the Caucasus	On-going
Norwegian government	Assessment of marine equipment and machinery industry	2001
GTZ	Background assessments of Azeri firms in garments, wines, fruit and vegetable processing, and machine building, for a program of firm-level technical assistance	On-going
DFID	Investment Policy Review	2001
British Petroleum	Assessment of potential suppliers for oil and gas sector (supply chain analysis)	2001
British Petroleum	Enterprise center for provision of business information, matchmaking and other assistance to SMEs	On-going

Source: World Bank 2002b, table 3

APPENDIX 3. IMPORT TARIFF SCHEDULE

<i>Product category</i>	<i>Percent</i>
Live animals	15
Grain products	5
Ores	0.5
Organic and non organic chemicals	0.5
Fertilisers	0.5
Seeds	0.5 and 3
Tobacco	15
Wood and wood products	10
Paper and cardboard	0.5, 5, 10, 15
Textiles	0.5
Other Chemical fibers and fabric	15
Ferrous metals	5
Articles from ferrous metals	10 and 15
Nickel, Lead, Zinc, Tin	0.5
Vehicles	15
Ships	0.5
Medical equipment	0.5

Note: The list of goods is non-exhaustive
Source: US Department of Commerce, 2002

APPENDIX 4. LIST OF INSTITUTIONS AND PEOPLE VISITED BY THE AUTHOR

BAKER McKENZIE Mr. Daniel Matthews, Partner

BP, Mr. Roger T.Nunn, Vice president reputation and assurance

EBRD, Mr. Thomas Moser, head of office, Baku

GTZ, Mr. Marcel Schwickert, head of mission

HSBC, Mr. Charles Mason CEO

IFC, Aliya Nuriyeva, Program Coordinator, Azerbaijan Country Office

IMF, Michael Mered, Res Rep

IMPROTEX HOLDING, Mr. Ilham Assanov, (assistant to the president)

ITALIAN EMBASSY Ambassador Margherita Costa and Mr. Arturo Camillacci, attaché d'affaires.

MINISTRY OF ECONOMIC DEVELOPMENT, Mr. Elshan Mamedzade, Deputy Director, Department of Investments and International Economic Cooperation, Mr. Shovgi Mehdizada, head of Division for cooperation with WTO, Mr. Aur S. Jafarov, Department for investments and international economic cooperation, division for cooperation with WTO.

SAF Mr Elman Mirzakhanov, Chairman

TRACECA, General Secretariat: Mr. Aburashad Tagirov, Secretari General; Mr. Nazim Mamedov, Export in Maritime operations; Mr. Navruz Erkinov, Railway expert; *TRACECA*, Marc Graille, Supervisor, permanent secretariat, Mr. Peter ranger, expert

WORLD BANK, Mr. Akbar Noman, Resident Representative, Ms. Ulvia Ibrahimova

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