

BTI 2008 | Azerbaijan Country Report

Status Index	1-10	4.51	# 87 of 125	
Democracy	1-10	3.80	# 97 of 125	➔
Market Economy	1-10	5.21	# 70 of 125	➔
Management Index	1-10	3.85	# 99 of 125	

scale: 1 (lowest) to 10 (highest) score rank trend

This report is part of the Bertelsmann Transformation Index (BTI) 2008. The BTI is a global ranking of transition processes in which the state of democracy and market economic systems as well as the quality of political management in 125 transformation and developing countries are evaluated.

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Key Indicators

Population	mn.	8.4	HDI	0.74	GDP p.c.	\$	4,463
Pop. growth ¹	% p.a.	1.0	HDI rank of 177	99	Gini Index		36.5
Life expectancy	years	72	UN Education Index	0.89	Poverty ³	%	33.4
Urban population	%	51.5	Gender equality ²	-	Aid per capita	\$	26.9

Sources: UNDP, Human Development Report 2006 | The World Bank, World Development Indicators 2007 | OECD Development Assistance Committee 2006. Footnotes: (1) Average annual growth rate 1990-2005. (2) Gender Empowerment Measure (GEM). (3) Percentage of population living on less than \$2 a day.

Executive Summary

Despite the promises of Azerbaijan's young president, Ilham Aliyev, who has been in power since fall 2003, the country made only marginal progress in democratic transformation during the period under review. The parliamentary elections of November 2005 once again demonstrated that the ruling elite is not willing to loosen its grip on all relevant institutions of the state. International observers are also deeply concerned about the growing pressure on the media, including the murder of a well-known journalist and the beating of others by "unknown culprits."

Whereas, in the country's first years of independence, strong presidential rule was instrumental in stabilizing the country, it now presents a barrier to further democratization. Resistance at the top from the circles associated with the president's regime obstruct steps toward a shift of governmental authority toward parliamentary bodies and an independent judicial system. In view of Azerbaijan's vast social problems and the inefficiency of its administrative machinery, as well as the political system's inability to integrate sectors of Azerbaijani society, there is potential for mid-term instability. Finding a lasting solution to the Nagorno-Qarabagh conflict is of crucial importance for the country's future. A rise in the number of cease-fire violations in 2005 and 2006 underscore the conflict's potential in threatening regional stability. Azerbaijan's fast-growing state budget allowed for more military expenditures, accompanied by frequent calls for a military solution to the conflict. In 2006, the defense budget allegedly accounted for 15% of all government spending and exceeded \$1 billion. As attempts by international organizations – in the first place by the Minsk group of the OSCE – to reconcile both sides have failed, the probability of military clashes may grow. A peaceful solution in the short run – that is, in 2007 – seems unlikely, since the important elections scheduled to be held in 2007 and 2008 in both countries will preoccupy all relevant political actors.

President Aliyev continued to enjoy overwhelming authority in Azerbaijan's governmental system and was able to maintain political stability. This became obvious in the aftermath of the elections of November 2005, when two ministers were deposed and accused of an attempted coup. His government was also able to perpetuate economic stability thanks to a high level of continued economic growth owing to increased extraction of oil and gas and their growing prices on the world market.

The transformation toward a market economy has made substantial progress with regard to the institutional framework. However, conditions surrounding Azerbaijan's economic reality – such as insufficient infrastructure, massive corruption, an inadequate banking sector and the persistent inefficiency and incompetence in many areas of government administration – counteract these gains. Azerbaijan has made only limited steps toward developing a welfare system within the context of a market economy. This may change with the growing income from oil and the created oil fund, the purpose of which is to secure a sustainable development strategy. Development that focuses exclusively on the energy sector and a few limited regions of the country poses a great danger and can only be restrained by decisive policy. The currency was redenominated in January 2006 with the introduction of the new manat, which was valued at 5,000 of the former manat. This move points to an attempt to stabilize the currency and its increasing value against the dollar. Some macroeconomic indicators, such as inflation, took a turn for the worse in 2005 and 2006. High rents from oil and gas exports, the fast growth of the hydrocarbon- and transport-/building-related sectors and increasing state expenditures all increase the likelihood of a “Dutch disease” syndrome. Several areas of the law continue to require substantial reform (e.g., legislation of elections and political parties, the judicial system, property rights).

The relative management performance of the main political actors is mixed. While the reversal of the economic downtrend during the first half of the nineties and the stabilization of macroeconomic conditions constitute management achievements, the scant progress of democratization and the fact that only the rudimentary basics of a functioning economy have been established must be attributed largely to the failure of those in power, be it the late president Heydar Aliyev or his son and successor Ilham Aliyev. Azerbaijan has shown relative success in integrating itself into the international community. Unfortunately, this achievement found no counterpart in domestic policy. On the contrary, a collision course with the opposition and undemocratic behavior in a number of areas (e.g., massive repression after the presidential elections 2003, massive pressure on the media, forceful suppression of local protests, strengthening of presidential powers in the constitution, election fraud during the parliamentary elections 2005, etc.) dominated. Without substantial pressure from democratic countries and international organizations such as the Council of Europe, there seems to be little chance for truly democratic elections in Azerbaijan.

History and Characteristics of Transformation

The economic and political transformation in Azerbaijan has been slow to gain momentum. The democratic transition process was precipitated by changes in the political arena following the break-up of the Soviet Union. In July 1989, the Popular Front emerged as an informal political movement similar to others in former Soviet republics. It demanded national sovereignty, democracy and that Nagorno-Qarabagh remain under the jurisdiction of Azerbaijan. The internal conflict surrounding Nagorno-Qarabagh, however, a region predominantly inhabited by Armenians, has had far-reaching, negative effects on the political and economic development of the still young state of Azerbaijan. To date, the conflict has produced more than 18,000 casualties and more than one million refugees on both sides. Notwithstanding the efforts of international mediation, there appears to be no solution to this conflict. With the violent overthrow of Abulfaz Elçibey, president of Azerbaijan and leader of the Popular Front, Heydar Aliyev, the former chairman of the KP and KGB, assumed power and has ruled the country between 1993 and 2003, only to be succeeded by his son İlham Aliyev. The co-optation of both Aliyevs' power base, primarily from former KP officials and from regional power groupings from the enclave of Nakhichevan and Azerbaijanis originating from Armenia, imposes structural limits on the democratization process. Previous elections (e.g. the presidential elections of 1993, 1998 and 2003; parliamentary elections in 1995, 2000 and 2005), rated by Western observers as thoroughly undemocratic, only reinforced existing conditions. Azerbaijan joined the Council of Europe as a member on 25 January 2001 amidst persistent criticism of its human rights record. An authoritarian presidential system and manifold repression of the opposition and the media preclude Azerbaijan's democratization. However, politicians belonging to the old guard of the current president's father are gradually being replaced by younger officials with a more technocratic image.

