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Power Politics and Oil as Determinants
of Transition: The Case of Azerbaijan

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Juhani Laurila*

Power Politics and Oil as Determinants of Transition: The Case of Azerbaijan

“War and oil are the two greatest corrupters known to modern man.”

–Thomas Goltz, *Azerbaijan Diary*, page xix.

“We used oil for our major goal ...to become a real country.”

–Ilham Aliyev, *vice president of State Oil Company of Azerbaijan Republic (SOCAR) and son of the president of Azerbaijan*.

Abstract

Azerbaijan is a post-socialist transition country affected by regional tensions similar to those found in Armenia, Georgia, Tajikistan, Macedonia and Croatia. This article examines the historical background of a specific source of tensions, namely the Nagorno-Karabakh issue, its legacies and significance for the economic transition of Azerbaijan. The Azerbaijani economy has been among those to suffer most after the demise of the Soviet Union. These legacies underlie Azerbaijan's current situation whereby macroeconomic policies and structural reforms are driven by developments in exploration and exploitation of the Caspian hydrocarbon resources. The author finds evidence that economic and commercial cooperation can reduce political risks and discourage nationalistic power politics both in domestic and international contexts.

A firm and continuing commitment by the Azerbaijani government to pursue the process of economic transition combined with peace and stability in the region is necessary for the progress of transition. The rate of reform appears to be critical for the transition process in Azerbaijan and the Caucasus generally. Rapid economic growth fuelled by the expected influx of oil revenues could find Azerbaijan ill prepared to lock in the quality and sustainability of such economic growth. Subsequent papers in this series will deal with the implications for economic development, process of transition, structural reforms in Azerbaijan.**

The historical analysis brings up some interesting parallelisms with the ones seen in the recent Balkan crisis.

Keywords: Azerbaijan, oil, international organizations, transition economies

List of abbreviations

ADP	Asian Development Bank
AET	Azerbaijan Economic Trends
AIOC	Azerbaijan International Operating Company
AzSSR	Azerbaijan Soviet Socialist Republic
BOFIT	Bank of Finland, Institute for Economies in Transition
BP	British Petroleum
CFE	Conventional Forces in Europe (Treaty)
CIPCO	Caspian International Petroleum Company
CIS	Commonwealth of Independent States
CMEA	Council for Mutual Economic Assistance
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECU	European Currency Unit
EFF	Extended Fund Facility
ESAF	Enhanced Structural Adjustment Facility
EU	European Union
FDI	Foreign Direct Investment(s)
GDP	Gross Domestic Product
HRW	Human Rights Watch
IDP	Internally displaced person
IEA	International Energy Agency
IMF	International Monetary Fund
INOGATE	Inter-State Oil and Gas to Europe
KGB	Komitet Gosudarstvenny Bezopasnosti (State Security Committee of the USSR)
MEP	Main Export Pipeline
MVD	Ministerstvo Vnutrennykh Del (Ministry of Interior of Russia)
NATO	North Atlantic Treaty Organization
NIOC	National Iranian Oil Company
NIS	New Independent States
NKAO	Nagorno-Karabakh Avtonomicheskaya Oblast (Nagorno-Karabakh Autonomous Region)
OSCE	Organization for Security and Cooperation in Europe
PCA	Partnership and Cooperation Agreement
PSA	Production Sharing Agreement
SOCAR	State Oil Company of Azerbaijan Republic
STF	Systemic Transformation Facility
Tacis	Technical Assistance for the CIS
TRACECA	Transport Corridor Europe Caucasus Asia
UK	United Kingdom
UN	United Nations
US	United States
USA	United States of America
USD	US dollars
USSR	Union of Soviet Socialist Republics
WTO	World Trade Organization

1 Introduction

The historical past, the political present and a future of great promise characterises economic transition in Azerbaijan. This paper looks in detail the political and historical constraints and opportunities available to the Azerbaijani government as it oversees the process of transition from the Soviet Union's centrally planned command economy to a market economy based on private initiative.

