

Political Economy of Oil: The Case of Azerbaijan

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Abstract

On one hand, oil is considered to be a blessing. Unfortunately on the other hand it can be a curse. This current study analyzes role of oil in the political and economic performance of Azerbaijan throughout its independence years. The paper highlights some previous studies and their findings about natural resource curse to show pattern for oil-rich developing countries. Furthermore the study applies these findings to the case of Azerbaijan to examine whether oil has become curse or blessing for the country. Findings of this paper show that the pattern of Azerbaijan is almost the same with those who advocate that oil is a curse for a country; however there are some bright sides of oil. The paper gives main economic indicators of Azerbaijan to be compared with theoretical findings.

The paper finds that high level of corruption can be related to oil, however it is insufficient to determine a direct causal link between them. Moreover, the thesis finds that oil revenues increase living standards and on the other hand oil causes inflation. In fact, Azerbaijan is becoming more and more dependent on oil which slows down diversification of its economy causing decrease in other industries. Finally, the study finds that there are symptoms of “Dutch Disease” in Azerbaijan

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Introduction

In theory and according to basic logic, natural resource, especially oil, abundance should assist positive economic performance because oil revenues can be used to increase living standards, foreign exchange from oil exports can enhance domestic economy, and oil richness can attract foreign investment. However, in reality for some oil rich countries this is not a case.

In reality, some developing countries that do not have oil perform better than those of oil rich countries. It can be explained through many perspectives, but for this work the phenomenon of natural resource curse will be the main issue. Natural resource curse refers to resource (such as oil, gold) rich countries that exhibit less economic growth in comparison with resource-poor countries. This phenomenon may have different reasons such as a decline in non-resource sectors of economy, lack of proper management of resource wealth, weak political governance. The term ‘resource curse’ was first used by Auty who analyzes resource rich countries and concludes how these countries were not able to improve their economies and how these countries had lower economic growth than resource-poor countries.¹

Therefore, it is important to analyze the role of natural resources, especially of oil, in such countries in order to understand above mentioned challenges and their reasons.

This current work is an attempt to study the resource curse phenomenon in the context of political economy of oil in Azerbaijan, since oil is the major natural resource in the country. It examines the impact of oil on the country’s socio-economic and political performance since the independence of oil rich Azerbaijan from the U.S.S.R in 1991 up to current period.

¹ Auty R. M., “Sustaining Development in Mineral Economies: The Resource Curse Thesis”, London:Routledge, 1993

In the early years of the country's independence, the oil was seen as a tool to help with consolidation of its political and economic situation, ensure international recognition, attract foreign investment, and create the environment for better economic future. The oil was considered as an instrument to guide Azerbaijan through the transition period, help to build market economy on the ruins of the collapsed central economy which was a heritage of the U.S.S.R.

The importance of this research is to show whether oil is a natural resource curse or blessing for Azerbaijan. The previous studies on Azerbaijan stand on the scale of either black or white, without trying to distinguish anything in between. Some advocates, of oil's positive impact neglect to acknowledge or do not want to confess that there are negative effects of oil in the country. Others see oil as a curse, and blame it for everything bad in the country.

The main purpose of this thesis is not to argue with any of the sides, but to show the reality in Azerbaijan. My hypothesis is that Azerbaijan does not seem to be able to avoid problems that can classify oil as a curse.

The thesis proceeds as follows. Chapter 1 presents related literature and evidence on resource curse-political economy of oil, moreover on what kind of challenges oil rich countries face. Chapter 2 describes political -economic background of Azerbaijan in the early years of independence and mid 1990's. Chapter 3 provides some perspectives of oil and oil industry in Azerbaijan through an analytic narrative. Chapter 4 summarizes and attempts to demonstrate based on theoretical and empirical evidence to what extent Azerbaijan shows symptoms of a country where oil is a curse. Furthermore, it analyzes some economic indicators to show the relationship between oil and country's economic performance. The paper finds that high level of corruption can be related to oil, however it is insufficient to determine a direct causal link between them. Moreover, the thesis finds that oil revenues

increase living standards and on the other hand oil causes inflation. In fact, Azerbaijan is becoming more and more dependent on oil which slows down diversification of economy causing the decrease in other industries. Finally, the study finds that there are symptoms of negative effects of 'resource curse' such as signs of "Dutch Disease" in Azerbaijan.

Chapter 1- The Political Economy of Oil: Theoretical and Empirical Evidence

1.1 Introduction

Oil is one of the most important natural resources in the world. Oil industry is a locomotive for economies of oil producing countries. This so called black gold is considered to be a vital tool not just for oil rich countries but also for those who do not have it and have to import it. It is hydrocarbon which might seem useless without any artificial intervention of humans. However, now day's its political and economic value is indispensable. It provides advantages and opportunities, and often challenges to societies and governments.

In spite of oil's importance and indispensability, there are some important general issues and debates concerning the role of oil in economic and political performance of countries. Recent experience of some oil producing countries, such as Venezuela and Nigeria, suggests that increasing dependency on oil might not exactly lead to expected results and this dependency can be negatively correlated with economic and political performance.² The rest of this chapter is devoted to highlight the theoretical and empirical evidence on linkages between oil and political-economic development mainly from lenses of the resource curse phenomenon.

² Schubert R. S., "Revisiting The Oil Curse: Are oil rich nations really doomed to autocracy and inequality?", Oil and Gas Business, 2006

1.2 Resource Curse

As mentioned above, resource curse as a term was first used by Auty in 1993. Similarly to Auty, Karl defines “the resource” or “oil curse” as “the inverse relationship between high natural resources dependence and economic growth rates”.³

As a rational actor, any government in the world is or should be in favour of economic development, with an understanding of economic development as a better way of life for its citizens. But what is economic development that everyone wants but few have had? Falola and Genova⁴ define economic development as sustained growth in per capita income, meanwhile reduction of poverty, expansion and diversity of economy.

Do oil-rich countries have advantage in achieving economic development in comparison with non-oil producing countries? According to simple logic they should, because oil brings the windfall, the resources to make economic development easier and faster. However, Sachs and Warner⁵ noted that countries lacking natural resources, more specifically oil, had much stronger GDP growth per capita than oil-rich countries. Furthermore, they found that between 1960-1990 oil-poor countries experienced GDP growth rate two, three times higher than oil-rich countries.

On the contrary, Tselik and Ebel showed that most “countries with abundant oil resources have failed to translate oil-derived income into better lives for their citizens. Of 48 countries for which oil comprised more than 30 percent of total exports between 1965 and 1995, nearly

³ Karl T.L., “Understanding the Resource Curse”, Open Society Institute, New York, 2005

⁴ Falola T., Genova A., “The Politics of the Global Oil Industry”, USA, 2005, pg 145

⁵ Sachs J., Warner A., “Natural Resource Abundance and Economic Growth,” Development Discussion Paper no. 517a, Harvard Institute for International Development, 1995

half scored in the bottom third of the United Nations 2002 Human Development Index, which ranks countries according to poverty, education, health, and other indicators of quality of life.”⁶

In addition to exhibiting poor growth rates, too many resource-exporting countries tend to disproportionately suffer from bad governance.⁷ The International Monetary Fund (IMF) defines good governance as “the effective and transparent management of public resources; and a stable economic, regulatory, and legal environment conducive to sound management and efficient use of private and public resources.”⁸

The World Bank’s indicators of governance include the extent to which “citizens are able to participate in the selection of their governments, freedom of media, stability of government, the likelihood of violent conflict, corruption, public service provision, and enforceability of contracts.”⁹ Oil-rich countries are in the low end World Bank’s Governance Indicator.¹⁰

In a discussion of development, the first question that emerges is how a country spends its oil wealth. It is a fact that, although the resource is scarce, the short term gains or windfall is tremendous. For oil exporting countries oil provides the revenue, hard-currency, mostly in US dollars called-petrodollars. Petrodollars represent rent, which is revenue received from an industry in which the recipient collects without being involved directly. Basically, they represent easily earned money. The consequence is that with so much inward supply of

⁶ Tsalik S., Ebel R., “Caspian Oil Windfalls: Who Will Benefit?” , Open Society Institute, 2003, pg 3

⁷ Ibid pg 4

⁸ International Monetary Fund, “Guidance Note on Governance”, 1997

⁹ World Bank, “Governance and Corruption” <http://www.worldbank.org/wbi/governance> (Last Accessed May 23, 2008)

¹⁰ Tsalik S., Ebel R., “Caspian Oil Windfalls: Who Will Benefit?” , Open Society Institute, 2003, pg 4

money, governments lose the incentive to develop local industry, more presically, non-oil industries. Therefore, windfall becomes a substitute for other forms of national income instead of a supplement. Hence, problems arises such as this windfall is soon or later will end, because either the oil reserves will end or the oil boom will end. That is why oil rich countries should use revenues to supplement the income they receive from other sources. Otherwise such countries could have lower saving rates, due to the fact that oil wealth is short-lived.

Ross defines such countries as rentier states that “derive a large fraction of their revenues from external rents”.¹¹ However, in the early twentieth century the term “rentier state” was referred to the „European states that extended loans to non-European governments.”¹² Mahdavy defines the term as state that receives substantial rents from “foreign individuals, concerns or governments.”¹³ Beblawi defines this term such as a rentier state is one where the rents are paid by foreign actors, where they accrue directly to the state, and where “only a few are engaged in the generation of this rent (wealth), the majority being only involved in the distribution or utilization of it.”¹⁴

Futhermore, Blaydes¹⁵ provides a rentier state theory which argues that „ countries dependent on external rents, like oil, develop a different bond between governments and their citizens than those that rely primarily on taxation. Such states, the theory argues, are less likely to be

¹¹ Ross M., “Does Oil Hinder Democracy?” World Politics 53, pg. 329

¹² According to Lenin, “The Rentier State is a state of parasitic, decaying capitalism, and this circumstance cannot fail to influence all the socio-political conditions of the countries concerned”. Lenin V.I, “Imperialism, the Highest Stage of Capitalism” in Tucker R.C, New York, 1975

¹³ Mahdavy H., “The Patterns and Problems of Economic Development in Rentier States: The Case of Iran” Studies in Economic History of the Middle East, London, 1970, pg 428

¹⁴ Balawi H., “The Rentier State in the Arab World”, New York, 1987

¹⁵ Blaydes L., “Determinants of Authoritarian Durability”, 2004

democratic than those that are tax-reliant.”¹⁶ Finally, Ross sorted out claims about rentier state into two categories: ”those that suggest oil wealth makes states less democratic and those that suggest oil wealth causes governments to do a poorer job of promoting economic development.”¹⁷

What makes natural resource wealth from other types of wealth? Two things: First, there is no need to produce such wealth, extraction process is enough. This kind of wealth is acquired independently from other economic processes or industries within a country. Second, natural resource wealth is nonrenewable. Therefore, these two aspects of natural resource wealth causes political and economic processes that negatively affect the economy.

1.3 Oil and Politics

Oil influences every aspect of a country, regardless of the fact if it is oil-producing or non-producing country. A country’s oil strategy has an impact on domestic policies, such as monetary, fiscal and environmental policies, foreign policy. As a result, oil could possibly lead to either domestic stability or instability.

Oil-producing countries, as a typical rational actor, have a goal of collecting as much oil-revenues as possible to ensure economic development. However, such a goal can not be achieved without proper political institutions and without solving the internal political instability. What oil has to do with politics? There is a causality direction between oil and politics. Such as political changes or decisions within certain countries, especially of those oil

¹⁶ Blaydes L., “Determinants of Authoritarian Durability”, 2004

¹⁷ Ross M., “Does Oil Hinder Democracy?” pg. 330

producing countries may affect world oil prices, furthermore any change in oil prices in international markets may affect other countries' domestic political, hence economic decisions.

Although impact of oil on international and foreign politics is beyond the scope of this work, it will be proper to state that the oil has become a political weapon. Oil-exporting countries can use their natural resource to meet the domestic and international interests. On international arena, the clearest example of oil being used as a political weapon is performed by OPEC whose members are in control of domestic oil industries and have a major say in the pricing of oil on world markets.¹⁸

If to speak about domestic arena, oil-producing countries have to satisfy not just their international interests, but domestic interests also. Promising oil revenues are expected to be used for increasing the living standards of people, enhance economic safety of a country, such as to have enough foreign currency reserves and etc. On one hand, such decisions taken by governments are economical, but on the other hand it provides governments to popularize themselves or even to legitimize their governments through more materialistic means and help them to “earn” more votes for upcoming elections.

1.3.1 Oil and Domestic Stability

Oil can also negatively affect politics. It can cause conflicts not just outside but within a country itself and challenge territorial integrity. Oil can cause domestic instability which can weaken a country's economic and political power in international arena. Therefore, oil should be treated carefully whenever an issue of domestic tensions are to be solved.

¹⁸ OPEC (Organization of the Petroleum Exporting Countries) Brief History, <http://www.opec.org/aboutus/history/history.htm> (Last Accessed May 23, 2008)

Domestic political conflicts caused by oil can challenge country's unity. Location of oil creates advantages for oil-rich regions and disadvantages to others. Oil-rich regions usually do not want to share something that they "owe". Therefore, sometimes they claim for independence to enjoy the fruits of oil by themselves. As a result usually such countries, where secessionist movements or regions want independence end up having civil wars. Recent studies show that natural resources, especially oil, and civil war are highly correlated.

Civil war in Nigeria, the war between Chechens and Russian government were affected by the struggle for oil. In the case of Nigeria, from 1967 to 1970, there were regional ethnic groups that were struggling for the control of oil fields. As in the case of Chechnya and Russia, once again oil played an important role in causing the conflict. Chechens wanted independence to enjoy their oil and its revenues, without Russia. However the importance of Chechen oil pipelines for Russia was a reason to secure Russian Federation's territorial integrity by force.¹⁹

Furthermore, some authors, such as Ross²⁰, found that there is not just connection but also a causal link between oil and civil war. Ross notes that oil not only increases the probability of civil war, and but revenues from oil can be a source for financing such civil wars, hence making civil wars longer and causing more casualties. Similarly, Tsalik²¹ and Ebel note that oil-rich countries spend a large amount of money as a part of military expenditures, and divert financial resources into military industries.

In conclusion, it can be said that oil-rich states with weak political capacity and legitimacy are more likely to have civil wars. In such states, oil-revenues give incentives to non-state

¹⁹ Falola T., Genova A., "The Politics of the Global Oil Industry", USA, 2005, pg 92-98

²⁰ Ross M., "How Does Natural Resource Wealth Influence Civil War?" Unpublished paper, 2002. Available at <http://www.polisci.ucla.edu/faculty/ross/HowDoesNat.pdf> (Last Accessed May 23, 2008)

²¹ Tsalik S., Ebel R., "Caspian Oil Windfalls: Who Will Benefit?", Open Society Institute, 2003, pg 4

actors to gain the power and enjoy the oil wealth.²² With this in mind, it would proper to state that a possibility of civil wars, the explicit change of existing regimes could be considered as one of the major negative impacts of oil in oil-rich countries.