Sustained political apathy among the population coupled with government oppression and internal quarrels has left the opposition largely marginalized. Nevertheless, it has been relatively successful in maintaining a certain degree of flexibility for its modus operandi. External actors, such as the OSCE, the Council of Europe and embassies of Western countries, have also played a positive role in this context. Amendments to the constitution, which the population approved by a referendum (of dubious legitimacy) in 2002, only reinforced the presidential nature of the constitution and, with it, the legal opportunities for continued authoritarian rule. The opposition essentially agrees with the government on key issues of foreign policy such as Azerbaijan's orientation to the West and Turkey, its critical position toward Iran and Russia and its unwillingness for compromise in the Nagorno-Qarabagh conflict. At the same time, it is incapable of harnessing widespread social discontent to pursue its own interests.

Ayaz Mutallibov, the first post-independence head of state (1990-92), was instrumental in initiating the transition to a market economy. Nevertheless, he was failed to develop any lasting dynamism in the early years of independence owing to turbulent internal political strife up until 1994 and the military conflict surrounding Nagorno-Qarabagh, which lasted until the ceasefire of May 1994. Crucial for the economic development of the country was the transfer of former union-owned industries into republican ownership, particularly in the petroleum and petrochemical sectors, in January 1992. One of the great mid- to long-term challenges for the country is diversifying its vulnerable oil- and gas-dependent economy, Azerbaijan's only internal issue that has attracted foreign investment. Nevertheless, the manat, the new currency introduced in 1993, stabilized (until very recently) and the national debt has been significantly reduced. This can be attributed almost exclusively to the export of oil and (increasingly) natural gas, the continuous rise in crude oil prices on the international markets and, finally, a generally restrictive policy of expenditure lasting until just recently. The post-Soviet deterioration of the country's industrial base, however, has yet to be reversed.

The majority of small enterprises and a number of medium-sized enterprises have been privatized, while the majority of large-scale enterprises remain under state ownership. Production figures in the largely privatized agricultural sector have risen significantly. Low productivity, however, necessitates continued food imports, and the local food-processing industry operates at a loss. With the dissolution of the Soviet Union, the standard of living of the population at-large has declined alarmingly, and social spending only continues to diminish. In line with other post-Soviet societies, Azerbaijan has witnessed the emergence of a nouveau-riche class, usually owing its prosperity to strong ties with the ruling regime. In spite of negative spillover effects from the Russian economic crisis of 1998-99, the implementation of the late President Heydar Aliyev's rigorous economic plan has reversed the general downward trend of the Azerbaijani economy that originated in the early nineties. A significant hurdle to economic development, however, is corruption, which has been widespread for years (Transparency International still ranks Azerbaijan as one of the countries with the highest perceived level of corruption worldwide). Loans and grants provided by international financial and donor organizations have aided greatly in the process of consolidation.

Transformation Status

I. Democracy

1 | Stateness

Stateness poses a problem in Azerbaijan. First of all, Armenian forces occupy about 17% of its territory. Second, border demarcation on the Caspian Sea has not yet been determined decisively between Azerbaijan, Iran and Turkmenistan, and no multilateral agreement has been concluded among the five littoral states. Furthermore, conflicts over small segments of the boundary between Azerbaijan and Georgia remain unresolved. However, the state's unrestricted monopoly on power extends over all its unoccupied regions.

Monopoly on the use of force

In theory, the basis for defining citizenship and who qualifies as a citizen has been established. In reality, there remain considerable problems surrounding the right to citizenship for Armenians from Nagorno-Qarabagh, the displaced Armenians from Baku and other unoccupied regions of the country and smaller groups of immigrants and refugees (e.g., Chechens and Meshketians). All citizens enjoy equal civic rights, and the state's constitution is fundamentally acknowledged by the majority of the population.

State identity

State and religion are separate. Political processes are largely secular, although religion (Islam) is increasingly becoming a factor. Growing religious fervor, however, has not led to the direct transfer of religious norms into laws.

No interference of religious dogmas

The state is present with basic infrastructure throughout the entire unoccupied national territory, but it exhibits grave deficiencies (e.g., corruption, incompetence). Law and order are largely maintained.

Basic administration

2 | Political Participation

Universal active and passive suffrage exists, although it is frequently violated in practice. Western observers have judged the great majority of elections held thus far in Azerbaijan as being fraught with grave deficiencies (i.e., as being neither

Free and fair elections

free nor fair). There is no evidence of real improvement over the past few years (constitutional referendum of 2002, presidential elections of 10/2003, municipal elections 12/2004, parliamentary elections 11/2005, municipal elections 10/2006). The façade of “re-electing” the president or rather the government (no changeover of power since 1993, besides the election of Ilham Aliyev as president after his father’s death in 2003), makes a mockery of the principles of open, competitive and fair election processes in several cases.

The effective power to govern lies with the president and his government. There are no veto powers or political enclaves in the hands of the military or other influential groups. However, there remain non-legitimized power structures related to the president and his entourage influencing the course of politics.

Effective power
to govern

Independent political and civic organizations are entitled to form, but they experience occasional problems with registration and encounter state repression. Opposition parties are systematically disabled. For example, from 2005 to 2006, the headquarters of the main opposition parties were confiscated by the state. Independent youth organizations close to the opposition also became a target of repression. There are a number of NGOs corresponding to ethnic groups, which restrain their efforts to humanitarian and cultural activities. Certain ethnic groups (e.g., the Lezgians close to the northern border) are discouraged from forming political organizations. So-called “non-traditional” religious groups (e.g., evangelical missionaries, “Wahhabis,” non-conformist Shiite groups) encounter difficulties with registration and find that their activities are in part prohibited, largely owing to pressure from the media and mainstream Islamic organizations. In line with Soviet tradition, union activity largely remains state-controlled, thereby preventing the formation of independent unions and any effective participation of unions in determining wage levels. Freedom of assembly is only possible on a very restricted basis and dependent on decisions of the state authorities, despite the guaranteed constitutional right of freedom of assembly. This is especially true during election times. For example, in autumn 2005, public meetings of the opposition were only occasionally allowed and then only with unfavorable restrictions, especially in the provinces.

Association /
assembly rights

State-run media and electronic media owned by members of the ruling elite are subject to governmental control, and disagreeable private media are at times under considerable economic, financial and legal pressure (as well as physical pressure, as show by the beating and killing of prominent journalists). In 2006, the pressure against opposition media grew considerably. Thus, freedom of opinion is limited, despite some positive legal steps such as the establishment of a Press Council (March 2003) and a Law on the Public Broadcasting Service (Sept. 2004, followed by a presidential decree in Nov. 2004). A code of conduct signed by government and media representatives in May 2005 failed to resolve problems with the government and to improve professional and ethical standards among

Freedom of
expression

journalists. An important development was the transformation of the second state television channel into a public service broadcast in August 2005, despite the fact that it is still subject to high governmental control.