The Azeris, originally from Persia, were Turkified by the 9th century. The Azeris have lived always under foreign powers or as a divided nation. Presently, some 15-20 million Azeris live in Iran, far more than the 7.6 million population of Azerbaijan. From the 11th century until 1723 and between 1735 and 1813 the Azeris have been politically united as a part of Persia. The expansion of the Russian Empire since 1813 brought the borderline roughly to its present location in 1828 (Treaty of Turkmanchai). The Russian Revolution in 1917 brought back the Turkish army to Caucasus and an attempt was made to create an independent Transcaucasian Federation joining Armenia, Azerbaijan and Georgia. This attempt failed due to religious and ethnic animosities and the federation was dissolved and the Democratic Republic of Azerbaijan – the first secular democracy in the Muslim world - was formed on 28 May 1918 with support of the Turkish army. During its two years of independence, Azerbaijan was occupied by troops of both the Allied and Central Powers. The Red Army invaded Azerbaijan in April 1920 and Azerbaijan became a part of the Soviet Union, the AzSSR (Goltz 1998, p. 17).

The historical past comprises continuous collisions between Islam and Christianity, between the Persian-Turkish Empire and Russian-Soviet Empire. More recently in the Nagorno-Karabakh conflict of 1988-1993, Christian Armenia supported by Russia has sought lost glory of the past and compensation for the injustice they suffered against the Turks in 1915. The demise of the Soviet system has left Azerbaijan alone with huge enterprises that have no orders, but rather a legacy of environmental damage, inefficient and corrupted practices, and misconceived ideas about the 'freedoms' of free market economy. The historical background and developments culminating in the Nagorno-Karabakh conflict are further examined in section 2.

The recent availability of offshore technologies to explore and exploit oil and gas deposits under the Caspian seabed has brought international oil companies flocking to the region. The companies have promised to invest USD 40-50 billion over the next 5-10 years on the condition that there is political stability and that the regional governments allow them to do their work. This historical situation allows to the Azeris less than ten years to get themselves institutionally prepared to deal with the new situation and to figure out what kind of economic future would be best for their country. This question will be elaborated in the two other papers examining economic development and needs for a structural reform respectively. The emergence of the expected "third oil boom" is reviewed in section 3.

In an attempt to describe the status and potentials of economic transition in Azerbaijan, it is scarcely possible to ignore political developments. First, political developments determine economic potential and constraints. Second, understanding the problems of transition in post-Soviet economies implies that the effects of old Soviet legacies are identified and acknowledged. We ultimately conclude that the cooperation and partnership created through liberalised and free markets and commercialisation that pushes aside ethnic and religious conflicts, isolation and territorial demands, can be seen as a part of the transitional process. We show below that an oil-driven transition, if successfully implemented in Azerbaijan, would likely increase political stability in the Caspian region and Caucasus.

The rate and quality of the economic growth of the Azerbaijan is determined by the commitment of the Azerbaijani government to implement reforms and streamline its own activities. The fascinating issue of sustainability of economic growth and the structural reform measures necessary to save the “first generation” reform achievements must here be left to the subsequent papers. In any case, no matter how deeply the government is committed to transition, the contribution of the international organizations in the form of know-how and funds continue to be invaluable, particularly as these countries lack formal experience of a market economy. The contributions of the international organizations are described in section 4. Stability, the other prerequisite for successful transition, is endogenously determined by the policy of the Azerbaijan government, and exogenously by way of balancing the controversial energy-related geopolitical interests between the West and Russia and cultural-religious geopolitical interests between South and North. These problems are discussed in section 5.

The developments in the Southern Caucasus¹ in general, and particularly in Azerbaijan, provide interesting evidence of how attractive economic and commercial prospects and expectations can gradually override political aspirations based on ethnic or territorial claims. The lesson that Caspian commercial cooperation may deliver is that economic and commercial cooperation bring higher returns than the politics of isolation. That is, political compromise may in this case be more expedient than the use of power. Admittedly, the old political disputes probably still persist, but there is strong evidence that the prospects of commercial profits and economic growth bring people together. Thus, politicians may readily accept that economic cooperation will pave road for political compromises and stability.