1.3.2 Oil, Political Systems and Quality of Governance

The issue in this section is how oil or oil revenues affect political system. Considering that today, there are many oil-rich countries that are developing countries which are considered to be non democratic, it is important to look at how those countries governance systems has been affected by oil.

One would expect that nations rich in natural resources, and particularly in oil have an advantage for creating democracy. However, this is not a case. Because among the world's top ten oil exports, only Norway and Mexico can be considered as democracies.²³ Therefore, the most problematic side of the oil richness with respect to political system is undemocratic political regimes.

Does oil have antidemocratic features? If yes, then why is Norway a democracy? If no, why most of other oil rich countries such as Nigeria is not a democracy? Do oil and democracy match?

Oil abundance gives little incentives to political elite or leaders of a country to share power with anyone else. Besides no incentives of power sharing, oil windfall allows leaders to „legitimize” themselves, instead of earning this legitimization through general elections. So

²² Collier P. and Hoeffler A., “Greed and Grievance in Civil Wars”, Working Paper World Bank, 2000

²³ Schubert R. S., “Revisiting The Oil Curse: Are oil rich nations really doomed to autocracy and inequality?”, Oil and Gas Business 2006, pg 1

that, the will of government officials to have access to the oil windfall and control the wealth discourages democracy.²⁴

However, Schubert also states that it can be not the oil, but the political and economic heritage before oil windfall that might have affected political regimes. As an example, he gives example of countries such as Norway, Canada and the United Kingdom and states that „all three were established democracies before they struck oil leading one to believe that path dependence plays a significant role. It could be that countries with strong institutions, rule of law and strong tax system before the discovery of oil are better suited survive the oil curse.”²⁵

Karl argues that oil revenues can make states weaker. He argues that the oil-windfall could make a government less dependant on citizens.²⁶ Basically, when governments receive most of their revenues from oil, they tend to collect less money from its citizens. Therefore, there is a weak linkage between government and citizens. When citizens are untaxed they sometimes have less information about state activities, therefore they may demand less from state. Hence, even if they disapprove state's behavior, citizens have no means to express themselves, they can not withdraw financial support, only thing is the choice of 'voice', but it works in rare cases, because undemocratic and more autocratic governments tend to 'win' elections somehow in anycase.²⁷

²⁴ Foreword by Stiglitz E. J.in, Tsalik S., Ebel R., “Caspian Oil Windfalls: Who Will Benefit?” , Open Society Institute, 2003, pg xi

²⁵ Schubert R. S., “Revisiting The Oil Curse: Are oil rich nations really doomed to autocracy and inequality?”, Oil and Gas Business 2006, pg 3

²⁶ Karl T.L., “The Paradox of Plenty: Oil Booms and Petro-States”, Berkeley: University of California Press, 1997

²⁷ Giacomo L., “Allocation vs Production States: A Theoretical Framework” in Beblawi and Luciani, “The Rentier State”, New York, 1987

In addition Tsui²⁸ found that countries rich in natural resources-in particular, in oil-are less likely to become democratic than states that do not export oil. Tsui's cross national studies relate the discovery of oil in a given period to democratic changes over few decades and find that there is a negative correlation between two.

Furthermore, oil revenues can allow government to successfully repress their oppositions, and thus avoiding having relinquish power through electoral competition. Ross explains three features that help to analyze the relationship between oil abundance and the lack of democratization."First, governments do not feel the same pressures to exchange political power for the rights to tax, since they can raise revenues from other sources. Second, they can invest in coercive capacity that can be used to quell threats to their political power. Finally,citizens in these states are less likely to undergo the transformative effects of industrializing countries that have been associated with demands for democratization elsewhere."²⁹

It is equally important to mention that the massive revenues generated by oil give government the resources to forge mutually beneficial relationships with private interests and provide little or no incentive to open the political process. According to Karl³⁰, leaders in oil oil-rich countries have no motivation to be rational and careful in their decisions, and they have no incentives to decentralize the political system. Furthermore, high oil revenues lead to further concentration of power in the hands of certain leaders.

²⁸ Tsui K., "More Oil, Less Democracy?Theory and Evidence from Crude Oil Discoveries." Economics.uchicago.edu/download/tsui_applwksp_120505.pdf (Last Accessed May 24, 2008)

²⁹ Ross M., "Does Oil Hinder Democracy?" World Politics 53, pg 326-61

³⁰ ³⁰ Karl T.L., "The Paradox of Plenty: Oil Booms and Petro-States", Berkeley: University of California Press, 1997

Likewise, dependence on oil creates incentives for a current government to maintain the status quo and to prevent any change in the future. Such pattern can be best seen in the example of Middle East countries.³¹ Ross³² tests the claim that “oil impedes democracy” in 113 states between 1971 and 1997 and finds that oil has antidemocratic properties. Ross notes that states reliance on oil makes a country less democratic. Democratization was harder to achieve because of oil in such states as, Malaysia, Mexico and Nigeria. In addition, Ross³³ clarifies three causal mechanisms that correlate oil and authoritarianism. He highlights “A rentier effect, through which governments use low tax rates and high spending to dampen pressures for democracy; a repression effect, by which governments build up their internal security forces to ward off democratic pressures; and a modernization effect, in which the failure of the population to move into industrial and service sector jobs renders them less likely to push for democracy.”³⁴ Furthermore, Ross claims there is a possibility of “group formation” effect which implies that government does not share its oil revenues with other social groups, in turn this prevents establishment non governmental social organizations.³⁵ Thus, ‘rentier-state’ which leads to authoritarianism can be a negative political consequence of oil politics. However, once again, there are some oil-rich countries which tend to be a democracy, such as Norway, Netherlands and Mexico.

In conclusion, it can be said that even if leaders have good intentions to translate oil revenues into political development, which is a rare case, it is still hard to escape the adverse effect of oil on democracy.³⁶

³¹ Ross M., “Does Oil Hinder Democracy?” World Politics, April, 2001, pg 1

³² Ibid, 1

³³ Ross M., “Does Oil Hinder Democracy?” World Politics, April, 2001, pg 32

³⁴ Ibid, 32

³⁵ Ibid, 32

³⁶ Tsalik S., Ebel R., “Caspian Oil Windfalls: Who Will Benefit?” , Open Society Institute, 2003, pg 4

1.4 Oil and Economic Development

As with any other good, while the price of oil is determined by supply and demand forces, it is also influenced by international events and politics. Therefore, prices are affected by any major change in political and economic arena of the world. Lately, oil prices are climbing, already passing \$124 per barrel. It does not seem that this process will go backwards any time soon. Oil producing countries are enjoying the oil boom and the windfall which is associated with the increase of oil prices. Meanwhile sudden windfall could create an opportunity for oil rich countries, specially those developing countries, to have a possibility of faster economic growth.

However, the shocking truth is that, in the past, not all the oil rich countries managed to show the economic growth that they should have, only few managed to use oil revenues to foster economic growth. This phenomenon had been researched and has become the subject of both theoretical and empirical studies. As a result several important explanations have been provided.

It was, first, in 1950's that economists showed some concern about slow growth of natural-rich countries compared to poor ones. Prebisch³⁷ and Singer³⁸ noted a tendency for primary goods prices to decline compared to manufacture goods' prices, and assumed that the share of primary goods in GDP will diminish due to technical progress. That is why countries that are dependent on primary goods sector have to grow slower than economies which depend on manufacturing industries. This hypothesis is known as Prebisch-Singer hypothesis which

³⁷ Prebisch R., "The economic development of Latin America and its principal problems", Economic Bulletin For Latin America, 1950, pg 1-12

³⁸ Singer H, "The distribution of gains between investing and borrowing countries", American Economic Review, May, 1950, pg 473-85

implies that it is in the interest of developing countries to impose protective tariffs that could help them to industrialize.

The second explanation of slow economic growth of natural rich countries was provided in 1960's and 1970's by Baldwin³⁹ and Hirschman⁴⁰. They argued it was the exports of primary goods thanks to which some countries had been developed and that primary resource sector influenced the economic growth of those countries were dependent on the linkages between primary goods sector and the other industries. Hence these linkages make an economy more diversified and not dependent on just primary goods exports. Therefore, linkages cause diversification of an economy. However, if such linkages do not exist or exist but are weak there is no diversification and in such scenario the production factors are concentrated in the resource sector mostly, leaving other sectors of an economy with less production factors which leads an economy into staple trap.

1.4.1 Dutch Disease

The term “Dutch Disease” became popular in 1970's and is the latest explanation of resource curse and its negative economic result. “Dutch Disease” is called so because this phenomenon was the experience of the Netherlands. A large amount of gas was found there. The government received the windfall gain hence proceeded to spend it mostly on its welfare system and pretty soon such governmental spending lead to higher inflation and simultaneous

³⁹ Baldwin R.E, “Patterns of development in newly settled regions”, Manchester School of Social and Economic Studies, 161-179, 1956;

Baldwin, R.E. “Economic development and export growth: a study of Northern Rhodesia, 1920-1960”, Berkley and Los Angeles, CA: University of California Press. 1966

⁴⁰ Hirschman, A.O, “The strategy of economic development”, New Haven CT: Yale University Press, 1958

Hirschman, A.O, “A generalized approach to development, with special reference to staples”, Essays on Economic development and Cultural Change, University of Chicago Press, 1977

currency appreciation. The manufacturing sector became unable to compete with foreign products.⁴¹

At the end, the Netherlands did not experience economic growth even though it had the windfall and wealth. Why did it happen? The economic implications of “Dutch Disease” were first discussed by Corden and Neary⁴². They analyzed the economy by dividing it into three main sectors: export sector which was having a boom of oil and gas, export sector which was lagging such as other goods and the non-traded goods sector.

Furthermore, they argued that the wealth itself without any corrective intervention does not lead an economy into the right direction. The Dutch Disease causes a *currency appreciation, an increase in imports. The resource export sector outruns the traditional export sector, capital accumulation decreases. It causes the diversification of capital from other sectors into resource export sector*. They concluded that resource boom may have negative effect on the long run economic growth. *Due to the fact that traded and non-traded goods decline in the domestic traded goods sector and this leads to reduced employment*. It is so because the domestic traded goods sectors become unprofitable as prices rise, and then these price rises feed into the non-traded goods sectors since they need traded goods to survive.

Essentially, the “Dutch Disease” explains the possible negative consequences of natural resource price boom, unless the windfall is properly managed by a government. *It is a widely held view that an abundance of natural resources has been associated with a distortion of the industrial structure. A natural resource windfall generates a sudden increase in export earnings and draws resources out of the production of traded goods. “Increased revenues*

⁴¹ “The Dutch Disease”, The Economist, November 1977, pg 82-83

⁴² Corden M., Neary J.P., “Booming Sector and De-industrialization in a Small Open Economy”, Economic Journal 92, pg 825-848

*resulting from a commodity boom, the reasoning goes, increase the demand for good in the economy and raise the price of non-tradable goods. As the price of tradable goods is internationally fixed, the impact of higher wages and real exchange rate appreciation diminish the overall productivity in the sectors that produce those goods.”*⁴³

Furthermore, Gylfason⁴⁴ notes that this “disease” is a result of harmful diversification of resources from manufacturing, trade, and services to primary production on economic growth. In addition, the author notes that natural resources make nations rich in the short run, at the expense of long-run economic growth.

There are some skeptics disputing the “Dutch Disease”. Such as Ross, who proposes ‘crowding-out’ model which implies that “a booming resource sector draws labour and capital away from manufacturing in mineral economies which are unharmed by export booms because local labour and capital shortages could always be easily be offset by foreign capital.”⁴⁵

In conclusion, it can be said that those oil rich countries that experience a decrease in the other sectors of economy, besides oil sector are to be considered as ‘victims’ of ‘Dutch Disease’.⁴⁶

⁴³ Everhard S., Duval-Hernandez R., “Management of Oil Windfalls in Mexico: Historical Experience and Policy Options for the Future”, Policy Research Working Paper 2592, The World Bank, 2001, pg 12

⁴⁴ Gylfason T., “Resources, Agriculture and Economic Growth in Economies in Transition”, Kyklos, Vol. 53, No.4, 2000, pg 552

⁴⁵ Ross. M, “The Political Economy of the Resource Curse”, pg 302

⁴⁶ Ebrahim-Zadeh C., “Back to Basics: Dutch Disease. Too Much Wealth Managed Unwisely.”, Finance and Development 40, 2003, pg 50-51

1.4.2 Oil, rent-seeking and corruption

Moreover, the literature on the political economy of oil points out rent seeking behaviour of actors, as a reason for slow economic growth. Sachs and Warner⁴⁷ argue that investments into rent seeking to gain the control of resources are economically much better than investments into production. Corruption level increases and it causes slightly decrease in the economic growth.

Mauro⁴⁸ confirms that corruption is more prevalent in resource-abundant countries than in poor ones. Leite and Weidmann⁴⁹ show that corruption is linked to the presence of natural resources. It depresses economic growth, albeit by somewhat less than the 1 percent for each one standard deviation in dependence on natural resource exports estimated by Sachs and Warner.⁵⁰

In addition, Leite and Weidmann⁵¹ have found that oil can be seen as a major determinant of corruption. Furthermore, Tsalik and Ebel⁵² noted that oil revenues encourages misuse of such revenues by government, and increases rent seeking by non-government actors who hope to enjoy revenues. Besides corruption raises transactions costs of doing business, thus non-oil sector's development takes more time, which in return affect country's overall economic performance.

⁴⁷ Sachs J., Warner A., "Natural Resource Abundance and Economic Growth, National Bureau of Economic Research" Working Paper 5398, 1997

⁴⁸ Mauro P. "Corruption and Growth", Quarterly Journal of Economics, Vol. 90, 1995

⁴⁹ Leite C., Weidmann J., "Does Mother Nature Corrupt? Natural Resources, Corruption and Economic Growth", IMF Working papers WP/99/85, July 1999.

⁵⁰ Sachs J., Warner A., "Natural Resource Abundance and Economic Growth, National Bureau of Economic Research" Working Paper 5398, 1997

⁵¹ Leite C., Weidmann J., "Does Mother Nature Corrupt? Natural Resources, Corruption and Economic Growth", IMF Working papers WP/99/85, July 1999

⁵² Tsalik S., Ebel R., "Caspian Oil Windfalls: Who Will Benefit?", Open Society Institute, 2003, pg 4

Furthermore, since a resource-rich country's revenue is not dependent on success of the economy, but on windfall from oil-prices, resource rich governments tend to engage in activities that support economy less favourably.