3 | Rule of Law

With respect to state power, Azerbaijan shares similarities with other post-Soviet states in that the constitution provides for a clear dominance of the executive branch and the president and his apparatus play the principal role. Due to the dubious election processes and the utter domination of forces close to the president, the parliament is limited even in its ability to exercise its monitoring function as provided for in the constitution.

Separation of powers

In theory, the institutionally separate judicial branch and the Constitutional Court (established in 1998) are independent, but in fact they are largely subordinated to the executive. The president (in the case of the courts of first instance) appoints the judges either directly or through recommendations to parliament, and can dismiss them with a presidential decree. To date, reform of judicial structure has been inadequate, thereby preventing it from acting as a counterbalance to the executive. Adverse judicial and political decisions tend to be rescinded by presidential decree. In some instances, the pressure for democratization exerted by external actors (OSCE, Council of Europe, U.S. State Department) necessitated subsequent corrections of antidemocratic decisions by way of a presidential decree. Admission to the Council of Europe in January 2001 mandated that the laws affecting a variety of areas conform to European standards (e.g., requiring the abolition of the death penalty and ratification of the European Convention on Human Rights), even though legal practices affecting the media in particular continue to be plagued by obvious deficiencies. Despite the release of many political prisoners under an amnesty introduced by the president in spring 2005, the issue of political prisoners again gained momentum before the elections in autumn 2005 and in 2006, when several high-ranking governmental officials – including two ministers – were imprisoned under doubtful accusations. Corruption of the judiciary and the Ministry of Internal Affairs remains a serious problem, and the involvement of a number of high- and middle-level officials in severe organized crime became public during 2005 and 2006. The poor condition of the penitentiary system, widespread corruption and the mistreatment of prisoners led to a revolt of prison inmates in early spring 2005, which precipitated a presidential intervention and the firing of several high officials. Nevertheless, the structural problems remain unresolved.

Independent judiciary

Political and bureaucratic corruption is regarded as being very high by the population, and it is widely criticized. In an opinion poll conducted in 2005, corruption and incompetence within the government bureaucracy was regarded as

Prosecution of office abuse

the country's second greatest problem after the unresolved Qarabagh conflict. Only in rare cases is corruption fought effectively by way of a court ruling. Prosecution of corruption is also used to authorize the dismissal of high-ranking government officials, without affording them proper legal recourse. Despite several new laws against corruption (the Law on Combating Corruption and the State Program on Fighting Corruption came into force in January 2005), the situation remains largely unchanged. The auditing capacity of the legislative branch is weak, and government investigations of civil servants are usually politically driven. Legal and other forms of harassment are commonplace for persons who publicly allege corruption on the part of government officials. This is especially true for journalists attacking the government on the issue of corruption, although the government may also use such accusations to blackmail and extort funds from the accused official. The exclusion of civil society and the media from the commission for the fight against corruption also diminishes its effectiveness. Azerbaijan must still substantially improve the legislative and administrative processes for investigating corruption by government officials and civil servants. Such programs must include regulations guaranteeing that anti-corruption measures are applied free of political bias. It remains to be seen whether the country's participation in the Anti-Corruption Network for Eastern Europe and Central Asia of the OECD will lead to real improvements in this field. As of yet, the state administration has not undergone structural reform. Salaries in many administrative departments are still not enough to cover living expenses, which in turn encourages corruption and inefficiency.

In principle, civil liberties are guaranteed by the constitution but are selectively violated. Problematic, for instance, is the required registration of religious institutions and congregations at the State Committee for Relations with Religious Organizations, which restricts religious freedom in certain areas. Legal discrimination against particular ethnic or religious groups (or of women) does not exist, but women and religious converts do encounter social discrimination.

Civil rights

4 | Stability of Democratic Institutions

Democratic institutions have severe deficiencies. With a single exception (the presidential elections of 1992), post-Soviet Azerbaijan has yet to witness a transfer of power legitimized by democratic elections. With the transfer of power from the late president Heydar Aliyev to his son Ilham Aliyev, via elections in October 2003 that were neither fair nor free, the existing power structures remained predominantly the same. The opposition is divided: while some confront those in power, others hope to be co-opted into the existing power structure. The parliament plays a negligible role. Independence of the judiciary and political neutrality of the state administration has yet to be established.

Performance of
democratic
institutions

During the last years, the level of professional performance has somewhat improved, but prospects for the establishment of a functioning system of checks and balances remain limited.

The vast majority of political actors formally accepts democratic institutions. But, in practice, democratic institutions are disregarded and distorted in an undemocratic regime. The sole fundamental opposition to the political system might emerge from the growing Islamist current in the population, but it has yet to organize. An opinion poll in spring 2006 showed that 19% of the population allegedly supports the idea of an Islamic state (whatever this means, concretely) and another 30% would welcome the partial introduction of Shariah-based laws (e.g., in family law).

Commitment to
democratic
institutions

5 | Political and Social Integration

The political party system is highly fragmented, although there are only about five parties of nationwide relevance. The dominant New Azerbaijan Party headed by the president mainly unites government officials and patronage structures without having a clear political program. The high degree of verbal polarization among the key stakeholders has not led to massive social polarization for a number of reasons. First, the principle of peaceful political contest has largely met acceptance. Second, the political parties are rather poorly rooted in society. And, third, voter volatility is considerable. Most parties reflect patronage-based structures centering on certain public leadership figures and groups rather than on social interest groups. Before the parliamentary elections of November 2005, there was a drive for the unification of the fragmented opposition. Some prominent personalities in two election blocs led to hopes for a more effective and representative party system. The total defeat of these blocs by the pro-government forces – due, in part, to government manipulation of elections – and the following conflicts inside the opposition weakened the parties even further. In 2006, even the governing party showed signs of defection.

Party system

Due to the hitherto low degree of social differentiation and the authoritarian nature of government, there are only very few other organized groups representing the interests of different parts of the population. Large parts of the impoverished and unemployed – or rather underemployed population, in particular – are unable to articulate their political interests, which clearly constitutes a risk to stability. If groups that are currently not integrated into the country's political system (e.g., Islamists) succeed in articulating the interests of these parts of the population, the possibility of mid-term destabilization might arise.

Interest groups

In principle, the majority of the population accepts a democratic system, although in political everyday life large parts of the population tend toward an authoritarian style of politics. Over the last years, one can observe a steadily growing disappointment with democracy owing to the poor performance of the post-socialist system and the alleged double standards of Western democracies. In comparison to 2003, when more than 67% of the 1,000 respondents in an opinion poll regarded democracy as the best form of government, the percentage dropped to 57% in 2004. In the same poll, 63% of respondents answered that only a powerful leader could change the situation for the better. In contrast, only 19% put their faith in good laws and a mere 3.8% in powerful parties. An important indicator for this process is the low voter turnout during the parliamentary elections of 2005, which had a voter participation rate of less than 50%.