2 War and Peace

Nagorno-Karabakh, or the “Mountainous Black Orchard” is a province² within Azerbaijan home to about 130 000 Armenians. This province has been a source of continued political tension since the latter part of the 1980s. For Armenia, Nagorno-Karabakh holds the key to formation of a Greater Armenia; for Russia, the possibility to restore the former Soviet-borders between the Caspian Sea and Black Sea. The price of attempts to pursue these political aspirations has been dear in terms of human suffering, death, mutilation, poverty and material losses. Yet little has changed. The question “Whose fault?” would produce name lists of political leaders that have, each in turn, expressed noble intentions to serve their country. To do this, they have made efforts to increase their power and influence by taking advantage of the deeply rooted historical antagonisms among the people of Southern Caucasus.

The list includes Mikhail Gorbachev. According to Goltz, the unfortunate idea of trying to solve the ethnic questions of Nagorno-Karabakh by giving it to Armenians was first implemented by an ill-informed Gorbachev, who introduced and designed the policy while he served in the office of general secretary of the Communist Party (Goltz 1998, pp. 67-68). During his presidency, he launched an effort to implement this policy through escalation of the conflict.

In protest of this policy, Heydar Aliyev, president of Azerbaijan since 1993, resigned his position in the Soviet Politburo in 1987. Moreover, both the Azerbaijani and Soviet governments refused Armenian requests, which triggered demonstrations in Nagorno-Karabakh and Yerevan, and provoked the Azeris into violent pogroms that killed dozens of Armenians living in Azerbaijan. Armenians allegedly provoked the Azerbaijan pogroms in 1988 and 1990 in Sumgait and Ganja in support of the Nagorno-Karabakh issue.

Russian historians generally consider that Gorbachev mistakenly thought he could “blackmail” the Caucasian republics by maintaining the ethnic contradictions and hence demonstrating the alleged need of the Soviet power as a guarantor of Soviet law and order.³ To do this, he had to keep the both republics under Soviet rule. An alternative, according to Vinnikov, would have been to introduce the Soviet jurisdiction in Nagorno-Karabakh. This would have stopped the escalation of the conflict and the Soviet Union loosening its political hold from Azerbaijan. The loss of this political hold was sealed by a further mistake by Gorbachev, the intervention of the Soviet army to the Azeri capital of Baku arranging the massacre of more than 200 peaceful civilians in January 1990 (Vinnikov 1998, pp. 262-263).

The contrast between Christian-Orthodox Russia with Armenia and Muslim Turkey-Azerbaijan has deep historical roots. Both parties have had their share in initiating and reinforcing the vicious circle of pressures, bloodshed and revenge. The Azerbaijanis can be accused of depriving the 130 000 Armenians living in the Nagorno-Karabakh of their possibilities to watch TV broadcasts from Yerevan, of their right to study Armenian history and their access to Armenian literature. The Azerbaijani government, too, can be said to have conducted racial, cultural and economic discrimination against the Nagorno Karabakh Armenians. Over 80 000 Nagorno-Karabakh residents signed an address asking for annexation of Nagorno-Karabakh to Armenia. Based on this address the Council of Representatives of Nagorno-Karabakh turned to Supreme Council of the USSR, Azerbaijan and Armenia with request to transfer the Nagorno-Karabakh under Armenia (Vinnikov 1998, 256-257).

The refusal of this request by both Soviet and Azerbaijani governments triggered huge demonstrations in Nagorno-Karabakh and Yerevan. Rumours that some Azerbaijani refugees leaving Armenia had been attacked led to three days of anti-Armenian violence in Baku and Sumgayit in February 1988, when, according to the official information 32 people died, most of them Armenians. The unrest continued and led to a mass exodus of refugees from both Armenia and Azerbaijan. The Soviet government made an effort to regulate the situation by establishing a special administration Committee directly responsible to the USSR Council of Ministers and dispatching 5 000 troops of the Soviet Ministry of Internal Affairs (MVD) to stabilise the situation. This solution was not satisfactory to any of the parties.