Resource curse phenomenon, so far, has been explained through basic economic and political understanding such as natural resource, oil, abundance is a possible reason for destabilization of exchange rates. It can be guilty of currency appreciation that causes imperfect diversification of economy that weakens industries not based on natural resources. Natural resource abundance, oil, does not create employment throughout the whole economy, although it brings large amounts of petrodollars into the country. Hence poor economic performance and strong materialistic incentives lead to less democratic countries.

But how to deal with 'Resource Curse'? What can governments do to escape this curse? First two issues that come to mind related to above mentioned questions are the good management of natural resources (oil) itself and management of oil revenues. If so, then how to achieve good management? Throughout history, different oil producing countries dealt with this issue differently. Some were successful, such as Norway, others were unsuccessful-Venezuela can be a good example of failure. Both these countries created institutions such as Norway's State Petroleum Fund and Venezuela's Stabilization Investment Fund in order to deal with 'resource curse'.

Why one failed, while another one succeeded with 'resource curse'? In case of Venezuela, high levels of corruption irrational governmental spending played a vital role in the country's failure to escape 'resource curse'. Furthermore, oil funds in Venezuela failed to achieve

success because of weak fiscal discipline. There was high debt accumulation, which did not let the fund to play a stabilization role.⁵³ Moreover, the Fund could not „forbid” the government to borrow or increase its expenditures.⁵⁴ It is a clear case that existence of any fund itself, can not guarantee a good management of oil revenues.⁵⁵ Therefore, Venezuela case showed that any stabilization fund is necessary but not sufficient condition to escape ‘resource curse’, but rather it depends on the structure of fund itself, who controls it and how.

The case of Norway is an example of good governance and sound management of oil revenues. Norway as any other oil abundant country, faced difficulties with management of oil revenues. Unlike most other oil producing countries Norway was a democracy and had high living standards when oil production started there.⁵⁶ However, as Galeson noted Norway also faced high inflation. „The country’s current account deficit widened and its currency appreciated as oil became the primary export. Non-oil sectors of the economy contracted.”⁵⁷ The state’s expenditure and share of employment increased. From 1972 to 1984 the public sector increased from 18 to 27 percent of total employment.⁵⁸ Norway’s oil fund was created under such circumstances. The difference of Norway’s oil fund from Venezuela’s fund is that legislature in Norway created strong accountability and transparency, and furthermore borrowing constraints on Norway’s government.⁵⁹ Norway’s oil fund does not depend on personality, but more on legislature which ensures checks and balances, therefore, along with great accountability and transparency, there is a success of escaping ‘resource curse’.⁶⁰ On

⁵³ Clemente L., Faris R., Puente A., ‘Natural Resource Dependence, Volatility, and Economic Performance in Venezuela : The Role of Stabilization Fund’, Andean Competitiveness Project Working Paper, February 2002

⁵⁴ Ibid, 54

⁵⁵ Tsalik S., Ebel R., “Caspian Oil Windfalls: Who Will Benefit?”, Open Society Institute, 2003, pg 32

⁵⁶ Ibid, 36

⁵⁷ Galenson W., “A Welfare State Strikes Oil: The Norwegian Experience” 1986

⁵⁸ Ibid, 46

⁵⁹ Ibid, 54

⁶⁰ Tsalik S., Ebel R., “Caspian Oil Windfalls: Who Will Benefit?”, Open Society Institute, 2003

the other hand, it can be said that such success is a result of democracy. Democracy that other oil-producing lack, interestingly enough, such countries failed to escape resource curse so far.

In conclusion it will be correct to state that for any natural resource fund to work effectively, there has to be some binding power on government. If there is no such bindings or constraints on governments, natural resource funds do not function properly. And in order to have such binding power, oil funds should be governed not just by a single person but among different actors. This allows to have checks and balances, accountability in the performance of natural resource funds.⁶¹

Most countries have created natural resource funds for a stabilization and saving purposes. Besides these functions, such funds-if managed properly-help to escape 'resource curse'. Meanwhile, natural resources funds can stabilize country's exchange rate and regulate revenues.⁶² However, these can be achieved, only under certain conditions such as independence from governments and greater extent of public accountability. Otherwise, even natural resource funds can not help an oil-producing country.

1.5 Conclusion

As Karl notes "the resource curse is not a claim that natural resource abundance is always or inevitably bad for economic growth or development. To the contrary, there are powerful historical examples of successful resource-based development."⁶³ *As negative consequences of resource curse it is superior to note 'Dutch-Disease', rent-seeking, corruption, civil strives*

⁶¹ Ibid, 2

⁶² Ibid, 18

⁶³ Karl T. L., "Understanding The Resource Curse", pg 22

and lack of democracy. These issues will be analyzed in the coming chapters for the case of Azerbaijan in order to see if these symptoms are applicable to Azerbaijan.

The chapter highlights that oil and oil revenues can lead to economic and political instabilities, if not managed properly. Therefore, as Schubert notes what matters most is not the inherent character of the oil itself but how wealth generated by petroleum is shared and utilized.⁶⁴ Hence, the existence of oil, can not either harm nor benefit a country. At the end of the day, it depends on a government and its behavior. Government decides how to deal with oil and revenues. However, oil abundance may shape governments' attitudes both in positive and negative ways. The oil abundance is considered as advantage, a blessing in Norway. This case shows that resource curse phenomenon can be escaped through different policies such as better governmental accountability and transparency both on political and economic areas. Meanwhile it is a curse for the rest of oil-rich countries more precisely Venezuela where oil abundance lead to less democratic regime and more instable economic situation.

⁶⁴ Schubert R. S., "Revisiting The Oil Curse: Are oil rich nations really doomed to autocracy and inequality?", Oil and Gas Business 2006, pg 22

Chapter 2-The Case Study of Azerbaijan

2.1 Introduction

The previous chapter highlights the findings of several studies conducted by different scholars who tried to explain the political and economic challenges that oil-rich countries face. These findings will be used for the case study of Azerbaijan in the next two chapters. Therefore, this chapter analyzes Azerbaijan's past political and economic conditions and explains whether oil had any role in the establishment of the political regime in Azerbaijan after gaining independence. Furthermore, the chapter analyzes why it was inescapable path towards authoritarian system back in 1990's.

2.2 Political and Economic Background

As Freedom House reports of the year 2004 state "In Azerbaijan, there is an authoritarian system with limited scope for political competition. Azerbaijan's rating for national democratic governance is 6.00, which reflects the government's continued reliance on an authoritarian regime and use of force rather than democratic institutions and the rule of law."

⁶⁵

2.2.1 Geopolitical Background

After collapse of the USSR, there were few newly independent states for which the main concern was to maintain its independence and to preserve territorial sovereignty rather than to think about economic reforms or future economic prosperity. The major problems for these

⁶⁵ <http://www.freedomhouse.org/template.cfm?nit=355&page=47&year=2005>

countries were ethnic conflicts, military disputes with neighbouring countries and internal struggle for the power. Those countries were Moldova, Georgia, Armenia and Azerbaijan. Moreover, these countries were an area where interests of major regional powers overlapped. Due to such strategic location and natural resources, the Black Sea and Caspian Sea regions were areas where competition among regional powers such as Russia, Turkey and Iran for keeping these regions under an influence was at its climax. Russia wanted to gain back the control over “lost territories”. Turkey and Iran were willing to have access to new markets and to rich natural resources. These above mentioned reasons undermine why for those few newly independent countries, particularly for Azerbaijan, political stability was the top priority issue. Under given circumstances, it was unrealistic to dream about economic prosperity while there was no political stability.

2.2.2 Political Situation in Azerbaijan in 1990's

Dissatisfaction with the USSR's central policy and increased tensions in Nagorno Karabakh region of Azerbaijan between Armenians and Azerbaijani people living there, gave Azerbaijani Popular Front chance to become active in the political arena of Azerbaijan in early 1989. The ideology of Azerbaijan Popular Front was nationalistic and hence anti-Soviet policy the main purpose of such ideology was the restoration⁶⁶ of Azerbaijan's state independence.⁶⁷ There were demonstrations and action of protest which occurred in all the territories of Azerbaijan. The situation was also compressed by flow refugees from Armenia (Azerbaijani living in Armenia) as a result of anti-Azerbaijani riots and inaction of the central and local governments concerning situation in Nagorno Karabakh.

⁶⁶ Azerbaijan as a republic was first established by Rasolzadeh in 1918 and existed up to 1920, under the name of Azerbaijan Democratic Republic.

⁶⁷ Fuller E., Summary, “Azerbaijan at the Crossroads”, Post Soviet Business Forum, Royal Institute of International Affairs 1994

In January of 1990 demonstrations in Baku intensified and gradually turned to anti-Armenian and anti Soviet riots led by Azerbaijani refugees. Later on 20th of January, the last president of the Soviet Union Mikhail Gorbachev ordered the Soviet Army to enter Baku in order to “stabilize” the situation and prevent the further clashes in the capital.⁶⁸

Following the entrance of Soviet troops in Baku, Azerbaijan declared its independence from the USSR in 1991 with pro-Russian Ayaz Mutallibov the former Secretary of the Azerbaijan Communist Party, becoming the country's first president. All attempts of Mutallibov to establish coalition with Popular Front failed. There was no unity in the country. Political unity, back then, implied an issue of capable of mobilizing the masses. Azerbaijan Popular Front's leader, Abulfaz Elchibey, realized that “the country's population was largely indifferent to questions of political liberalization and that the only issue that could unite the masses was Nagorno-Karabakh conflict, therefore he adopted increasingly radical stance on this issue, in order to exert pressure on the leadership of the Azerbaijani Communist Party.”⁶⁹ However, within Popular Front there was “three way split. The European-oriented moderates continued to adhere to the Front's original programme advocating the building of a democratic Azerbaijan with the USSR.”⁷⁰ The other wing was Social-Democrats who separated from the Popular Front. This was the most powerful fraction, ‘national democrats’ who extremely were in favour of secession from the Soviet Union. This group was the one that would come to power later with the presidency of Abulfaz Elchibey.⁷¹ Thus, this group

⁶⁸ Prologue in Goltz T., “Azerbaijan Diary: A Rogue Reporter's Adventures in an Oil-Rich, War-Torn, Post-Soviet Republic”, M.E. Sharpe Inc, New York, U.S.A, 1998

⁶⁹ Fuller E., Summary, “Azerbaijan at the Crossroads”, Post Soviet Business Forum, Royal Institute of International Affairs 1994, pg 3

⁷⁰ Ibid, 3

⁷¹ Fuller E., Summary, “Azerbaijan at the Crossroads”, Post Soviet Business Forum, Royal Institute of International Affairs 1994, pg 4

did not want to unite with the president Mutallibov who “committed a severe tactical error by expressing his support-hastily retracted-for the Moscow putsch.”⁷²

This lack of political unity, clash of different ideologies between pro-communist Mutallibov and nationalist-Elchibey when there was only one major national concern such as the conflict with neighbouring Armenia over Nagorno Karabakh, had negative consequence for Azerbaijan. According to Cornell “Azerbaijan had failed to create any self-defense forces; the fighting in Nagorno Karabakh was carried out by paramilitary formations. By contrast, Armenia characterized by political stability and unity had long since created a national army. As a result, the situation on the front worsened considerably, especially as the Soviet Union dissolved in December 1991 and the conflict now became one between two independent states rather than one between two components of the same state.”⁷³

Mutallibov resigned in 1992 due to political instability within the country. And Yagub Mamedov, the chairman of Supreme Soviet, became in charge of the country, as the interim president according to the constitution. However, the Popular Front was not satisfied with just resignation of Mutallibov. The Front demanded more such as abolition of the presidential’s office, new parliamentary elections. Negotiations between the Popular Front and Mamedov started only the latter called upon the former to participate in a coalition government for the sake of national unity.⁷⁴ However, negotiations failed because Mamedov rejected the Front’s demands. In May 1992, Popular Front Party (PFP) seized the power and

⁷² Ibid, 4

⁷³ Cornell S., *Small Nations and Great Powers: A Study of Ethnopolitical Conflict in the Caucasus*, Richmond: Curson Press, 2000

⁷⁴ The newspaper “Bakinskii Rabocii”, March 19, 1992

according to June elections pro-Turkish PFP leader Abulfaz Aliyev (known as Elchibey) was elected as the country's second President.⁷⁵

However, Elchibey stayed in power only for more than one year. He showed incompetence in solving the Nagorno-Karabakh conflict and managing the economy. These reasons were causing increased dissatisfaction among some political and military groups, and in June 1993 pro-Russian Surat Huseynov military colonel from Azerbaijan's second-largest city Ganja advanced with his special forces towards the capital without facing any resistance from the National Army. Under the threat for his life, president Elchibey fled to his native province, to Autonomous Republic of Nakhchivan. The National Council (back then there was no parliament yet) transferred presidential powers upon its new Speaker, Heydar Aliyev, former First Secretary of the Azerbaijani Communist Party and member of the U.S.S.R. Politburo and U.S.S.R. Elchibey was formally removed from presidency by a national referendum in August 1993, and Heydar Aliyev was elected as the third president of Azerbaijan. Political situation in Azerbaijan stabilized only after 1994, when the cease fire agreement was signed with Armenia and Heydar Aliyev was able to concentrate more on domestic issues.⁷⁶

The above mentioned events, up to the year of 1993 increased the need for political stability which was more vital than need for any democratic regime which could be reached in the long run only. The political instability was the rationale behind people's choice of the former communist leader Heydar Aliyev. The country facing internal collapse needed an 'strong hand' with an experience who would have been able to overcome all the political constraints within country, which was needed for further economic reforms in the country. From 1991

⁷⁵ Fuller E., Summary, "Azerbaijan at the Crossroads", Post Soviet Business Forum, Royal Institute of International Affairs 1994, pg 7

⁷⁶ Ibid, 8-11

till 1995 there was no effective economic reform, because there was no political stability. The first president lacked the internal support, although he had external support, the second president was not charismatic enough to solve political issues within its own team. After 1993 elections, when Heydar Aliyev came to power, even he needed some time till 1995 to implement the first economic reform, which by the way was a monetary reform. But before implementing any economic reform, Aliyev was concerned with the stabilizing the political challenges facing the country, creating future stage for further economic reforms and this explains why it took him also two years after being elected to pursue any further economic reforms.