Consent to
democratic
norms

Due to politico-cultural and socio-economic barriers, modern forms of social self-organization remain underdeveloped and have limited scope of action and trust among the population. On the other hand, traditional forms of social self-organization, mainly based on kinship networks, are widespread and help large parts of the population survive economically. Other forms of “traditional” solidarity networks are built on a common local or regional background.

Associational
activities

II. Market Economy

Azerbaijan has made progress in the transformation of its economy. The collapse of large enterprises that dominated the Soviet era has been compensated for, in part, by small- and medium-sized enterprises in food and light industry as well as in the trade and service sectors. Transition deficiencies exist with respect to the only partially implemented privatization of medium and large-scale enterprises, widespread corruption, the incomplete consolidation in the banking sector, reform and implementation of economic legislation and their respective regulatory bodies, and also the removal of regional developmental imbalances (concentrated on Baku and the Apsheron Peninsula). However, the confinement of economic development to the energy sector (which accounted for 42% of GDP in 2005 and 84.6% of the country’s export in 2006) is highly problematic, as are the spill-over effects to the transport and infrastructure sectors, which considerably slowed down after the inauguration of the Baku-Ceyhan pipeline in July 2006. Foreign investment is expected to drop off in the immediate future as major investment projects in the hydrocarbon sector move toward a less intensive development stage, but this fall will be partially offset by domestic investment.

6 | Level of Socioeconomic Development

Most central indicators point to a growing level of development mainly based on a boom in oil (and gas) income. However, based on the HDI, the development of the country still offers freedom of choice to only a small section of the population. Nonetheless, since 2003, the level of poverty in Azerbaijan has been declining rapidly, particularly in Baku. According to World Bank data, about 24% of the population lived in poverty in 2005 as compared to nearly 50% only two years before. The fall of poverty in non-Baku urban areas after 2004 also indicates increased social empowerment. Per capita income of the 850,000 internally displaced persons (IDPs) and refugees in the country had risen to the national average by 2005. According to a recent World Bank study, the comparably very low Gini coefficient can be explained by the unrepresentative data collected and by growing transfer incomes. Poverty is also a cause for social exclusion due to the privatization of parts of the higher education sector and growing demand for study fees in the public education sector. Since women are excluded from positions of leadership and female professions have traditionally been extremely underpaid, gender-specific exclusion is evident. Dire living conditions, especially in provincial towns and rural areas, have resulted in high (work-related) migration. Conservative estimates place the number of temporary or permanent immigrants – mainly in Russia – at approximately 1-1.5 million. The infrastructure in rural areas is often so poor that it impedes the development of the regions beyond the capital. An important contribution to the income of the rural population comes from household plots used for agricultural production. Average living standards are improving for parts of the population, especially for the ruling elite and their networks, but this of course leads to growing social inequality.

Socioeconomic
barriers

Economic indicators		2002	2003	2004	2005
GDP	\$ mn.	6,236	7,276	8,680	12,561
Growth of GDP	%	10.6	11.2	10.2	26.2
Inflation (CPI)	%	2.8	2.2	6.8	9.5
Unemployment	%	-	-	-	-
Foreign direct investment	% of GDP	22.3	45.2	41.0	13.4
Export growth	%	16.7	-4.4	10.7	58.5
Import growth	%	48.4	43.5	23.3	-0.6

		2002	2003	2004	2005
Current account balance	\$ mn.	-768.4	-2020.9	-2589.2	167.3
Public debt	\$ mn.	1,065.2	1,307.2	1,405.5	1,344.2
External debt	\$ mn.	1,498.9	1,745.8	1,982.1	1,881.1
External debt service	% of GNI	2.9	3.2	3	2.2
Cash surplus or deficit	% of GDP	-	-	-	-
Tax Revenue	% of GDP	-	-	-	-
Government consumption	% of GDP	12.4	12.4	11.4	10.9
Public expnd. on edu.	% of GDP	3.2	3.3	3.3	2.5
Public expnd. on health	% of GDP	0.8	0.9	0.9	-
R&D expenditure	% of GDP	0.3	-	-	-
Military expenditure	% of GDP	2.0	1.9	1.8	2.5

Sources: The World Bank, World Development Indicators 2007 | UNESCO Institute for Statistics | Stockholm International Peace Research Institute (SIPRI), Yearbook: Armaments, Disarmament and International Security

7 | Organization of the Market and Competition

Since the mid-nineties, important progress has been made in the transition to a market economy. In 2005, 79% of GDP was obtained by the private sector (1998: approx. 55%; 2003: 73%). In the meantime, market competition received an institutional framework. However, the economic environment is still hazardous, characterized by: widespread corruption; inadequate judicial and political settings; the arbitrary administration of justice by the state organs and the judicial system; as well as underdeveloped infrastructure and a lack of access to capital. Small- and medium-sized enterprises in particular encounter great difficulties. As a result, the informal economy is equivalent to 18% of Azerbaijan's GDP according to the State Statistical Committee, though the actual size may account for as much as 60% of officially recorded GDP (2005). Pricing has largely been liberalized with the exception of mainly public utilities like electricity, heat, telecommunication, water and domestically sold oil and gas products. On 6 January 2007, the government doubled the price of domestic energy, which led to price increases in the service sector and the entire domestic market.

Market-based competition

State monopolies command parts of the transportation sector as well as certain areas of the infrastructure (e.g., gas, electricity, water), although there have been

Anti-monopoly policy

partial privatization efforts. Foreign enterprises are active in certain areas of the infrastructure. Reforms in the telecommunications sector were initiated but are not yet completed. In the bank sector, the state-owned International Bank of Azerbaijan still holds a near-monopoly on power (2005: 49% of total banking system assets). As the oil and gas sector is of strategic interest for Azerbaijan's future, the central role of the state and the State Oil Company (SOCAR) continues. However, due to the lack of capital and technology, foreign oil companies play an important role. The only relevant legislation in the field of competition is the Law on Antimonopoly Activity of 1993. New investment and competition laws are in the works due to Azerbaijan's growing interest in becoming a member of the WTO, which makes WTO-consistent regulatory development necessary. Such laws, however, cannot prevent the concentration of ownership of privatized infrastructure enterprises in the hands of the kinship networks of the ruling elite, as has occurred in the telecommunications sector.

The political leadership is formally committed to the principle of free trade in its foreign trade policy, as well as "not less favored" treatment compared to local investors. However, unreliable custom and trade regulations, non-transparent registration mechanisms and partial restrictions inhibit the implementation of those principles. The recent inclusion of the three Southern Caucasus countries in the European Neighborhood Policy (ENP) could create closer trade links with Europe and positively influence the regulatory framework. Politics hinder regional trade, especially with Armenia. Mainly because of the fast growing oil and gas exports (about 90% of the exports) and imports related to the oil and construction sectors, the foreign trade volume has grown considerably since 2004. Azerbaijan applied for WTO membership in 1997 and has set a target of joining the WTO within the next couple of years.