The Nagorno-Karabakh conflict escalated into a full-fledged war in 1992-1993. Some 20 000-25 000 civilians and soldiers were killed and 100 000 wounded (Goltz 1998, pp. 87, 431, 439). Between 1988 and 1994 about 750 000-850 000 Azeris were forced out of Armenia, Nagorno-Karabakh, and the seven Azeri provinces formerly inhabited overwhelmingly by Azeris but now crowded out by Karabakh-Armenians. On the other hand, pogroms and political insecurity probably forced more than 350 000 Armenians to leave Azerbaijan. In 1988, there were about 500 000 Armenians in Azerbaijan, of which about 360 000 lived in Baku. In 1994, about 10 000 Armenians, mostly spouses of mixed marriages, lived in Baku (Goltz 1998, p. xxii).

Officially both Russians and Armenians – claiming that the combat operations took place only between Nagorno-Karabakh and Azerbaijani forces - deny their participation in the military operations. However, the non-governmental organization Human Rights Watch found evidence that Armenia mobilised its regular forces. The Russians participated by providing training and material assistance. According to Russian sources (Nezavisimaya Gazeta, Moscow, 6 April 1994, p. 3) mountain troops from the 128 Regiment of the 7th Russian Army based in Armenia participated in the seizure of Kelbajar Province of Azerbaijan in a *blitzkrieg* operation starting 27 March and ending 5 April 1993. A number of mercenaries (among others the Afghani ‘mujadeens’) participated in the war operations on the both sides.

(HRW 1994, p. 8). Also other sources (van der Leeuw 1999, pp. 82-83, 86) and eyewitness evidence (Goltz 1998, pp. 247-249, 263-264, 359 and other) confirm the direct military and political involvement of the Soviet Union.

Thereafter, the issue swelled completely out of proportion.⁴ Alleged concerns about well being of 130 000 Armenians living in Nagorno-Karabakh resulted in 1.1-1.2 million Azeris and Armenians having to leave their homesteads to live in temporary camps, shelters, railway wagons and dog holes. Several thousand civilians and soldiers were killed or mutilated by the war. About 20% of Azerbaijani territory remains occupied by the Armenian forces allegedly protecting Nagorno-Karabakh from Azerbaijani artillery fire (see Map 1.1).

Map 1.1 Political map over the Caucasus



The Karabakh-Armenians assert that occupation is necessary to create a buffer zone to protect Nagorno-Karabakh against artillery fire of the Azerbaijani troops. All villages in the area have been burned; the infrastructure has been blown up and demolished. The area consists of fertile agricultural land but is now under military surveillance and full of minefields. At present, the UN and humanitarian organizations are working to alleviate the conditions of internally displaced persons trying to survive in the temporary shelters. They oversee the reconstruction of Fizuli and Agdam regions, which have been freed from occupation and cleared of mines. Although straightforward starvation has been eliminated, food aid has continued to avoid the evident risks of malnutrition in certain areas.

The attitude of the Azerbaijani government towards the resettlement of these internally displaced persons⁵ is problematic from the viewpoint of reaching a fast and humane solution to settlement of displaced persons. The government does not encourage IDPs to settle in their present whereabouts but prefers to maintain status quo until the occupied areas will be freed, cleared of mines and reconstructed for the IDPs to return. The clearing of mines and

reconstruction would take perhaps ten years after the region is freed from Armenian occupation. Basically, the IDPs are political hostages waiting for the time Azerbaijani politicians, as they repeatedly promise, bring the war to the end and return the homesteads in the occupied territories.