Aliyev concentrated power in his hands. In turn, it created no “delegation of responsibilities in the governmental structures.”⁷⁷ Aliyev was the one nominating the cabinet of minister, including the prime minister. He controlled the activities of the National Bank of Azerbaijan.⁷⁸

Laurila claims that under such strong presidency and lack of effective institutional mechanism corruption was “inevitable outcome”.⁷⁹ Furthermore, she states that “corruption is facilitated by large and inefficient governmental structures that control and regulate most business life.”⁸⁰

Postponing democratic reforms, rejecting simultaneous political changes while implementing economic reforms back in mid 1990’s was an inescapable strategy for Azerbaijan, maybe not

⁷⁷ Laurila, J., “Power Politics and Oil as Determinants of Transition: The Case of Azerbaijan”, Bank of Finland Institute for Economies in Transition, 1999, pg 22

⁷⁸ Ibid, 22

⁷⁹ Ibid, 22

⁸⁰ Ibid, 22

for the sake of economic reforms, but at least for the future of the country. However, as Laurila notes Aliyev's such "line of promoting western values, democracy, free market economy and political stability in the area has not been understood or appreciated in the West. He has often been criticised of being former KGB-member; dictatorial and paying lip service for democratic, corrupted and allowing corruption. Much of this being true, he is a prisoner of time, political traditions and historical situation."⁸¹

2.2.3 Economic Background

Decades of Soviet regime and central economy caused significant imbalances in the Azerbaijan's economy. As Fuller notes "for decades the primary emphasis was on production of raw materials-oil, gas, cotton (of which Azerbaijan was the second largest producer within the Soviet Union, after Uzbekistan) and at least until the ill-fated anti alcohol campaign of 1985, grapes."⁸² Furthermore, she notes that "industrialization was based in one area only, such as Baku-Sumgait region, which produced 50 per cent more industrial goods than the remaining 93 per cent of the country in the final years of the Soviet era."⁸³ Also, the major obstacle on Azerbaijan's economy was that it was heavily dependent on exports to, and imports from Russia.⁸⁴ Thus, under the Soviet regime, Azerbaijan's economic production was mainly concentrated on industrial oil-related production, and agricultural production. Its trade partners were other republics of the former union, but mainly as mentioned above it was Russia. Therefore, after the collapse of the Soviet Union, Azerbaijan has lost its trade

⁸¹ Laurila, J., "Power Politics and Oil as Determinants of Transition: The Case of Azerbaijan", Bank of Finland Institute for Economies in Transition, 1999, pg 23

⁸² Fuller E., Summary, "Azerbaijan at the Crossroads", Post Soviet Business Forum, Royal Institute of International Affairs 1994, pg 22

⁸³ Ibid, 22

⁸⁴ Ibid, 22

partners, which resulted in decrease in production. Also, Nagorno-Karabakh conflict created refugees problem for Azerbaijan.⁸⁵

Azerbaijan entered the transition period with the collapse of central planned economy in 1991 with the acceptance of the Law on Basic Economic Development. The first reform was the price liberalization measures which resulted in hyperinflation.⁸⁶ The performance of Azerbaijan's economy worsened in 1992 when national income declined by 31.2 per cent compared to 1991, industrial production decreased by 34.3 per cent, production of consumer goods by 22.6 per cent, food production by 26.8 per cent.⁸⁷

It is important to mention that 1991-1994 was the period of Nagorno-Karabakh war which resulted with the loss of 20 per cent of its territory for Azerbaijan. „However, the region itself was not responsible for high share of GDP and the loss of territory did not significantly affect Azerbaijan's GDP. The agricultural potential of the lost territory and the cost of providing housing and supporting displaced persons has undoubtedly (i) raised both the level and composition of expenditures, (ii) reduced the potential growth of the holiday service sectors since the majority of these buildings are used to house displaced persons and (iii) reduced potential GDP.”⁸⁸

Nevertheless, International Monetary Fund's reports that “Azerbaijan's economy suffered from serious macroeconomic imbalances after the collapse of the U.S.S.R. Real GDP

⁸⁵ IMF, “Azerbaijan Republic: Recent Economic Developments”, Staff Country Reports No.98/93, August 1998, pg 5

⁸⁶ Laurila, J., “Power Politics and Oil as Determinants of Transition: The Case of Azerbaijan”, Bank of Finland Institute for Economies in Transition, 1999, pg 22

⁸⁷ Economist Intelligence Unit, Azerbaijan Country Report, Second Quarter 1993, pg 40

⁸⁸ Singh R., Laurila J., “Azerbaijan: Recent Economic Developments and Policy Issues in Sustainability Growth”, Bank of Finland Institute for Economies in Transition, 1999, pg 48

declined by more than 70 percent from 1992 to 1995, by which time high inflation had eroded real incomes, the exchange rate had weakened and international reserves were nearly depleted.”⁸⁹

Hyperinflation reached its peak in 1994 with 1.664 per cent.⁹⁰ Thus, in early 1995 the Azeri government under the supervision of IMF “tightened fiscal and credit policies and introduced structural reforms in the areas of exchange and trade liberalization.”⁹¹ After this reforms, in 1996 Azerbaijan’s economy started to recover, the year was a crucial for the economy. IMF reports that “tight financial policies combined with large foreign direct investments linked to the oil developments brought about a nominal appreciation of the manat (Azerbaijan’s national currency) vis-à-vis the dollar of about 8 percent, which in turn helped to bring down annual inflation to 7 percent by end year.”⁹² The production started to increase thanks to foreign investments in the oil fields, which in turn increased the performance of construction and services sectors.⁹³

2.2.3.1 Structural Reforms

Under the supervision of the IMF Azerbaijan’s government pursued the following structural reforms during the 1990’s.

- “The exchange rate was unified and the differentiated surrender requirements at below market prices were abolished in 1995. Both domestic and foreign trade regimes have been substantially liberalized with the abolition of the state order system, export and import quotas, licensing requirements, and ex-

⁸⁹ IMF, “Azerbaijan Republic: Recent Economic Developments”, Staff Country Reports No.98/93, August 1998, pg 5

⁹⁰ Laurila, J., “Power Politics and Oil as Determinants of Transition: The Case of Azerbaijan”, Bank of Finland Institute for Economies in Transition, 1999, pg 22

⁹¹ ⁹¹ IMF, “Azerbaijan Republic: Recent Economic Developments”, Staff Country Reports No.98/93, August 1998, pg 5

⁹² Ibid, 5

⁹³ Ibid, 5

ante export registration schemes. External tariff rates have been simplified with little dispersion. State owned trading companies involved both in exports and imports, including the cotton monopoly have been either privatized or liquidated.”⁹⁴

- The second phase of reforms was the privatization process which started in 1996 and supervised by the state property committee. The privatization process started with the adoption of “The state Program of State Property in Azerbaijan 1995-1998”. In order to bring people to take part in privatization process, the privatization check books were given out to any single citizen of Azerbaijan, who was born before January 1st, 1997. “The Privatization process has proceeded at a quick pace, with 40-60 enterprises being sold each month through the auction process. Moreover, the State Property Committee has started the case by case privatization of large and valuable enterprises for which strategic investors were sought. Within just 10 months, about 95 percent of the population received vouchers and a system of voucher auctions was put in place. Around 450 medium size enterprises were privatized through the voucher auctions by end 1997. In addition, more than 1300 small enterprises were sold.”⁹⁵

However, there was with above mentioned check books or vouchers. They created secondary markets, where people were selling their own checks for the less price, eventually it lead to the creation of monopolists in the private sector.

- “The agricultural sector was a subject of policy changes in 1997. The state order system was abolished and prices were liberalized. State companies operating in the wheat and cotton sectors were either privatized or liquidated. Parliament approved a law on land reform in July 1996, which clarified the land privatization process. More than 28000 private farmers had registered as legal entities by end 1997.”⁹⁶

This land reform eliminated the agricultural legacy of the Soviet economy where land was not owned by private farmers.

⁹⁴ IMF, “Azerbaijan Republic: Recent Economic Developments”, Staff Country Reports No.98/93, August 1998, pg 21

⁹⁵ Ibid, 21

⁹⁶ IMF, “Azerbaijan Republic: Recent Economic Developments”, Staff Country Reports No.98/93, August 1998, pg 21-22

In conclusion of this section it can be said it was thanks to IMF's pressure monetary and fiscal policies were tightened which in turn boosted Azerbaijan's economy:

“These reforms caused a reduction in inflation to 84,5 per cent in 1995, to 4 per cent in 1997 and deflation of 0.8 per cent in 1998, down from 1664 per cent in 1994. Price stability has been achieved against a backdrop of upward adjustment in domestic utility prices, which were previously subsidised, and which for other transition countries have seen inflation inertia. Further structural reforms in the form of liberalisation of the exchange rate mechanism and of the trade regime have helped improve the position of the Azeri economy and correct the mis-allocation of prices and incentives.”⁹⁷

So far, reforms pursued by Azerbaijan governments since the mid 1990's, except the increase in the gasoline and electricity prices in the beginning of 2007, as a result of IMF's pressure on the government to cut subsidies into this areas, is the only economic 'reform' so far that created social protests in the country, shaped public opinion as a opposition to current government, however it does not seem realistic that strong public opposition will change anything in 2008 presidential elections, at least because there is no alternative leader in the opposition (thanks to the Heydar Aliyev's regime) which could gain the support of the people. In addition, the current regime is the only “medicine” in the eyes of people which could solve the conflict over Nagorno Karabakh with Armenia. That is why presently the current political system under Ilham Aliyev is not subject to any pressure by people, they are concerned more with survival rather than to think of the long term future.

2.3 Conclusion

This chapter outlines the past political and economic developments in Azerbaijan. The conclusion is that political instability was a result of the U.S.S.R's collapse, the lack of political unity between pro-communist Mutallibov and nationalist Popular Front and of

⁹⁷ Singh R., Laurila J., “ Azerbaijan: Recent Economic Developments and Policy Issues in Sustainability Growth”, Bank of Finland Institute for Economies in Transition, 1999, pg 11-12

course the war with Armenia over Nagorno Karabakh. This political instability and poor macroeconomic policies led to macroeconomic insecurity, including hyperinflation in early 1990's. In turn, such political and economic conditions led to establishment of authoritarian regime in Azerbaijan in order to 'satisfy' the need for 'strong hand'.

Starting from 1995, Azerbaijan's government pursued IMF backed stabilisation reforms. These reforms allowed the government to "take control" of inflation and boost the stable GDP growth. Besides, stabilisation process Azerbaijan's governments have also pursued some structural reforms which led to trade liberalisation and the privatisation of small sized firms.

Chapter 3-Oil in Azerbaijan

3.1 Historical Perspective

Azerbaijan is one of the world's oldest oil producers.⁹⁸ Exploration and development of the country's oil reserves is vital to its economic future. Through various agreements and contracts with foreign companies Azerbaijan has opened its oil industry to fund its development.

The history of oil in Azerbaijan is obligatory part of any briefing given to international oil company executives visiting Azerbaijan. Such as Azerbaijan was the world's largest oil producer at the beginning of the twentieth century.⁹⁹ Azerbaijan's oil was of crucial importance to Soviet army during the Second World War.¹⁰⁰

When the Nobel brothers travelled to Baku-the capital of Azerbaijan- in 1873, they were looking for walnut trees, and wood for mankind rifle stocks.¹⁰¹ Instead they found oil and established the first international oil company in the region.¹⁰² As a result of foreign investment in the development of oil Baku faced the oil boom, and became the fastest growing city in the Russian empire.¹⁰³ It became not just the center of Russian oil production, but also the center of Russian oil refining. Five large refineries, with an annual throughput capacity of 18 million tons operated in Baku.¹⁰⁴ The Baku area produced about 8 million tons

⁹⁸ The fields of Sabunchi, Balakhany, and Romany have produced oil without interruption since 1870's. Hassmann H., "Oil in the Soviet Union" Princeton University Press, 1953, pg 67

⁹⁹ Ibid

¹⁰⁰ Azerbaijan's share of the total Soviet oil production was 70 percent in 1940's. Ibid pg 69

¹⁰¹ Yergin D., and Gustafson T., "Evolution of an Oil Rush", New York Times, 6 August, 1997

¹⁰² Olsen W., "The Role of Oil in the development in Azerbaijan", in "The Caspian: Politics, Energy and Security" Ed. Akiner Shirin, pg 127

¹⁰³ Ibid

¹⁰⁴ Hassmann H., "Oil in the Soviet Union" Princeton University Press, 1953, pg 68

of oil in 1916. During the expansion of the oil industry under the Soviets, Baku increased its production steadily from 8 million tons in 1916 to 22 million tons in 1940. But after the Second World War the situation has changed significantly. Discovery of oil in new regions of the Soviet Union, such as Volga-Ural region, and later in Siberia diversified Soviet investment from Azerbaijan to those new regions. As a result, in the early 1990's, when Azerbaijan became independent, the oil production was about 200,000 barrels of oil per day and importing oil from Russia to run refineries.¹⁰⁵

3.2 Oil Industry

In 1920 oil industry of Azerbaijan was nationalized. In consecutive years new oil fields were discovered thus oil production reached 23.6 million tons in 1941 which was 76% of total Soviet oil production.¹⁰⁶ In late 1940's and early 1950's Azerbaijan's oil industry moved to offshore. Neft Daxları (Oil Rocks) an offshore field in the Caspian Sea "was established on Estacada for the first time in world oil history. This period is also known for the development of technology and hydro technological oil plants."¹⁰⁷ In 1969 Azerbaijan oil industry entered into new phase of rapid development under Heydar Aliyev as the First Secretary of the Azerbaijan Soviet Communist Party. During Aliyev's regime between 1970's and 1980's "the technical devices used in the Caspian Sea allowed working only on the depth of 40 meters. Almost all of the oil and gas fields were discovered in the Caspian Azeri sector at the depth of 40 meters at that time. The increase in the oil and gas production in the sea was due

¹⁰⁵ Olsen W., "The Role of Oil in the development in Azerbaijan", in "The Caspian: Politics, Energy and Security" Ed. Akiner Shirin, pg 127

¹⁰⁶ "History of Development of Oil Industry in Azerbaijan" available at http://www.azerbaijan.az/_Economy/_OilStrategy/oilStrategy_02_e.html

¹⁰⁷ Ibid

to the availability of greater oil and gas reserves in the lower depths. Azerbaijan was supplied with over 400 of 75 types of load-lifting boats, seismic, passenger and other vessels.”¹⁰⁸

Azerbaijan had oil boom during the Soviet regime, therefore it is not something new, there are historical roots of this phenomenon in Azerbaijan. Despite a long history of producing oil, Azerbaijan has little experience managing its petroleum wealth. Until the country's independence in 1991, this task was the responsibility of the Soviet Union.¹⁰⁹

As Nassibli writes:

‘Oil as a factor, once again, constituted one of the significant leading components in the political and economical life of Azerbaijan. In the early years of Azerbaijan's independence it became apparent that the claim of the existence of large hydrocarbon reserves, what the Soviets considered to be anything but rumors, turned out to be real. Consequently, the talks and agreements began with the world's largest petroleum companies. Soon it was realized that to be able to utilize the new oil deposits on the Caspian offshore of Azerbaijan, one needed to have a large amount of capital and the most advanced technology.’¹¹⁰

Foreign companies were able to express much more interest in Azerbaijan as a result of the political and economic liberalization of the Soviet Union in the mid 1980's, thanks to Gorbachev's „Perestroika” which created “favorable conditions for foreign companies interested in Azerbaijan oil. In the late 1980s, Chirag, Azeri, and Guneshli oil deposits located in the Caspian Sea bed off Baku received the initial attention of foreign oil companies.”¹¹¹

In January 1991, the Azerbaijan government issued a decree “soliciting bids for the exploitation of the three fields, which were treated as three separate contracts. Amoco won

¹⁰⁸ History of Development of Oil Industry in Azerbaijan” available at http://www.azerbaijan.az/_Economy/_OilStrategy/oilStrategy_02_e.html

¹⁰⁹ Tsalik S., Ebel R., “Caspian Oil Windfalls: Who Will Benefit?” , Open Society Institute, 2003, pg 90

¹¹⁰ Nassibli N., “The Independent Azerbaijan's Oil Policy” available at <http://www.azerbaijan.com/azeri/nasibzade1.html> (Last Accessed May 30, 2008)

¹¹¹ Ibid, 4

the tender for the Azeri field. Other participants in the bid were Unocal, McDermott, and a British Petroleum (BP) / Statoil alliance. At that time, Pennzoil and Ramco were negotiating for the Guneshli field, and BP / Statoil was bidding for Chirag.”¹¹²

In June 1991, Azerbaijan’s government decided to form a consortium to exploit the Azeri oil field. Participants of this consortium were Unocal, BP / Statoil, McDermott, and Ramco. In October 1992, a feasibility study concerning the project completed.¹¹³

The collapse of the Soviet Union in 1991 provided new opportunities to foreign companies and investors to start direct negotiations with the government in newly independent state of Azerbaijan.¹¹⁴

3.3 Oil Contracts

The process of negotiation in order to sign contracts foreign oil companies hence attract foreign investment started in 1991. The first major oil contract signed in September 2004. According to this contract three oil fields – Azeri, Chirag and Guneshly were intended for exploitation during 30 years with estimated reserves of 511 million tons. The contract is based on the "production sharing" principals. In this contract the share of Azerbaijan’s State Oil Company (SOCAR) is 10%, BP-17%, Amoco-17%, Lukoil-10%, Pennzoil- 9.8%, Unocal- 9.5%, Statoil-8.6%, Itochu-2.4%, Ramco- 6.7%, Delta- 1.7%.¹¹⁵

¹¹² Nassibli N., “The Independent Azerbaijan’s Oil Policy” available at <http://www.azerbaijan.com/azeri/nasibzade1.html> (Last Accessed May 30, 2008)

¹¹³ Ibid, 5

¹¹⁴ Olsen W., “The Role of Oil in the development in Azerbaijan”, in “The Caspian: Politics, Energy and Security” ed. by Akiner Shirin, pg 127

¹¹⁵ Nassibli N., “The Independent Azerbaijan’s Oil Policy” available at <http://www.azerbaijan.com/azeri/nasibzade1.html> (Last Accessed May 30, 2008)

The contract earmarked \$8 billion till 2024 only as investment meanwhile it also meant revenues from 511 millions tons of oil which would be produced. In political terms it helped Heydar Aliyev to stabilize political situation by extending implicit foreign presence which led to further oil contracts.¹¹⁶

The second contract was signed among Caspian International Operating Company investors in 1995. The investors were SOCAR, LUKOIL, PENNZOIL, AGIP, and the Lukoil-Agim joint venture. The main purpose of the contract was the exploration of Karabakh offshore oil field.¹¹⁷ According to the contract, the investors invested \$2 billion in this field.

In 1996, the third consortium was created for the purpose of exploring and developing Shah-Deniz site in the south of Absheron Peninsula. The value of this agreement was about \$4 billion. The investors of this contract were once again SOCAR, BP/Statoil, LUKOIL, ELF, Iran's National Oil Company and Turkish company TPAO. BP has the controlling share of 51%. Besides 100 million tons of oil, Shah-Deniz site is believed to have 200 million tons of condensate gas, 500 billion cubic meters of natural gas.¹¹⁸

Few months later, the fourth contract was signed among AMOCO, UNOCAL, SOCAR, ITOCHU (Japan) and Delta Nimir (Saudi Arabia) in order to explore Ashrafi and Dan Ulduzu oil and gas fields. This contract required \$2 billion of investment.¹¹⁹

¹¹⁶ Ibid, 4-5

¹¹⁷ Ibid, 4-5

¹¹⁸ Nassibli N., "The Independent Azerbaijan's Oil Policy" available at <http://www.azerbaijan.com/azeri/nasibzade1.html> (Last Accessed May 30, 2008)

¹¹⁹ Ibid, 5-7

Finally the fifth main oil contract in Azerbaijan was signed in 1997 between SOCAR and French companies, such as ELF and TOTAL. The aim of this contract was exploration and development of Lenkoran Deniz and Talish Deniz oil fields in the south of Caspian Sea. This contract also valued at \$ 2 billion.¹²⁰

What could the positive factors of such contracts and an intensive exploitation of oil resources? Export of Azerbaijani oil to the European markets and integration to world markets, increase in foreign direct investments, opportunity for capital investments to the sectors adjacent with oil sector, possibility of creating currency stocks and implementation of independent investment policy.¹²¹ And in 2007 as a consequence of previously signed contracts the foreign investments in Azerbaijan's oil industry reached \$4176.3 million compared to \$546.1 million in 2000.¹²²

3.3 Main Challenges of Oil Industry

3.3.1 Export Pipelines

The major geopolitical impediment of Azerbaijan's oil industry after the collapse of the U.S.S.R was the lack of infrastructure in order to export oil to world markets. Previously all export pipelines were going through Russia. Therefore, Azerbaijan started to look for development of other oil export pipelines in order to decrease its dependence on Russia.

However, the early offshore oil went through Russia to its Black Sea coast in 1997. From there oil was pumped to tankers. In 1998, about 2.5 million tones of SOCAR's oil was transported

¹²⁰ Ibid, 6

¹²¹ Olsen W., "The role of oil in the Development of Azerbaijan", in *The Caspian: Politics, Energy and Security*

¹²² The State Statistical Committee of the Republic of Azerbaijan, "Azerbaijan in Figures 2008", Seda Press, Baku 2008, pg 259

from Russia.¹²³ However, as Cornell states “Azerbaijan lost large amounts of income from this pipeline, because Azerbaijan was filling the pipeline with high-quality oil, but from Russian territory lower-grade crude was exported.”¹²⁴ Furthermore, this pipeline was not safe because Russian port Novorossiysk located on the Black Sea was becoming a dangerous place given its closeness to Chechnya.¹²⁵

Another route was through Georgia, Baku-Supsa pipeline which allowed exporting about 100000 barrels of oil by end of 1999. But this pipeline need further upgrade which could have cost about \$ 1.8 billion, however its transport capacities were not enough to carry Azerbaijan’s oil.¹²⁶ The capacity of both above mentioned pipelines was limited. Therefore, it would have not allowed for full development of the Azeri-Chirag-Guneshli fields which were the subject of the first major oil contract in Azerbaijan.¹²⁷

Therefore, Azerbaijan started to search for alternative routes. The most preferable choice for Azerbaijan was the construction of Baku-Tbilisi-Ceyhan major export pipeline. Construction of BTC started in September 2002 and finished in early 2005. The first oil was pumped in May.¹²⁸ Exploitation of BTC Azerbaijan ensures its “independence” from Russia’s monopoly on oil exports.

¹²³ Laurila J., “Power Politics and Oil as Determinants of Transition: The case of Azerbaijan”, Bank of Finland: Institute for Economies in Transition, 1999, pg 17

¹²⁴ Cornell S., Tsereteli M., Socor V., “Geostrategic Implications of the Baku Tbilisi Ceyhan Pipeline”, pg 19

¹²⁵ Ibid, 19

¹²⁶ Laurila J., “Power Politics and Oil as Determinants of Transition: The case of Azerbaijan”, Bank of Finland: Institute for Economies in Transition, 1999, pg 17

¹²⁷ Olsen W., “The role of oil in the Development of Azerbaijan”, in *The Caspian: Politics, Energy and Security*, pg 135

¹²⁸ Ibid, 135

3.3.2 Legal Status of the Caspian Sea

The Caspian Sea is the largest inland sea in the world. It is bordered by five countries: Russia, Kazakhstan, Turkmenistan, Azerbaijan and Iran. During the Soviet regime, there were only two countries the Soviet Union and Iran.

However, after the collapse of the Union new independent states of Russia, Kazakhstan, Turkmenistan and Azerbaijan emerged instead of the Soviet Union. Each of these countries had different claims on the “sharing” of the Caspian Sea.¹²⁹ These countries could not agree on the division of the Caspian Sea into sectors. There was not a certain mechanism to do so. Therefore, the legal status of the sea created tensions between Azerbaijan and other countries.

Russia and Iran claimed that Azerbaijan had no right to sign the first major contract in 1994. As Granmayeh notes “Russia’s reaction changed from complaint and accusation to warning. Yeltsin had issued instructions to his government to impose financial, commercial and naval sanctions against Azerbaijan, if it continued to implement the oil agreement.”¹³⁰

Iranian Foreign Minister Velayati stated that “before the legal regime of the Caspian Sea has been determined, such multilateral agreements are not valid; and the implementation of such agreements can be completed only when the legal basis of the Caspian Sea is determined.”¹³¹ The most problematic ‘conflict’ between Iran and Azerbaijan in the Caspian Sea happened in July 2001 in a disputed zone. “Iran used military means to stop Azerbaijan’s oil operations in

¹²⁹ Granmayeh A., “Legal History of the Caspian Sea”, in *The Caspian: Politics, Energy and Security*, 2004, pg 17-19

¹³⁰ Ibid, 23

¹³¹ Ibid, 25

the offshore field, Alborz or Alov which is located 90 miles of Baku and would have been within Iranian waters if Iran would agree on 20% share of the Caspian Sea.”¹³²

The uncertain legal status of the Caspian Sea created tensions between Turkmenistan and Azerbaijan. In 1997, Turkmenistan claimed its right over the field of Azeri and Chirag. These two fields were developed as a result of the first major contract between Azerbaijan and foreign oil companies. There was another field Kyapaz or Serdar which was a subject of argument between. Turkmenistan blamed Azerbaijan for the deals over its territory.¹³³

After almost two decades of arguments and disputes over the legal status of the Caspian Sea slightly discourages foreign investment into oil industry of Azerbaijan. Therefore, leaves many disputed oil fields unexplored and underdeveloped. There is no security in the long run, tensions between could one day lead to major confrontations between the states of the Caspian Basin.¹³⁴

3.4 State Oil Company of Azerbaijan Republic

Article 14 of the Constitution of Azerbaijan Republic states that „without prejudice to rights and interests of any physical persons and legal entities natural resources belong to the Azerbaijan Republic.”¹³⁵ The president of Azerbaijan is in charge for managing natural resource wealth.

¹³² Ibid, 29

¹³³ Ibid, 26

¹³⁴ Granmayeh A., “Legal History of the Caspian Sea”, in *The Caspian: Politics, Energy and Security*, 2004, pg 40

¹³⁵ Constitution of Azerbaijan Republic, Article 14

Currently, there are few state-owned monopolistic companies that are responsible for managing natural resources. Among them State Oil Company of Azerbaijan (SOCAR), the one which controls the management of oil resources, has important role in the economy.

SOCAR operates as a vertical integrated cooperation that is responsible for extractive industry and for providing ready commodities, such as gasoline, to consumers. It is the only domestic, monopolistic, cooperation that operates in the field of oil and gas industry, currently employing 58945 people.¹³⁶ Therefore, it is “the key institution for the management of oil industry in Azerbaijan.”¹³⁷

SOCAR was created by Presidential decree on November 13th, 1992. According to this decree about „The establishment of State Oil Company of Azerbaijan Republic”, the main purpose of establishment of SOCAR is to have a national strategy to manage oil resources and to modify oil industry and increase the performance of oil and gas cooperations. Therefore on the basis of „AzNeft” and „Azneftkimya” state cooperations SOCAR was established.¹³⁸

According to another presidential decree of April 5th, 1994 the previous decree was annuled and SOCAR’s new Charter was announced. The last charter of SOCAR was established on January 24th, 2003 with the decree of the President on „Modification of the Structure of SOCAR”.

¹³⁶ The number is taken from SOCAR website <http://www.socar.gov.az/about-az.html>

¹³⁷ International Monetary Fund, “Azerbaijan Republic-Selected Issues and Statistical Appendix”, Country Report, No. 03/130, 2003, pg 11

¹³⁸ The Presidential decree on “The Establishment of State Oil Company of Azerbaijan Republic”, Baku, Azerbaijan, November 13, 1992

According to the first Charter of SOCAR, the structure of SOCAR was the following, Council of Directors, Board of Administration, President and Apparatus of the President. Council of Directors was the highest management organ. The structure of the Council of Directors was in a way that according to the decrees of the President of Azerbaijan Republic, it was consisting of not just the high ranking official of SOCAR, but also representatives of civil society. Such structure created a basis for transparency and collective management of SOCAR. However, according to the last Charter of SOCAR the highest management consisted of President and the council of SOCAR. And there were no representatives from civil society. Hence the management of SOCAR went from collectivism into personal management. First, such structure „establishes” SOCAR more as a private-commercial cooperation, although it is formally under the control of the government, second the structure of SOCAR disables public participation and accountability, which is in charge of Public Good-such as natural resources are defined as public good according to the Constitution of Azerbaijan. Such environment within the SOCAR creates perfect atmosphere for corruption. That is why it is not a surprise, that in the previous years, SOCAR’s name was circulated in major corruption scandals in Azerbaijan. It is closely related to the fact that it is „closed” cooperation.