Liberalization of
foreign trade

The banking sector remains underdeveloped and a bottleneck for the development of the private sector. With the domination of the state banks (which in 2006 accounted for more than 50% of all bank deposits, albeit a fall from previous years), competition is lacking and most banks are undercapitalized. At the same time, the situation is gradually improving due to moderate increases in capital requirements, mergers and closures (1994: 250 banks; 2006: 44), reforms of laws and formalities and increasing professionalism. Total banking system assets still stood at only about 18% of GDP at the end of 2005. In January 2004, the government adopted a new law on the banking system (enacted in 2005) that is consistent with the Basel core principles. Small- and medium-sized enterprises and people in rural areas encounter great difficulties in procuring capital. However, this changed partially with the assistance of foreign donors and international banks such as the EBRD, KfW and the World Bank.

Banking system

8 | Currency and Price Stability

The period of investigation was characterized by consistent inflation and currency policies. In December 2004, the National Bank Law was enacted giving the National Bank considerable de jure independence to pursue monetary policy and more accountability. Fiscal and debt policies were oriented towards stability. Beginning in 2004, inflation started to rise, only to reach a two-decade high in April 2005 exceeding 15%. Average monthly inflation for 2004-2005 reached 9.6%. Inflation returned to single digits by fall 2005 and was 10.3% in September 2006 on a year-to-year basis. This highlights the mounting inflationary pressures of the macroeconomic environment caused by factors such as the growing foreign exchange inflows from the oil sector and rising prices for several basic commodities such as oil, gas, water and wheat. With the introduction of the new manat in January 2006, a re-domination of the currency took place, exchanging 5,000 old manat for one new manat.

Anti-inflation /
forex policy

The government consequently follows a policy of macroeconomic stability in order to preserve fiscal stability and a low level of debt. In 2004, the government continued to pursue a prudent fiscal policy. The overall deficit at 2% of GDP was somewhat less than in 2003. Over the medium term, no major negative change is expected because of high oil prices on which Azerbaijan's economic growth is largely based. During 2005 and 2006, public spending in the welfare sector aimed at diminishing the widespread poverty and in improving the underfinanced education and health sectors grew considerably. The non-oil primary deficit is expected to increase from 11% of non-oil GDP in 2005 to over 30% in 2006. Such a government strategy is fiscally sustainable with today's oil prices.

Macrostability

9 | Private Property

Private property rights and the acquisition of private property are formally well defined. However, the implementation of the pertinent laws is deficient and at times experiences state arbitrariness and corrupt procedures. In 2006, the regulations for registration of legal entities were streamlined and, in 2007, the registry will be computerized. The establishment of a nationwide immovable property registration system also is in the making, which will make property rights more secure and better allow real estate to be used as collateral for credit. The legislative and institutional framework for the protection of intellectual and industrial property rights remains incomplete and does not fully match the requirements of the modern information age. Another problem is the implementation of the existing laws. For instance, at present, these laws do not prevent films from being broadcast without permission of the companies owning the rights for those programs.

Property rights

Privatization in agriculture (ca. 98%) and of small enterprises has largely been completed. Sections of the medium- and large-scale enterprises either have yet to be privatized or could not be privatized for lack of interested parties. Government sources reveal that, between 1997 and 2002, the percentage of small and medium-scale enterprises increased from 24.7% to 42.7% of GDP. In 2006, reportedly, the GDP share of the private sector was 81% (2005: 76%), although independent analysts estimate much less. The overall progress of the “second wave” privatization (Second Privatization Program), which should be finished by January 2008, remains slow. There are still several large and inefficient state companies, especially in the utility sectors. The discussion of the privatization and/or restructuring of SOCAR (State Oil Company of the Azerbaijan Republic) continues, but privatization seems to be an unrealistic option for the near future particularly in light of Azerbaijan’s dependence on the oil sector.

Private
enterprise

10 | Welfare Regime

By regional standards, Azerbaijan had a reasonably extensive social safety net during Soviet times. The post-Soviet welfare system, however, suffers from considerable underfunding and can fulfill its obligations in only a handful of areas. Health care is inadequate, at least for the poorer sections of the population. In 2005, public expenditure on health care amounted to only 1.0% of GDP (1995: 1.4%). The new management at the Ministry of Health launched a Health Sector Reform Project in 2006, which is expected to gain momentum in 2007. Significant progress has been made on pension reform. However, pensions do not yet cover living expenses. A new targeted social assistance system went into effect in July 2006, but the development of a modern social security system is still in its infancy. Minimum wages rose almost fourfold between 2002 and 2005, and average wages rose substantially. The rural population is less affected by poverty than parts of the urban population; inhabitants of small towns, in particular, can take refuge in the largely privatized agricultural sector. Family networks and money transfers from family members working abroad act as a stabilizing force for parts of the population. In absence of reliable unemployment statistics, estimates indicate that up to 25% of the employable population is without work. The state lacks an active employment policy and a functioning system of employment exchange. There is also no state support for the vast majority of the unemployed. Social stabilization constitutes one of the central challenges in the country’s future. In 2003, the government launched a State Program on Poverty Reduction and Economic Development (SPRED) and, in 2005, developed a new State Program on Poverty Reduction and Sustainable Development (SPPRSD) for 2006-2015.

Social safety nets

Equal opportunities exist in theory and are the normative role model owing to the egalitarian attitudes within the population. In practice, however, considerable restrictions do exist due to informal networks (nepotism), financial restrictions on access to education and widespread corruption. Increasingly, women experience discrimination in all social areas, an issue that the government – in spite of verbal acknowledgement – has yet to address. Mechanisms associated with the advancement of women, people with disabilities and the socially disadvantaged are very limited. Members of minority ethnic and religious groups have near-equal access to higher education and assistance mechanisms. Access to some public positions, however, may be limited for certain groups, e.g., ethnic Russians. Institutions to compensate for gross social differences are very limited in scope and quality, but growing social transfers from oil income have provided somewhat of a windfall.

Equal opportunity

11 | Economic Performance

After the Russian crisis of 1998, the GDP growth has averaged 10% annually with an impressive growth of more than 26% in 2005. However, these data can be misleading, as Azerbaijan ended up once again at its low initial level after seven years of plummeting GDP performance (all-time nadir in 1993: -23.1%). Although macroeconomic data appear largely positive (e.g., relatively low inflation, a largely balanced budget, low national debt, a relatively positive trade balance), they do not reflect the actual low economic performance due to factors such as the almost total lack of industrial production outside the oil/natural gas sector and the related infrastructure and transport sector as well as high unemployment and a low domestic demand due to the general impoverishment of the population. Of singular potential for development is the energy sector with all its uncertainties (2006: 84.6% of total exports). There are, however, some positive signs, such as improving living standards and growing real per capita income.