As there appears to be no solution to the dispute in the foreseeable future, and the prospects of a peace settlement are fading, the Armenians again find themselves allied with the Russians. Earlier it was a question of expansion or defending the empire against Turks; or it was defending Christianity (expressed in Armenian Orthodox Church) against Islam, or European civilisation against oriental Arabic-Turkoman culture. In most cases, the territory of Armenia served as a battlefield in these conflicts. For example, a major disaster took place in 1915 when the Turks, having occupied Southern Caucasus, decided to deport the entire Armenian population of about 1.75 million people to Syria and Mesopotamia. About 0.6 million Armenians died or were massacred en route. About 0.5 million Armenians avoided deportation by escaping to the West. Armenians, who ruled and inhabited vast areas of eastern Turkey, were forced back to the north behind the present Armenian-Turkish border after the Russian revolution in 1918.

The occupation of a fifth of Azerbaijan's territory represented a first step in creation of a Greater Armenia and served as compensation for part of the areas lost to the Ottoman Empire and depopulated of Armenians after 1915 (Goltz 1998, p. xxii). The loss of area consisting of a major part of eastern Turkey was sealed through peace treaty of Alexandropol (Leninakan) signed between Turkey and Armenia in 1920. This peace treaty stripped Armenia from the Kars district, which according to the treaty of Sèvres had belonged to Armenia since 1914, and moved the Turkish-Armenian border between Turkey and Armenia to its present location.

The low-profile alliance of Armenia and Russia to penetrate Azerbaijan has long traditions. As a matter of curiosity it might be mentioned that the Armenian politician Anastas I. Mikojan, later Minister of Foreign Trade of the USSR, was a key figure in the foundation of the Communist party of Azerbaijan in 1918. Mikojan was a key person in the Bolshevik terrorist group in arranging – with support of Armenian nationalists, “dashnaks”, an ethnic bloodshed in Baku 1905-1907 and soon spreading out to other towns in Azerbaijan and leaving over 600 killed (van der Leeuw 1999, pp. 70-71).⁶ The party worked as a “Fifth Column” in preparation of the Communist coup. The coup led to declaration of the Soviet Power in Baku on 28 April 1920 and annexation of Azerbaijan together with Armenia and Georgia as Soviet Republics to the USSR on 22 December 1922. The Soviet persecutions hit Azerbaijan hard. In the 1920s more than 100 000 Azeris were ‘dispatched’; in the 1930s the Azeri kulaks were ‘freed’ from their lands with the help of the Russian army and military aircraft! During the Second World War, Stalin made liberal use of the Muslim nations as cannon fodder, which meant that Azerbaijan lost over 100 000 men in that war. In 1944, Mikojan designed a plan of mass deportation of Azeris to the deserts of Kazakhstan and to incorporate Azerbaijan to Armenia (van der Leeuw 1999, pp. 16-19, 23-24).

Russian has employed a traditional *divide et impera* policy in Southern Caucasus by standing on the Armenian side. Azerbaijan recently expressed its wish to have NATO base on its territory for protection against Russia equipping its military bases in Armenia with new MIG-29 fighters and SS-300 anti-aircraft missiles (Ekspert No 3, 25 Jan 1999, p. 5). Also the Western presence in the Southern Caucasus want to transport oil and gas through the Southern Caucasus instead of Russia. This runs against Russian interests. Likewise, conservative Russian politicians are annoyed by plans to revive the old “Silk Road” connections from China to Central Europe (for instance the Tacis “Traceca” program) by reconstructing the rail

and road connections and organising their administration and maintenance in a way that bypasses Russian territory altogether. The monopoly on transport of Caspian and Central Asian hydrocarbon products and the mineral wealth of Central Asia would guarantee enormous revenues for Russia as well as geopolitical control over these resources. For these reasons, Russia is actively seeks to frustrate these plans and destabilise southern Caucasus (Satter 1998, pp. 1-2).

Nagorno-Karabakh dominates Armenian politics today. The Armenian media and press perpetuate the invincibility and heroism of Armenians and their determination to solve the “Nagorno-Karabakh problem” without mentioning the dream of Greater Armenia. We cite the summarised assessment of Charles van der Leeuwe in his excellent book “Storm over the Caucasus” (p. 100):

“Beyond doubt, the Armenian nation throughout its long and turbulent existence has fallen victim to many fateful events – including mass deportation and mass destruction. But the most serious thing they have mainly fallen victim to in our times is mass confusion. First of all, the location of the ‘historic Armenian birthground’ has remained subject to dispute up to this day and its relevance remains no less doubtful.