According to Committee of Oil Industry Worker’s Rights Protection’s Report on corruption in Azerbaijan oil industry prepared for EBRD & IFC investigation arms „It is necessary to take into account that State Oil Company of Azerbaijan (SOCAR) is the central point of corruption in Azerbaijan. It operates with the oil incomes, which are the main part of the state budget, and it is directly controlled by Presidential Bureau...”¹³⁹

¹³⁹ The Committee of Oil Industry Workers’ Rights Protection, “Report on Corruption in Azerbaijan Oil Industry prepared for EBRD & IFC Investigation Arms”, Azerbaijan, October 2003

The same report explains the basic corruption schemes in Azerbaijan that are related to the oil industry and SOCAR. For example, managers of SOCAR establish their own private firms under the name of relatives or friends. Then SOCAR provides orders to such firms, and these firms perform a task and provide an invoice where the price is higher than market price, then SOCAR pays the firm the full price indicated in the invoice. Of course, since indicated prices are higher than market prices, in reality there is some money left, and usually the SOCAR manager who is the real owner of the private firm gets the left cash. As a result, the budget of SOCAR is being reaped off.¹⁴⁰ Furthermore, if there is any inspection such from Ministry of Taxes, it never clarifies the corruption case till the end. Usually not high officials are dismissed or arrested for corruption. High officials pay substantial part of estimated fraud to the inspection, they give this money to their own head officers, and those officers at the end of the day are controlled by the Cabinet of Ministers. Therefore, it is a circle, going through higher officials.¹⁴¹

For example, Baku Factory of Constructions, which is a subdivision of SOCAR, rented construction grounds to British Petroleum in 2001. The rent profits should have been spent on reconstruction of the factory, new equipment purchasing, or creation of new jobs. But BFDC used the profit for minor reconstruction works, which of course were overpriced. The subcontractor companies that did the work reconstruction works for BFDC were Ildurum Company indirectly owned by Rafiq Aliyev of Socar (He was arrested in 2005 officially for tax evasion) and AG Grade indirectly owned by Rovnaq Abdullayev, the current president of

¹⁴⁰ The Committee of Oil Industry Workers' Rights Protection, "Report on Corruption in Azerbaijan Oil Industry prepared for EBRD & IFC Investigation Arms", Azerbaijan, October 2003

¹⁴¹ Ibid

SOCAR.¹⁴² There are some other cases of major corruption cases in SOCAR which can be considered as a major obstacle to economic development of the country.

3.5 State Oil Fund of Azerbaijan Republic

The local economy of Azerbaijan almost entirely depends on the oil industry. Oil revenues account for up to 50 per cent of income in the state budget. At the same time, most of the people in the country live below poverty line.¹⁴³

In order to avoid dependency of the economy on the oil industry and to ensure that oil revenues go to state budget, and not anywhere else, the World Bank and the IMF have supported the creation of National Oil Fund in Azerbaijan.¹⁴⁴ The main purpose of the NOF is to provide transparent management and ensure proper allocation of the revenues from oil.

The State Oil Fund of the Republic of Azerbaijan (SOFAZ) was established in accordance with the Decree of the President of the Republic of Azerbaijan # 240 dated December 29, 1999 "On Establishment of the State Oil Fund of the Republic of Azerbaijan".¹⁴⁵

The rationale behind the Oil Fund creation is to ensure equality of benefit with regard to the country's oil wealth, and improve the economic well-being of the people and ensure

¹⁴² The Committee of Oil Industry Workers' Rights Protection, "Report on Corruption in Azerbaijan Oil Industry prepared for EBRD & IFC Investigation Arms", Azerbaijan, October 2003

¹⁴³ Informal sources suggest that in 2000, 80 per cent of the population were living below the poverty line. "Pocketing Caspian Black Gold: Who are the Real Beneficiaries of Oil Industries in Georgia and Azerbaijan?" Central and Eastern Europe Bankwatch Network, April 2002, pg 9

¹⁴⁴ Karayianni M., "Production Sharing Agreements and National Oil Funds" pg 151, in The Caspian: Politics, Energy and Security ed. by Shirin Akiner

¹⁴⁵ History of State Oil Fund of Azerbaijan Republic, <http://www.oilfund.az/index.php?n=8> (Last accessed May 24, 2008)

economic security for future generations.¹⁴⁶ According to IMF's report SOFAZ was established "as an extra budgetary fund in order to ensure transparency in the management of oil revenue and to curtail the use of assets."¹⁴⁷ As April 1st, 2008, the total assets of SOFAZ amounted to US\$ 3335,8 million or 2775,0 million manats ¹⁴⁸ As stated in SOFAZ's the first quarterly statement for the year of 2008 "1094,0 million manats was received from implementation of oil and gas agreements, including 1079.2 million manats from the sale of profit oil, 0.8 million manats as acreage payments, 14.0 million manats from Azerbaijan's State participation share in the Baku-Tbilisi-Ceyhan (BTC) Main Export Pipeline and 0.04 million from sale of assets received from foreign companies. The revenues from managing assets of the Fund for the reporting period amounted to 22.4 million manats. The Fund's extra-budgetary revenue due to asset revaluation stood at 20,2 million manats."¹⁴⁹

The oil fund is accountable and responsible to the President of Azerbaijan, who has the power to appoint or dismiss the Fund's director. SOFAZ no longer allows the use of revenues in order to cover state budget deficit or to subsidize agriculture.¹⁵⁰ However, spending policies are lacking special attention. Expenditure guidelines are general and entirely at the discretion of the president.¹⁵¹

¹⁴⁶ History of State Oil Fund of Azerbaijan Republic, <http://www.oilfund.az/index.php?n=8> (Last accessed May 24, 2008)

¹⁴⁷ ¹⁴⁷ International Monetary Fund, "Azerbaijan Republic-Selected Issues and Statistical Appendix", Country Report, No. 03/130, 2003, pg 11

¹⁴⁸ State Oil Fund of Azerbaijan Republic, "Last Figures" available at <http://www.oilfund.az/en/content/15> Last Accessed May 30, 2008

¹⁴⁹ State Oil Fund of Azerbaijan Republic, "SOFAZ Revenue and Expenditure Statement for January-March 2008 (non-audited)" available at <http://www.oilfund.az/en/account/35> Last Accessed May 30, 2008

¹⁵⁰ Karayianni M., "Production Sharing Agreements and National Oil Funds" pg 151, in *The Caspian: Politics, Energy and Security* ed. by Shirin Akiner

¹⁵¹ Bagirov S., Akhmedov I., Tsalik S., "State Oil Fund of the Azerbaijan Republic" in Tsalik S., Ebel R., "Caspian Oil Windfalls: Who Will Benefit?", Open Society Institute, 2003, pg 112

According to the regulations of the Fund, it can be used for „solving the most important nation-wide problems,” for „construction and reconstruction of strategically significant infrastructure facilities” and for „socio economic progress of the country.”¹⁵² Basically, there is no long term expenditure strategy of the State Oil Fund, therefore, it can be considered as a „secondary budget”.¹⁵³ The Fund’s expenditures so far, has been directed towards projects such as building homes for refugees and covering the cost of Azerbaijan’s share of pipeline costs.¹⁵⁴ In 2006, the Fund transferred 37000 manats (USD \$ 1=0.87 manats, May 2008) to Samur Absheron irrigation system, 150000 manats to State Budget, 110032 manats to Refugees Committee, 82749 manats to building of water canal from Oguz-Gabala zone to Baku city, 90000 manats to Azerbaijan Investment Company.¹⁵⁵

Respectively in 2008, the fund’s expenditure was directed towards projects such as “the participation of the Republic of Azerbaijan in BTC Main Export Pipeline Project (the project's financing closed in 2006) - 297,9 million manats, Settlement of the problems of refugees and internally displaced persons - conflict - 385,2 million manats, financing "Baku-Tbilisi-Kars railway" - 20,7 million manats, repayment of State Oil Company's share in the project on joint exploration and development of Azeri, Chirag and Guneshli oilfields - 87,6 million manats, transfers to the state budget - 1940 million manats”¹⁵⁶

The State Oil Fund, as the State Oil Company of Azerbaijan, lacks checks and balances. According to the regulations of the Fund „it shall be accountable and responsible to the

¹⁵² Regulations of State Oil Fund of Azerbaijan, Utilization and Fund’s Assets, Section 4, <http://www.oilfund.az/index.php?n=165> (Last Accessed May 24, 2008)

¹⁵³ Bagirov S., Akhmedov I., Tsalik S., “State Oil Fund of the Azerbaijan Republic” in Tsalik S., Ebel R., “Caspian Oil Windfalls: Who Will Benefit?” , Open Society Institute, 2003, pg 112

¹⁵⁴ Ibid, 112

¹⁵⁵ Annual Report of Azerbaijan’s State Oil Fund, 2006, pg 27

¹⁵⁶ State Oil Fund of Azerbaijan Republic, “SOFAZ Revenue and Expenditure Statement for January-March 2008 (non-audited)” available at <http://www.oilfund.az/en/account/35> Last Accessed May 30, 2008

President of the Republic of Azerbaijan.”¹⁵⁷ Therefore, the president has all the power in the taking strategic decisions. The parliament of Azerbaijan has no power in controlling the State Oil Fund, which is not the case of Norway, where legislators decide on fund’s expenditure policies.¹⁵⁸

As a result, in 2002 the International Monetary Fund suspended the \$17 million tranche of its Poverty Reduction and Growth Facility loan to Azerbaijan. The reasons were shown as the no law on the State Oil Fund that would sufficiently control expenditures of the Fund, and also there was no long term strategy for effectively using Azerbaijan’s oil revenues.¹⁵⁹

However, the government have also performed better than some other oil-producing countries, such as Venezuela. Unlike, Venezuela Azerbaijan did not accumulate large amounts of foreign debt.¹⁶⁰ However, in order to pursue further economic development and reduce poverty, the government should promote non-oil economic growth. Therefore, to do so, there should be structural reforms. The access to small and medium-size enterprises should be improved.¹⁶¹ And there should be well-developed spending and investment strategy of the State Oil Fund. The government should improve the Fund’s accountability in the way oil revenues are spent, otherwise the fate of Venezuela and not Norway, can be repeated.

¹⁵⁷ Regulations of State Oil Fund of Azerbaijan, Utilization and Fund’s Assets, Section 4, <http://www.oilfund.az/index.php?n=165> (Last Accessed, May 24, 2008)

¹⁵⁸ Bagirov S., Akhmedov I., Tsalik S., “State Oil Fund of the Azerbaijan Republic” in Tsalik S., Ebel R., “Caspian Oil Windfalls: Who Will Benefit?”, Open Society Institute, 2003, pg 115

¹⁵⁹ Ibid

¹⁶⁰ Bagirov S., Akhmedov I., Tsalik S., “State Oil Fund of the Azerbaijan Republic” in Tsalik S., Ebel R., “Caspian Oil Windfalls: Who Will Benefit?”, Open Society Institute, 2003, pg 119

¹⁶¹ Ibid, 119

3.6 Conclusion

This chapter highlights the historical importance of oil in Azerbaijan. Due to lack of references and statistics the chapter takes a brief look only at Azerbaijan's oil industry during the USSR without being able to provide deeper research. It provides some numbers that show the importance of Azerbaijan's oil industry for the Soviet Union. In addition, stating that the collapse of the oil industry of Azerbaijan in early 1990's was a legacy of the U.S.S.R's collapse when Azerbaijan has lost its trade partners, mainly Russia.

Additionally, the chapter provides the brief summary of the major oil contracts of Azerbaijan during its independence years and highlights challenges to the oil industry and shows the lack of infrastructure and the legal dispute over the Caspian Sea statues as two key impediments for the oil industry in Azerbaijan back in 1990's. Oil contracts were the major events that affected both political and economic situation in Azerbaijan back then. Politically oil contracts meant "recognition" of the regime, which is undemocratic. Economically these contracts laid the grounds for economic prosperity of Azerbaijan in the mid-term range.

The last section of the chapter provided background and some data about the State Oil Company and State Oil Fund of Azerbaijan. The importance of these two institutions can not be neglected in the management of Azerbaijan's oil wealth. Azerbaijan's future path and the solution of current problems, such as corruption, depend on these institutions attitude and behaviour towards managing the oil revenues. Both these institutions are responsible for lack of transparency, and accountability in the oil industry of Azerbaijan, hence they play major role in existence of corruption not just in oil industry but also in entire country.

Chapter 4- Is oil a curse or blessing for Azerbaijan?

4.1. Introduction

This last chapter of the thesis summarizes and analytically demonstrates based on what has been writing before to what extent Azerbaijan shows various symptoms of a country where oil is a curse. The main hypothesis of the chapter is as mentioned in the introduction of the work is that Azerbaijan does not seem to be able to avoid problems that can classify oil as a curse.

4.2 Political Developments

This section will analyze political developments and challenges in Azerbaijan in relation with oil. The purpose is to point out whether oil has/had any connection with the current political situation in Azerbaijan. First, sub-section is devoted to political instability in the early years' of independence caused by ethnic movements. Second, sub-section analyzes oil's impact on corruption in Azerbaijan to point whether presence of corruption can be linked to oil. The last sub-section analyzes oil's impact on current political system of Azerbaijan. All three above mentioned cases are related to oil as being a curse. As it can be seen from the first chapter, scholars argue that oil can cause conflicts within an oil rich country hence challenge territorial integrity. In turn, it can result in weak political and economic situation. Furthermore, oil rich countries have higher corruption and rent seeking. In addition oil and democracy do not match.