Output strength

12 | Sustainability

Ecologically tolerable growth finds only marginal consideration and is not at all entrenched institutionally, although the creation of the Ministry of Ecology and Natural Resources in 2000 presents some degree of improvement. In addition, partial de-industrialization and the modernization of the petroleum and natural gas sector, achieved in cooperation with international consortia and donors, have proven positive for the environment. Nevertheless, damage incurred by the production and processing of petroleum and natural gas, poor water quality, degradation of arable lands, de-forestation, pollution and over-fishing in the Caspian Sea, and the threat to nature reserves continue to pose massive problems.

Environmental policy

In 2003, a National Program on Environmentally Sustainable Socioeconomic Development was developed. But this initiative and all other environmental legislation, although in place in several areas, still needs further development and better implementation. Azerbaijan is party to the Kyoto Protocol, but it still needs to implement its relevant provisions.

Facilities for education, training and research do exist in key segments, but they differ considerably in quality and, in the case of research and development, show obvious deficiencies. During the assessment period, the percentage of GDP invested in education remained almost unchanged in recent years (2003: 3.3%; 2004: 3.3%; 2005: 3.2%). Overall quality is still low, funding remains inadequate and the educational sector does not meet labor market needs. Inequity of access to education and the quality gap from urban to rural areas are growing. Neither the recently established private education sector nor foreign endeavors can make up for this. Research and innovation activities are not given much attention. The brain drain of recent years has yet to be addressed and stemmed.

Education policy
/ R&D

Transformation Management

I. Level of Difficulty

Azerbaijan's leadership faces a moderate level of difficulty in executing the tasks required for transformation. There are several structural constraints, some inherited from the pseudo state-run structures of the Soviet era and some accumulated during and after the breakdown of the USSR and the ensuing collapse of economic structures, physical infrastructure and social services, as well as lingering environmental damage. However, over the last years, Azerbaijan recovered to a certain degree from post-Soviet decline. Prominent exceptions remain, such as the failure of the still deteriorating public education system to assure the previously high level of education enjoyed during the Soviet years. If the announced development strategy were realized, the oil and gas reserves of the country would give Azerbaijan a long-term comparative advantage over other transformation countries. Unfortunately, Azerbaijan also faces a major obstacle to further development: the frozen conflict between Azerbaijan, Armenia and the Nagorno-Karabakh Armenians, which has resulted in placing nearly 17% of Azerbaijan's territory beyond government control, more than 800,000 IDPs and refugees from Armenia as well as the emigration of a considerable number of professionals with non-Azeri ethnic background.

Structural
constraints

Civic traditions are weak, but for the last years the NGO sector has been growing. Political and oppositional NGOs, however, are under consistent pressure from the state authorities. Without international support, the NGO sector would be in an even more fragile state. The growing disappointment among the populace with democracy, which is an outcome of the regular falsification of the elections and the bad performance of many politicians – both in government and in the opposition – is problematic. Overall, the vast majority of the population regards politics with even more passivity than in the past. However, the growing consciousness for civic engagement among some young professionals who have studied abroad could bear fruit in the future.

Civil society
traditions

The enduring conflict with the Armenian population of Nagorno-Karabakh and the Republic of Armenia (ceasefire: May 1994), rising religious divergence and income disparities, and growing inter-regional development differences

Conflict intensity

constitute problems for the future stability of Azerbaijan. With the exception of the Nagorno-Karabakh conflict, the government was successful in containing domestic strife and preventing the emergence of new ethnic conflicts during the period under study. Radical political actors stay isolated, basically due to the prospects of the oil-based economical success of the period under review.

II. Management Performance

14 | Steering Capability

The political leadership successfully managed the transfer of power from President Heydar Aliyev to his son Ilham Aliyev in autumn 2003. Thereby, it has proven its ability to organize policies according to strategic aims, i.e., the continuation of its rule and the stabilization of the political situation. After the new president came to power, the leadership succeeded in attaining its strategic goal of macroeconomic stabilization, which also served the main political actors' own material and political interests. The parliamentary elections of autumn 2005 again proved the ruling elite's ability to maintain and even broaden its political basis without engaging in real democratization of the country. Over the last years, the government – supported by international organizations and donors – defined several long-term priorities, especially for sustainable economic development and poverty reduction (State Program on Poverty Reduction and Economic Development, National Program on Environmentally Sustainable Socioeconomic Development, etc.). However, there is no clear strategy for democratization beyond rhetoric nor for a socially responsible market economy.

Prioritization

The government seeks to achieve reforms at least in the economic field, but even there it fails to implement some of them properly. This is especially true for the fight against corruption, which remains inefficient because of the central unwillingness to pursue a consistent policy that could hamper the interests of the ruling elite. Furthermore, privatization in agriculture and of small- and medium-size enterprises has been implemented, whereas the privatization of large enterprises has fallen behind.

Implementation

Following advice from international donors, the government successfully reduced energy-related subsidies (2000: est. 22% of the GDP; 2003: approx. 10%; 2004: 6.5%; 2005: approx. 4.7%; last price increases January 2007 in order to move closer to cost-recovery). The collection of tariffs improved during the past years, reaching rates of an estimated 83% for gas and 70% for water in

September 2005, but it still poses a formidable challenge. With the creation of a state oil revenues fund (SOFAZ) in 1999, the government tried to address previously neglected long-term development and socio-political objectives (stock: \$1,538 million as of 1 February 2007; up to 1 February 2007 SOFAZ has transferred \$1,013.7 million to the state budget from a total amount of some \$3,439.8 million received 2001 to 1 February 2007). Contrary to the proclaimed goals of the fund in 2003, about \$100 million transferred to the state budget for industrial investments were mainly used for wage rises before the presidential elections. In 2006, about \$600 million were transferred to the state budget and mainly used on the budget deficit and social welfare projects.

On 27 September 2004 President Ilham Aliyev signed “The Long-term Strategy of Oil and Gas Revenue Management of Azerbaijan” in order to ensure the effective use of oil revenues. The strategy covers the period up to 2025 and sets key principles for efficient management of national wealth. The strategy on the use of oil and gas revenues includes the following objectives: developing the non-oil sector and the regions; large-scale development of infrastructure; fulfillment of poverty reduction measures and the resolution of other social problems; and stimulating the improvement of the intellectual, material and technical base of the economy. Since 2005, some important projects have been initiated, but it is too early to judge their effects on the future development of the country. Under a 30 March 2006 decree, President Aliyev announced that the government plans to transfer about \$100 million from the Oil Fund to a State Investment Company (SIC), intended to facilitate government-funded development of the economy’s non-oil sector. The SIC was set up as a joint stock, and its activities will be mainly focused on the acquisition of shares of joint stock companies and other commercial organizations operating mostly in the non-oil sector.

In addition to other measures intended to improve the investment climate, the government had proclaimed in August 2002 the ambitious Program for State Support for the Development of Small and Medium Entrepreneurship. However, widespread corruption, paternalistic structures in the provinces and the incompetence of large parts of the administrative system inhibit its implementation. Reforms focusing on the judicial system and state administration are only partially realized and lack clear overall objectives. The change of the parliament election system from a mixed majority/party-list system to a majority system in 2002 had a negative impact on further democratization since it decreased the potential for political integration of the opposition. However, as shown by the last parliamentary elections, it has helped to integrate local or regional power holders into the political system. Consequently, in some places two or even more candidates belonging to the ruling party competed for a seat in parliament. Overall, the leadership showed its

ability to pursue strategic aims in the economic field. However, it does not focus on the development of a market-based democracy, as its performance in the political field clearly shows.

The paternalistic, patronage-based structure that dominates the political system poses a substantial constraint on any kind of coherent and flexible democracy-oriented reform policy. The transition from the former president in 2003 to his son as new president transpired without much inner-elite conflict. Contrary to the expectations of many Western observers, the new president did not change the government's policy toward democratization and the rule of law. During the last two years, some ministers and high-ranking officials were exchanged and thrown into prison, sometimes under crude accusations. This policy may lead to a rejuvenation and more technocratic outlook for the regime, but – combined with the constant pressure on critical media and the opposition – reveals a growing trend toward a more authoritarian regime instead of toward democratization. On the one hand, as there is no legal barrier against the implementation of reforms, the president and his apparatus are fully responsible for the stalemate in large parts of the reform process. On the other hand, the ruling circles show their ability to learn when confronting the combined pressures of economic interests, international organizations, large (oil) companies and donors.

Policy learning

15 | Resource Efficiency

The government utilizes only some of the available human, financial and organizational resources efficiently. The level of red tape remains high, and inefficiency and incompetence are widespread. In hiring practices at the managerial level, political connections and membership in certain networks play a significant role, hence restricting competitive recruiting practices. Budget resources are used quite efficiently, although the need for transparency remains. The overall budget deficit of 1.8% in 2005 was somewhat less than in 2004 (2%), partly as a result of high oil prices and restrained spending. The non-oil budget deficit stood at 32.6% of GDP in 2006, which shows the structural problem of the Azerbaijani economy and the deficiencies of the tax system. If the recent reforms and development programs had been fully implemented, Azerbaijan would have used its oil income efficiently. Consequently, a high non-oil budget deficit would have been acceptable for a short period. Reforms affecting some of the ministerial structures noticeably improved efficiency, although in administrative practice – especially at the lower and intermediate level – not much has changed. In spite of three rounds of municipal elections in 1999, 2004 and 2006, local self-administrative bodies do not possess financial autonomy and are, in fact, subordinate to the executive bodies of the districts

Efficient use of assets

appointed by the president. Now and again, the government engages in accelerated reform. Such reforms are implemented, however, without public discussion and thus lack needed transparency and planning, namely training and professional development in the judicial and administrative domains. Appropriation of public services to-date is highly deficient, and the decline of social services and the education sector still has to be reversed. With respect to infrastructure, several reforms were initiated in coordination with international organizations like the IMF, the World Bank and the EBRD (particularly in the energy, transport and financial sectors).

Azerbaijan has a presidential system with a strong president and a powerful apparatus, which results in very limited possibilities for the ministries to pursue consequent policies. Quite often this leads – together with conflicts among the ruling circles with their informal networks – to an incoherent policy. Because of the centralized system and nontransparent decision processes, some policies have counterproductive effects on other policies. This is highly evident in the provinces where local power holders backed by members of the central state bureaucracy pursue their personal goals without any regard for the interests of their constituencies.

Policy coordination

In Azerbaijan, corruption represents a significant barrier to development. Transparency International still ranks Azerbaijan as one of the most corrupt countries in the world. Patronage-based networks are able to appropriate substantial state and natural resources in the country due to the lack of transparency in government revenue and expenditure policy as well as in the lack of parliamentary and legal controls. To date, it is impossible to assess to what extent anti-corruption legislation passed in the previous years – including the State Program on Fighting Corruption, which covers the period from 2004 to 2006 and the international conventions signed thus far – will lead to actual improvement. Despite the significant strengthening of the legal framework (an anti-corruption law in force since 1 January 2005), the complexity and fragmentation of the counter-corruption system as well as the underdeveloped judicial system partly explain the law's limited effectiveness. It remains an open question whether the rationality of the ruling system is built on corruption. The growing oil wealth even appears to reinforce the position of deeply entrenched, corrupt elites. To some extent, the state oil fund is a positive exception, as it pursues a relatively transparent policy based on the recommendations of the Extractive Industries Transparency Initiative (2003) and a Memorandum of Understanding between the government, oil and gas companies and some NGOs from November 2004.

Anti-corruption
policy

16 | Consensus-Building

Government as well as opposition claim to strive for a market-based democracy. Fundamental opposition comes only from the growing (though not yet relevant) Islamist opposition. The ruling circles give much more impetus to economic progress than to democratic reforms. The opposition's main criticism targets not the reforms but rather the lack of democracy and reform implementation as well as its slow speed, political patronage and corruption. However, the fast-growing income from oil exports leads to growing populist demands for increased governmental spending, which consequently leads to falling support for a liberal market economy system in some parts of the political arena.

Consensus on goals

There are no relevant veto actors. However, elements within the power structure can thwart reform measures by boycotting them. The main problem is that, in general, the government is only interested in reforms in a very limited number of fields – namely, economics.

Anti-democratic veto actors

The positions of the government and the divided opposition seem irreconcilable, but – in principle – a wide range of coalition variants is possible. As most political parties are not based on specific social groups or a distinctive ideology but are rather leader-oriented, political development depends very much on personal factors. The population, meanwhile, exhibits indifference towards government policy and internal opposition quarrels. Widespread social discontent has been articulated only selectively. As the state's institutional possibilities for a peaceful reaction to protest or for negotiating solutions are very limited, the government mainly reacts with police force. During the past two years the regime pursued a policy of escalation against the opposition and social protest movements, which by and large led to dividing the opposition even more and further depoliticizing of the population. The growing expectation among the large, poverty-stricken parts of the population that they should get their fair share of the oil income may deepen political cleavages in the near future.

Cleavage / conflict management

With minor exceptions, the political leadership frequently ignores civil society actors and formulates its policy autonomously. NGOs and other self-organized groups often encounter difficulties in registration procedures and public activities. This is especially true when political or material interests of the ruling elite's clientelist networks are threatened, which has at times led to serious consequences for activists and critical journalists. The government does extend its support to some fields such as sports or non-political youth activities. When outside and inside pressure from the Council of Europe and civil actors combine (as in the case of a public TV station), the government tries to regain the initiative by dominating the topic and neutralizing possible independent actors.