4.2.1 Oil's Role in Civil Strives in Azerbaijan

As Ross¹⁶² points out there is not just connection but also a causal link between oil and civil war. In Azerbaijan currently, there is only one national problem related to ethnic issues and territorial claims. It is Nagorno-Karabakh dispute with Armenia. This sub-section does not talk about pre-history or the consequences of the conflict rather it shows that oil had no role in existence of the conflict. The conflict started in 1988 with local tensions between Azerbaijanis and Armenians in Nagorno Karabakh itself. Nagorno-Karabakh is located in the South-West of Azerbaijan and there are no oil fields. And considering that the most of Azerbaijan's oil fields are offshore, this conflict can not be seen as a conflict between oil-rich regions. However, current oil boom allows Azerbaijan to expand its military expenditure compared with oil-poor Armenia. As Fuller notes, "the President Ilham Aliyev announced that defence expenditures has increased in 2005 to US \$300 million announced compared to US \$175 million in 2004, and would double in 2006 to reach US \$ 600 million."¹⁶³

Another ethnic problem for Azerbaijan was Lezgin independence claims. According to Fuller "lezgins are Caucasian Muslim people numbering almost one million who live on the territories of Southern-Dagestan (Russian Federation) and North-Eastern Azerbaijan."¹⁶⁴ In 1991, the Lezgin started to claim an independence from Azerbaijan and hence reunification with Southern-Dagestan. Although it did not happen to due some political reasons, once

¹⁶² Ross M., "How Does Natural Resource Wealth Influence Civil War?" Unpublished paper, 2002. Available at <http://www.polisci.ucla.edu/faculty/ross/HowDoesNat.pdf> (Last Accessed May 23, 2008)

¹⁶³ Fuller, L., "Azerbaijan: Military Has No Cash, but No Security Doctrine", February, 2006

¹⁶⁴ Fuller E., "Azerbaijan at the Crossroads", Post Soviet Business Form, 1994, pg 28.

again this dispute can not be correlated to oil in Azerbaijan. It was a matter of ethnic issue rather than economic incentives.¹⁶⁵

The last ethnic tensions caused by Talish people's claim for Talish-Mugan Republic in early 1990's. The Talish are an Iranian ethnic group, and speak Iranian language which is different from Azerbaijani. As in the case of other small ethnic minorities, the Talish were deprived of cultural rights, such as schooling in their own language etc. This discrimination resulted in separatist sentiments. However, in 1993 Heydar Aliyev was able to mobilize the local Talish population in favour of Azerbaijan and arrest the separatist leader Gumbatov.¹⁶⁶ Once again as in other cases, this civil tension in Azerbaijan was a result of ethnic issues rather than oil. The Talish separatist movement claimed independence from Azerbaijan in order to be able to exercise their own cultural and ethnic rights.¹⁶⁷

4.2.2 Oil and Political System in Azerbaijan

It is not a secret that Azerbaijan's political regime is considered to be an authoritarian or at least to the extent where "government continues to rely on authoritarian regime."¹⁶⁸ As it is discussed in Chapter 2, due to political and economic instability in mid 1990's there was a need for a "strong hand" in Azerbaijan, and Heydar Aliyev was the one who took advantage of such situation, hence an authoritarian regime was established in the country. Oil was not directly linked to the establishment of such regime. However, major oil contracts mentioned in Chapter 3, allowed for an international "legitimization" of Aliyev's regime starting from 1994, when the first oil contract was signed. By signing oil contracts foreign companies from the United States, France, United Kingdom, Turkey, Norway and etc. politically supported

¹⁶⁵ Fuller E., "Azerbaijan at the Crossroads", Post Soviet Business Form, 1994, pg 28

¹⁶⁶ Ibid, 28

¹⁶⁷ Ibid, 29

¹⁶⁸ Freedom House, http://www.freedomhouse.hu/images/fdh_galleries/NIT2007final/nit-azerbaijan-web.pdf

Heydar Aliyev's regime. Therefore, even though the factor of oil did not create undemocratic regime, it helped to legitimize such regime.

The current president of Azerbaijan Ilham Aliyev, the son of Heydar Aliyev, was elected as a president of Azerbaijan in October of 2003. He enjoys high public support and was able to "sustain political and economic stability thanks to a high level of economic growth related to oil revenues."¹⁶⁹ Therefore, high oil revenues and growth allows Ilham Aliyev to strengthen the existing political regime, as a successor of his father. Therefore, it is hard to believe that he will lose the upcoming elections in October, 2008. Indeed, Economic Intelligence Unit reports that:

'Ilham Aliyev, will remain the dominant figure on Azerbaijan's political scene during the 2008-09 period. Azerbaijan's growing oil wealth will enable Aliyev to increase expenditure on wages and infrastructure, allowing him to claim that he is distributing the benefits of the oil boom. *The president will also use the oil windfall to maintain the patronage network that rewards loyal members of the political elite for their support, fostering cronyism and corruption.* Ensuring the continuing loyalty of the political elite in the run-up to the next presidential election, which will be held on October 15th 2008, will be Mr Aliyev's main aim in the short term. In this he is likely to be successful, and he will win a second term of office.'¹⁷⁰

Early years of independence in the case of Azerbaijan puts the country within Schubert's hypothesis that the political and economic heritage before oil windfall could affect establishment of the current political regimes.¹⁷¹ Hence, oil can not be fully accountable for creation of an authoritarian regime in Azerbaijan, but only for 'legitimization' of such regime.

¹⁶⁹ Nazli K., "Azerbaijan", Freedom House, http://www.freedomhouse.hu/images/fdh_galleries/NIT2007final/nit-azerbaijan-web.pdf, Last Accessed May 30, 2008, pg 107

¹⁷⁰ Economic Intelligence Unit, Azerbaijan Country Profile, 2008
http://www.eiu.com/index.asp?layout=displayIssueArticle&article_id=1933297778

¹⁷¹ Schubert R. S., "Revisiting The Oil Curse: Are oil rich nations really doomed to autocracy and inequality?", Oil and Gas Business 2006

In the case of current regime, oil revenues can be seen as a way for strengthening Ilham Aliyev's regime. Therefore, oil in terms of political system can be seen as a curse for Azerbaijan.

4.2.3 Oil and Governance

According to the Constitution of Azerbaijan Republic, Azerbaijan is a unitary state. Constitution provides the separation of powers between legislative, judiciary and executive branches. Constitution also proclaims the people of Azerbaijan as a source of power, furthermore gives the people right to decide their own fate and form of governance.¹⁷² However, in practice all power is vested in the president.

The parliament, Milli Majlis, does not have a deciding vote in the country's decision-making process. Judicial branch is dependant on the parliament and the president. Judges are appointed by the parliament, on the recommendation of the president.¹⁷³

Hence, there is a strong presidential system in Azerbaijan. The president has the authority over all other branches of the power. The president appoints local executives officers. Therefore, local governance of Azerbaijan is considered to be undemocratic.¹⁷⁴

Similarly, EUI reports:

'Azerbaijan's personality-centred, clan-based political system"with power concentrated in the presidency"has ensured that political parties play only a limited role in decision-making. Founded by former communist supporters of Heydar Aliyev in 1992 and now led by his son, Ilham Aliyev, the New Azerbaijan Party is the country's main political organisation, holding all the main positions in the

¹⁷² Constitution of Azerbaijan Republic, Article 1, 2, 7

¹⁷³ Economic Intelligence Unit, Azerbaijan Country Profile, 2008
http://www.eiu.com/index.asp?layout=displayIssueArticle&article_id=1933297778, pg 10

¹⁷⁴ The Freedom House, Azerbaijan Country Report, 2007
http://www.freedomhouse.hu/images/fdh_galleries/NIT2007/azerbaijan_not%20final%20ltrs%20ed.pdf

executive branch, and the largest number of seats in parliament. It acts more as a vehicle for the Aliyev family to dominate Azerbaijan's electoral politics than as a traditional political party.'¹⁷⁵

At first glance, such pattern can be considered usual for a post-Soviet state and for authoritarian regime. However, the case with Azerbaijan is slightly different because of its oil factor. As Tsalik and Ebel point out while talking about hazards of petroleum wealth for Azerbaijan and Kazakhstan:

'The centralization and democracy-dampening tendencies of petroleum development are likely to undermine the already uneven progress toward democracy in these countries. The lack of transparency, absence of separation of powers, political discretion afforded the president's administration, and unclear property rights in countries such as Azerbaijan and Kazakhstan make it extremely easy for the kind of patronage politics to emerge that characterize economies such as those of Saudi Arabia, Venezuela, and Nigeria. Weak governance makes these countries less likely to convert social expenditures into improved outcomes. At the same time, the abundance of oil revenues removes the incentive to improve governance. The weakness of parliament, the judiciary, and political parties provides few checks on the ability of powerful interest groups to capture the state.'¹⁷⁶

Therefore, it is possible to say that oil has a significant share in strong centralized power in Azerbaijan. Because oil revenues are collected by the central government and foreign oil companies usually are in favour of working with strong central government, hence oil production often overlaps with the strengthening of executive branch and the weakening of any opposition in the country. This is the pattern of Azerbaijan, where the president has unlimited power, while parliament and judiciary branches are limited in their decision-making role, and civil society is weak.¹⁷⁷

¹⁷⁵ Economic Intelligence Unit, Azerbaijan Country Profile, 2008
http://www.eiu.com/index.asp?layout=displayIssueArticle&article_id=1933297778, pg 11

¹⁷⁶ Tsalik S., Ebel R., "Caspian Oil Windfalls: Who Will Benefit?", Open Society Institute, 2003, pg 11

¹⁷⁷ Tsalik S., Ebel R., "Caspian Oil Windfalls: Who Will Benefit?", Open Society Institute, 2003, pg 11

In conclusion, it can be said that as long as there is oil factor, it is less likely that Azerbaijan will have democratic regime, because prospects for democracy such as strong governance are slim. Continuing oil boom ensures the current system to be more consolidated and stable thanks to economic growth.

4.2.4 Oil and Corruption in Azerbaijan

Transparency International ranks Azerbaijan among top corrupted countries in the world.¹⁷⁸ The fact that Azerbaijan is among top corrupted countries proves the hypothesis of Mauro¹⁷⁹, Leite and Weidmann¹⁸⁰ that corruption is mostly linked to the presence of natural resources. For example, two neighbouring countries of Azerbaijan with no oil, or other significant natural resources, Georgia and Armenia were ranked as 99th and 93rd respectively in 2006, while Azerbaijan was 130th among 163 countries. In 2007, Georgia was 79th most corrupted country, Armenia 99th, while Azerbaijan's position was 150th among 179 countries.¹⁸¹

On the other hand, existence of corruption in Azerbaijan can not be directly related to oil. At least, because corruption is not a new phenomenon for Azerbaijan, it existed during the U.S.S.R's regime. Therefore, it can be related to the legacy of the Soviet Union. But still, as mentioned in the report of Committee of Oil Industry Worker's Rights Protection, SOCAR is

¹⁷⁸ Transparency International, Corruption Perception Indices for Azerbaijan

¹⁷⁹ Mauro P. "Corruption and Growth", Quarterly Journal of Economics, Vol. 90, 1995

¹⁸⁰ Leite C., Weidmann J., "Does Mother Nature Corrupt? Natural Resources, Corruption and Economic Growth", IMF Working papers WP/99/85, July 1999

¹⁸¹ Transparency International, Corruption Perception Indices for 2006, 2007

http://www.transparency.org/policy_research/surveys_indices/cpi/2007

http://www.transparency.org/policy_research/surveys_indices/cpi/2006

the central point of corruption in Azerbaijan.¹⁸² Therefore, the oil can be seen as a major determinant of corruption in Azerbaijan.

4.3 Economic Developments

This section highlights economic developments of Azerbaijan directly or indirectly related to oil. The purpose of doing so is to examine whether oil is an economic curse or blessing for Azerbaijan. Due to data limitation, most of the time series will cover the period starting from the year of 2000. Although short time series is a limitation of this paper, significant changes in the economy of Azerbaijan started to happen approximately that year.

4.3.1 Growth in Azerbaijan

In the last few years, due to increasing oil prices and oil revenues Azerbaijan's economy is the fastest growing economy in the world with Gross Domestic Product growth of 26% in 2006, 34% in 2007, and with estimated growth of 30% in 2008.¹⁸³ GDP was US \$ 13.2 billion in 2005, reached US \$ 20 billion in 2006 and US \$ 30 billion in 2007. In turn, growth of total GDP increased GDP per capita which was US \$ 3473.9 in 2007 compared to US \$ 2508.5 in 2006 and US \$ 1600.4 in 2005.¹⁸⁴

Such growth rates of the GDP have positive and negative effects on the population. It raised the population income and enhanced the population expenditure and increased savings, and improved living standards¹⁸⁵ Thanks to such growth rates poverty decreased to 50% in 2001

¹⁸² The Committee of Oil Industry Workers' Rights Protection, "Report on Corruption in Azerbaijan Oil Industry prepared for EBRD & IFC Investigation Arms", Azerbaijan, October 2003

¹⁸³ Economic Intelligence Unit, Azerbaijan Country Profile, 2008

http://www.eiu.com/index.asp?layout=displayIssueArticle&article_id=1933297778,

¹⁸⁴ The State Statistical Committee of the Republic of Azerbaijan "Azerbaijan in Figures 2008" Seda Press, Baku 2008

¹⁸⁵ Ibid

compared to 68% in 1995.¹⁸⁶ Furthermore, poverty is 16% in 2008 as president Ilham Aliyev claims¹⁸⁷.

However, such supply of money caused Azerbaijan's budget has increased five times, which causes some challenges, such as increased government expenditure, inflation, appreciation of the national currency.¹⁸⁸ Expansion in government expenditure increased inflation which reached 16.7% in 2007.¹⁸⁹ This inflation rate is the highest rate since 1996, when Azerbaijan's government under the supervision of IMF followed monetary policies to bring down hyperinflation. (See Chapter 2)

4.3.2 Oil Industry

Due to oil boom the share of oil industry in total industry is growing on yearly basis. In 2004 it was 50.7%, 55.2% in 2005, 61% in 2006%, 68% in 2007%. Foreign investments into oil industry increased and reached US \$ 4176.3 million in 2007 compared to US \$ 3422.3 million in 2006¹⁹⁰. Such investment rates "enhanced oil production and export capacity".¹⁹¹ The development of oil sector increased Azerbaijan's exports and imports. According to EUI report "total exports are estimated to have risen by more than 30% in volume terms in 2007, and imports grew by an estimated annual average of 20% in 2003-07, as a result of the need for capital goods and, as wages and household incomes have risen, consumer imports. Government consumption has expanded rapidly as oil-related revenue has risen."

¹⁸⁶ The State Statistical Committee of the Republic of Azerbaijan "Azerbaijan in Figures 2008" Seda Press, Baku 2008; World Bank Data

¹⁸⁷ Day.az reports with reference to the press service of president Ilham Aliyev <http://www.today.az/news/business/43945.html> (Last Accessed May 31, 2008)

¹⁸⁸ The State Statistical Committee of the Republic of Azerbaijan "Azerbaijan in Figures 2008" Seda Press, Baku 2008

¹⁸⁹ Ibid

¹⁹⁰ Ibid

¹⁹¹ Economic Intelligence Unit, Azerbaijan Country Profile, 2008 http://www.eiu.com/index.asp?layout=displayIssueArticle&article_id=1933297778

Such development of oil sector increased its share in Azerbaijan's total exports. In 2006, the share oil sector in exports was 84%.¹⁹² However, even there is an oil boom, it does not positively affect unemployment in Azerbaijan. Because, the oil sector is not the biggest employer in the economy. Its share of employment is only 1.1 % as a share of total employed population. The major employer in Azerbaijan is agriculture sector where 38.8% of total occupied employees are working.¹⁹³

The indicators of this section show that oil boom makes Azerbaijan more and more dependent on oil industry, which can be seen as an initial symptom of curse unless the economy is more diversified.

4.3.3 Non Oil Sector

This section analyzes pattern of Azerbaijan's non oil sector as a result of oil boom in the country. It is important in order to see whether Azerbaijan's economy is being diversified thanks to oil boom, even though it is becoming more and more dependent on oil, or not. After the oil sector, two important sectors, in the economy of Azerbaijan, are agriculture and manufacturing.