Civil society participation

The same is true for some domestic election observer groups, which are founded by forces close to the leadership in order to neutralize independent or opposition groups that serve as watchdogs. Positive exceptions do exist. For instance, in the case of the EITI (Extracting Industry Transparency Initiative) or OECD's Istanbul Anti-Corruption Action Plan, international combined with some societal pressure led to the involvement of NGOs.

Confronting and dealing with injustices committed during the Soviet and late-Soviet era has largely been put to rest, and they are equally unpopular among the elite and the population. Cases of torture and poor treatment in prison during the rule of the present regime are only addressed by oppositional media and some NGOs. Consequently, there was no reconciliation process between government and the opposition surrounding the state's harsh reaction to the violent protests against the manipulated presidential elections of 2003 and the injustices it committed.

Reconciliation

17 | International Cooperation

For government and opposition alike, international cooperation with international institutions and organizations (namely the IMF, World Bank, EBRD, Council of Europe, EU, NATO, ADB) enjoys top priority in all areas (e.g., government policies, legal reforms, economic reforms, financial cooperation, infrastructure measures, health and education sectors). International cooperation on multiple levels is indispensable for the development of Azerbaijan. In practice, massive problems continue to resurface owing to an inherent Soviet mentality, paternalistic ways of thinking, corruption, institutional weakness, incompetence and inefficiency. Several problems arose due to lack of competence on the part of Western and international partners with respect to country, culture and unspecific programs, especially during the initial years of cooperation. Because of the regime's authoritarian character, external advice does not facilitate significant policy learning in many cases, especially in the field of democratic reforms. In the field of economic and monetary policy as well as in the reform of the state bureaucracy, however, the government tries to make use of international assistance and improve its policies.

Effective use of support

The current government tries to act as a reliable partner in the international arena. Problems emerge with the acceptance of international law when material interests of the ruling elite are directly concerned, as was the case in an economic conflict with Turkey in 2004, which even led to the confiscation of Azerbaijan Airlines planes in Turkey. In the Council of Europe, Azerbaijan was warned several times about its failure to fulfill membership obligations concerning fair and free elections, democratic reform and the implementation of necessary laws. By and large, Azerbaijan's leadership is not considered a

Credibility

credible and reliable partner with regard to policies related to democratic reforms, but it does have a better record in the field of market-oriented economic reforms.

Political and economic cooperation in the wider Caucasus region is hampered by complex and conflicting inter-country relationships. In the case of Azerbaijan, regional cooperation is severely limited due to tensions with Armenia, a relatively conflict-laden relationship with Iran and the economic weakness of the bordering Russian constituent Republic of Daghestan. The change of leadership in Turkmenistan, however, opens new opportunities for cooperation, especially in the field of Turkmen gas exports to the world market via Azerbaijan. Despite minor political and economic conflicts, Georgia and Turkey remain its main regional partners, and relations with Iran have great potential. Iran's nuclear policy and the pressure of the United States on Azerbaijan to join an international coalition against Iran leaves the frontier state Azerbaijan in an uncomfortable position, which the country tries to escape by maintaining neutrality in the conflict. Owing to its geographical location, Azerbaijan possesses great transit potential (TRACECA), the full realization of which would however require substantial investment and a solution to the regional territorial conflicts. The Baku-Ceyhan pipeline opened in July 2006 is expected to give rise to significant progress in regional development and cooperation. The pipeline transports Azerbaijani and possibly Kazakhstani oil and natural gas via Georgia and Turkey to the world market. In spring 2007, Turkmenistan concluded a treaty with Russia to transport its natural gas via Russia to the world market. This decision severely hampered Azerbaijani and Westerns plans to connect Turkmenistan with Azerbaijan via an undersea pipeline and then to use the South Caucasus Pipeline (SCP) for transport to the world market. On the whole, Azerbaijan complies with the rules for cooperation set by international organizations.

Regional cooperation

Strategic Outlook

Without regime change and a peaceful and lasting solution to the Qarabagh conflict, there can be no clear progress made in Azerbaijan's political transformation. Unfortunately, given the growing material benefits for the population from the oil income, the regime's repressive character and the weakness of the opposition, these are not realistic scenarios. To solve the Qarabagh conflict by compromise is also a far-fetched possibility, as all parties – Azerbaijan, Armenia and the Qarabagh Armenians – believe they have time on their side and that a resolution of the conflict would only endanger their respective position or stability. It is not expected that the next presidential elections in October 2008 will lead to any substantial change in domestic or foreign policy. However, the conduct of the elections will show whether the ruling elite is willing to take a step towards democratization or to continue on its authoritarian course.

Azerbaijan's patronage-based power structure makes the emergent possibility of a partially rent-seeking system based on oil income a real risk. This peril can only be contained with unambiguous progress in democratization and the establishment of at least a de facto rule of law. However, the continuing lack of able politicians and administrative and legal professionals also lessens the likelihood of such progress in the short term.

The central challenge for Azerbaijan is twofold: one, the development of the petroleum and natural gas sector and the utilization of revenues for the sustainable development of the country; and two, the orchestration of balanced economic growth through the development of the non-oil sector. For this, a continuous acquisition of foreign investment is vital. The large inflow of foreign direct investment over the last years, which has been directed almost to the petroleum and related infrastructural sectors, dropped considerably in 2006. Reversing this will require sustained improvement of the investment climate. The reform and expansion of several areas of infrastructure (e.g., energy, water, transport) is urgent as their current state poses a serious obstacle to development. Together with the rise in oil income and capital inflows, the danger of high inflation (IMF forecast for 2007: 21.1%) and the pressure on exchange rate appreciation is also growing. The windfall gains from the export of oil and gas are relatively short-lived as oil production is projected to peak sometime between 2009 and 2012 and dry out by 2025. Therefore, a sustainable economic strategy will be of great importance, and the state oil fund holds the key to the country's future.

In the middle and long run, Azerbaijan has the chance to become a prosperous transit center for energy and goods flowing between Europe and Central Asia. To reach this goal, the essential infrastructure and services must be developed further. Another urgent task for the ruling elite is the development of a future-oriented social and educational policy to minimize the still-growing disparities in Azerbaijani society. Investment in education and especially in research still is much too low to contribute to sustainable development.

In view of the country's precarious geopolitical situation, a balanced and lasting foreign policy is indispensable. The offer of the European Union to develop and deepen its links with Azerbaijan on the basis of the European Neighborhood Policy (ENP; decided on 14 June 2004) may be a valuable opportunity for Azerbaijan to enhance its political and economic development. If the political elite of Azerbaijan succeeds in overcoming these challenges, the country will have good development potential.