4.3.3.1 Agriculture

As mentioned above, agriculture is the major employer in Azerbaijan which involves 38.8% of total employees in the country.¹⁹⁴ Early in 1990's its contribution to overall GDP was 30%. However, now days, it does not satisfy domestic needs, hence is a subject of governmental subsidies.¹⁹⁵ Its share in GDP started sharply to decrease from 2000 when it

¹⁹² The State Statistical Committee of the Republic of Azerbaijan "Azerbaijan in Figures 2008" Seda Press, Baku 2008

¹⁹³ The State Statistical Committee of the Republic of Azerbaijan "Azerbaijan in Figures 2008" Seda Press, Baku 2008

¹⁹⁴ Ibid

¹⁹⁵ Economic Intelligence Unit, Azerbaijan Country Profile, 2008
http://www.eiu.com/index.asp?layout=displayIssueArticle&article_id=1933297778

accounted to 15.9% of overall GDP to only 5.9% in 2007.¹⁹⁶ In turn, agricultural output decreased. Such decrease can be explained by two factors such as “structural inefficiencies in the sector and rapid development of the oil sector.”¹⁹⁷ Although it is a second exporter in Azerbaijan, due to production decrease agricultural exports have decreased and accounted for 8% of total export revenues in 2007.¹⁹⁸

It is obvious that the oil boom and increase in the oil production, negatively affects the agricultural sector of Azerbaijan. Azerbaijan pretty soon might become completely dependent on imports of agricultural products, if government does not diversify oil revenues to boost the agricultural sector.

4.3.3.2 Manufacturing

As in the case with agriculture, the manufacturing output has fallen in the last few years. As a part of industry manufacturing accounted for 29.9% of total industry in 2002, in 2007 this number became 24.9%. Similarly output of manufacturing decreased to 22% of total industrial output in 2007. Respectively, the share of manufacturing as a share of total GDP decreased from 7.4% in 2002 to 5.3% in 2007.¹⁹⁹ The above mentioned data shows that dependence on oil sector did not lead to positive consequences for manufacturing, which proves again that Azerbaijan’s economy is becoming less diversified and more concentrated on oil industry.

¹⁹⁶ The State Statistical Committee of the Republic of Azerbaijan “Azerbaijan in Figures 2008” Seda Press, Baku 2008

¹⁹⁷ Economic Intelligence Unit, Azerbaijan Country Profile, 2008
http://www.eiu.com/index.asp?layout=displayIssueArticle&article_id=1933297778

¹⁹⁸ Ibid

¹⁹⁹ The State Statistical Committee of the Republic of Azerbaijan “Azerbaijan in Figures 2008” Seda Press, Baku 2008

4.4 National Currency (Manat)

Azerbaijan managed to keep its national currency stable between the years 1995-1998 thanks to tight monetary policies pursued under the supervision of IMF. However, in 1998 financial crisis in Russia put negative pressures on manat. Due to this, in 1999 the government decided to intervene and 7% depreciation was initiated.²⁰⁰

Additionally, manat depreciated by 30% against US dollar due to low inflation and artificial depreciation of manat by the National Bank of Azerbaijan between the years 1999-2004.

However, increasing inflation due to huge oil revenues, hence supply of foreign currency caused appreciation of manat against US dollars by 10% in 2007. Such appreciation decreases the competitiveness of non oil sector products. The lack of competitiveness might lead to disappearance of non-oil sector.²⁰¹

4.5 Trade

The first trade balance surplus was achieved by Azerbaijan in the year of 2000. After Baku-Supsa pipeline allowed transporting the oil into world markets. In the last few years, Azerbaijan has positive trade balance thanks to oil exports. However, there was again a deficit in 2003, because to Azerbaijan had to import large amounts of equipment and capital to expand its offshore oil fields. Since then Azerbaijan has only trade balance surplus thanks to increased oil prices and increased capacity of the major export pipelines. Both exports and imports of Azerbaijan are conquered by oil and oil related capital goods. However, recently due to decrease of agricultural sector, imports of consumer goods have been increasing.

²⁰⁰ Economic Intelligence Unit, Azerbaijan Country Profile, 2008
http://www.eiu.com/index.asp?layout=displayIssueArticle&article_id=1933297778

²⁰¹ Ibid

The second major exports, after oil, belong to foodstuff, metal, chemicals and plastics. But in 2007, chemical and plastics share in export revenues dramatically decreased as a result of being non-competitive in the world markets.

Azerbaijan is mostly an oil exporter country; therefore its import sector is becoming more diversified and its share has been increasing as a result of inefficiency and non-competitiveness of non- oil sector.²⁰²

4.6 The “Dutch Disease”

This section summarizes findings of above written sections and sub-sections and compares them with symptoms of ‘Dutch Disease’ in order to see if Azerbaijan is having symptoms of ‘Dutch Disease’.

As mentioned in Chapter 1, this disease is associated with Netherlands, which faced high inflation, currency appreciation and decline of non-oil sectors as a result of non-competitiveness. Therefore, the country did not have economic growth.

Corden and Neary²⁰³ argued that ‘Dutch Disease’ can be associated with currency appreciation, increase in imports, with resource export sector outrunning the traditional export sector, diversification of capital from other sectors into resource export sector.

Which symptoms does Azerbaijan have?

1. Strong national currency as a result of appreciation caused by large oil revenues.

²⁰² Economic Intelligence Unit, Azerbaijan Country Profile, 2008
http://www.eiu.com/index.asp?layout=displayIssueArticle&article_id=1933297778

²⁰³ Corden M., Neary J.P., “Booming Sector and De-industrialization in a Small Open Economy”, *Economic Journal* 92

2. High Inflation which was reached 16.7% in 2007²⁰⁴
3. Rapidly developing oil sector, and diminishing agriculture, manufacturing sectors.
4. Sharp increases in oil exports outrun traditional export sectors.
5. Increase in imports of consumer goods and products, as a result of non oil sector being non-competitive, and diversification of capital from these sectors to oil sector

4.7 Conclusion

This chapter analyzes Azerbaijan's recent political and economic developments from the lenses of 'Resource Curse'. The aim was to examine these developments and to determine oil's role in Azerbaijan in order to be able to accept or reject the hypothesis that Azerbaijan does not seem to be able to avoid problems that can classify oil as a curse.

With respect to political performance of Azerbaijan oil can be considered as a curse. However, political stability achieved by such system is an advantage for Azerbaijan in order to attract foreign investments and boost its economy.

From economic point of view, oil did increase incomes of population, improved live standards, and reduced poverty. However, it is evident that Azerbaijan is having symptoms of 'Dutch Disease' which is associated with oil boom and large supply of oil revenues. The symptoms of 'Dutch Disease' will be more visible and furious after oil boom ends. Because

²⁰⁴ Inflation Report, National Bank of Azerbaijan www.nba.az/default.aspx?go=173&lng=en (Last Accessed May 22, 2008)

according to forecasts of the Ministry of Economic Development of Azerbaijan in 2012 GDP will start to decrease as a result of decline in oil production.²⁰⁵

²⁰⁵ Ministry of Economic Development of Azerbaijan, “2008-2011 ci iller ucun Azərbaycan Respublikasının esas makroiqtisadi proqnoz gostericileri” <http://www.economy.gov.az/Catalogs/files/file1207199747729.xls> (last accessed on May 30, 2008)

Conclusion

In chapter 1, the work highlights important parts and finds of literature related to ‘Resource Curse’ and its political and economic consequences. The chapter highlights that oil and oil revenues can lead to economic and political instabilities, if not managed properly. Therefore, as Schubert notes what matters most is not the inherent character of the oil itself but how wealth generated by petroleum is shared and utilized.²⁰⁶ Hence, the existence of oil, can not either harm nor benefit a country. At the end of the day, it depends on a government and its behavior. Government decides how to deal with oil and revenues.

Chapter 2 gives a brief political and economic background of Azerbaijan in order to highlight the early years of independence. Furthermore, the chapter points out that political instability was a result of the U.S.S.R’s collapse, the lack of political unity between pro-communist Mutallibov and nationalist Popular Front and of course the war with Armenia over Nagorno Karabakh. This political instability and poor macroeconomic policies led to macroeconomic insecurity, including hyperinflation in early 1990’s.

Chapter 3 shows the position of oil and oil industry in Azerbaijan from historical, political and economic perspective. It points out major oil contracts of Azerbaijan during its independence years as the major events in the oil industry and highlights challenges to the oil industry and shows the lack of infrastructure and the legal dispute over the Caspian Sea statues as two key impediments for the oil industry in Azerbaijan back in 1990’s.

²⁰⁶ Schubert R. S., “Revisiting The Oil Curse: Are oil rich nations really doomed to autocracy and inequality?”, Oil and Gas Business 2006, pg 22

Finally, chapter 4 summarizes and analyzes what was written in previous chapters and provides some empirical background on the recent political and economic background to see how oil affects Azerbaijan with a purpose of analytically testing that hypothesis of the thesis. The findings of the chapter do not give enough evidence to state that Azerbaijan avoided the ‘resource curse’. Therefore, the hypothesis that Azerbaijan does not seem to be able to avoid problems that can classify oil as a curse holds, unless significant positive political progress and economic diversification happen in near future.

Appendix

Table 1

Corruption Perception Index (CPI)

Ranking and Score of Azerbaijan

Year	CPI Score	Rank	Number of Countries Surveyed
1999	1.7	96	99
2000	1.5	87	90
2001	2	84	91
2002	2	95	102
2003	1.8	124	133
2004	1.9	140	145
2005	2.2	137	158
2006	2.4	130	163
2007	2.1	150	179

Source: Transparency International

Table 2

Gross Domestic Product (GDP)

Year	Mln.manat	Mln.US \$
1995	2133.8	2415.2
1996	2732.6	3180.8
1997	3158.3	3960.7
1998	3440.6	4446.4
1999	3775.1	4583.7
2000	4718.1	5272.8
2001	5315.6	5707.7
2002	6062.5	6235.9
2003	7146.5	7276
2004	8530.2	8680.4
2005	12522.5	13238.7
2006	18746.2	20983
2007	25228.1	29399.9

Source: The State Statistical Committee of the Republic of Azerbaijan "Azerbaijan in Figures 2008"
Seda Press, Baku 2008

Table 3

Gross Domestic Product Per Capita

Year	Manat	US \$
1995	282.1	319.3
1996	357.5	416.1
1997	409.2	513.2
1998	441.5	570.6
1999	480.1	582.9
2000	595.1	665.1
2001	665.2	714.3
2002	752.9	774.4
2003	880.8	896.8
2004	1042	1060.3
2005	1513.9	1600.4
2006	2241.1	2508.5
2007	2980.9	3473.9

Source: The State Statistical Committee of the Republic of Azerbaijan "Azerbaijan in Figures 2008"
Seda Press, Baku 2008

Table 4

Consumer Price Indices

Year 2000=100

	General indices	Food, beverages and tobacco	Non-food stuff	Services
2001	101.5	102.7	100.2	98.8
2002	104.4	106.5	102.4	98.6
2003	106.7	109.9	103.5	98.3
2004	113.9	120.9	105	99.1
2005	124.7	134.1	110.7	108.7
2006	134.9	150.2	116.4	111.5
2007	157.7	174.6	120.5	114.5

Source: The State Statistical Committee of the Republic of Azerbaijan "Azerbaijan in Figures 2008"
Seda Press, Baku 2008

Table 5

Inflation Rate

Year	Annual Inflation Rate
2005	5.4
2006	11.4
2007	16.7

Source: Inflation Report, National Bank of Azerbaijan

Table 6

Economic Activity as a share of GDP

Year	2000	2002	2003	2004	2005	2006	2007
Agriculture,							
hunting and related services	15.9	13.8	12.2	10.8	9	6.7	5.9
Industry-total	36	37.4	37.2	38.3	47.5	57.3	59.1
Crude oil and gas extraction							
and services related	27.6	28.8	27.5	29	39.4	50.8	52.8
Manufacturing	5.3	7.4	8.6	8.3	7.2	5.8	5.3
Other	51.2	50	51.7	51.9	55.6	36.7	64

Source: The State Statistical Committee of the Republic of Azerbaijan "Azerbaijan in Figures 2008"
Seda Press, Baku 2008

Table 7

Exports of Oil Products in 2002-2006

Years	Exports of oil products		
	Quantity, thsd. ton	Value, millions US dollar	The share of exports %
2002	11536.6	1901.9	87.8
2003	10951.8	2212.4	85.4
2004	11500.9	2962.2	81.9
2005	9033.1	3308.6	76.1
2006	12434.4	5354	84

Source: The State Statistical Committee of the Republic of Azerbaijan "Azerbaijan in Figures 2008"
Seda Press, Baku 2008

Table 8

Sectoral Structure of Industry

(As Percentage of Total)

Year	2000	2002	2003	2004	2005	2006	2007
All Industry	100	100	100	100	100	100	100
Extractive Industry	53.5	55.6	52.6	50.7	55.2	61	68
Manufacturing Industry	31.3	29.9	31.5	34.2	32.8	29	24.9
Production and Distribution of Electricity, Gas and Water	15.2	14.5	16	15.1	12	10	7.1

Source: The State Statistical Committee of the Republic of Azerbaijan "Azerbaijan in Figures 2008"
Seda Press, Baku 2008

Table 9

Number of Economic Active Population in Percentage

	2000	2002	2003	2004	2005	2006	2007
Economically active population, total	100	100	100	100	100	100	100
Total employed persons	98.8	98.7	98.6	98.6	98.6	93.2	93.5
Registered, unemployed	1.2	1.3	1.4	1.4	1.4	1.3	1.2

Source: The State Statistical Committee of the Republic of Azerbaijan "Azerbaijan in Figures 2008" Seda Press, Baku 2008

Table 10

Employment by kind of economic activities

	2000	2003	2004	2005	2006	2007	In percent to total
Occupated in economy, total	3704.5	3747	3809.1	3850.2	3973	4014.1	100
Agriculture, hunting and forestry	1517.2	1497	1502.7	1510	1548	1556	38.8
Fishing	2	2.8	3.3	3.8	4.3	4.3	0.1
Extractive Industry	39.6	42.3	41.9	42.2	45	45	1.1
Manufacturing	169.3	169.9	181.2	188.7	195	198.4	4.9

Source: The State Statistical Committee of the Republic of Azerbaijan "Azerbaijan in Figures 2008" Seda Press, Baku 2008

Table 11

Exchange Rate of manat in National bank of Azerbaijan
(At the end of the year; manat as unit of national currency)

Foreign currency	2000	2003	2004	2005	2006	2007
1 USD	0.91	0.98	0.98	0.92	0.87	0.84

Source: The State Statistical Committee of the Republic of Azerbaijan "Azerbaijan in Figures 2008" Seda Press, Baku 2008

Table 12

Poverty

Year	Poverty (% of population)
1995	68
2001	50

Source: World Bank Data

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