Whatever the case, the present-day nation of Armenia is small and ill situated, and to claim territory more than twice the size of Britain (refers evidently to Azerbaijan, north-western part of Iran and the eastern part of Turkey, author’s remark) in order to harbour a few million at the expense of those others whose roots have been there for eons, is ludicrous. All the more so since the intended ‘reconquista’ is driven by revenge rather than justice.

The Armenians won their war with it, but they lost their peace, as well as their senses, in the process. In previous chapters the turmoil wrought on a local scale by such a philosophy has already been well illustrated. However, it has also been exported to greater dimensions in the shape of international terrorism...”

Whether or not one fully agrees on the above assessment, negotiations for a peace process have continued six years since 1992 and most of the major issues remain unsolved. The peace negotiations are conducted in Minsk under the auspices of the Organization for Security and Cooperation in Europe (OSCE). As a result of the presidential elections in 1998, the moderate Ter Petrosian had to give way to Robert Kocharyan, who is from Nagorno-Karabakh and a former leader of the war against Azerbaijan. The new president looks the dead opposite of a peacemaker which – somewhat paradoxically – may present a good second-best solution to the extent the stalemate in the Minsk peace process with a cease fire represents a status quo and prevents the deterioration of situation in southern Caucasus. The Armenian side has urged restarting the peace negotiations with a clean table, leaving aside whatever has already been negotiated⁷. These negotiated results include the withdrawal of Armenian forces from the occupied territory and acceptance of the Lisbon agreement about the indivisibility of territories. Still, the leaders of both countries have stressed the importance of peaceful resolution of the conflict (Report, 1 May 1998).

Disagreements between Azerbaijan and Russia have arisen on different issues. Goltz characterises Russian interests as threefold: practical, strategic and emotional. From the practical point of view, it is convenient to maintain the frontier between Azerbaijan and Iran where it has been for the past 170 years. From the strategic point of view, Russia lost part of its military/industrial base when Azerbaijan became independent. From the emotional viewpoint, Russia lost its “Fun and Sun Belt” a region that also included Georgia (Goltz, pp. xx-xxi). Without doubt, Russia considers the mobilisation of the Caspian oil and other activities of the international and foreign organizations and companies as a Western intrusion into its tradition sphere of interest.

The breakdown of political relations between Azerbaijan and Russia dates back to 26 January 1990. To suppress the nationalist uprising triggered by increasing tensions between Azerbaijan and Armenia, the Soviet president sent the Soviet army with tanks to the largest cities. Hundreds of ordinary civilians were killed in Baku and Ganja.⁸ After the failed attempt to establish their military presence in Azerbaijan, the Russians continued to provide Armenians with weaponry and participated in war operations. During 1994-1997, Russia granted Armenia credits of about USD 1 billion for the purchase of military equipment including "B-300" missiles. It also signed a number of agreements to support political, economic and military cooperation.

Azerbaijan is not preparing for war. War does not attract foreign investments, or at least not the kind that mobilise oil wealth. Thus, defence expenditures are modest and constrained. For instance, the budget expenditures for purposes of the national defence have been reduced from 5% of GDP in 1993 (war year) to 2-3% a year in 1996-1998.⁹ No strong or widespread anti-Armenian sentiments in form of propaganda, meetings or demonstrations can be observed. Azerbaijan together with Turkey maintains a commercial blockade against Armenia. Still, the cease-fire is fragile, and 260 violations were reported in 1998. The Armenian forces had opened fire twice the positions of OSCE representative who had been conducting the monitoring on the fire-line. Russia goes on supplying updated weapons to Armenia (Exclusive, 25 February 1999). These developments have been lately pressing Azerbaijan to tighten military cooperation with Turkey and fostering opinions about the necessity of Azerbaijan joining the NATO in spite of the likely opposition of Armenia, Russia and Iran.

Improvement of relations between Azerbaijan and Russia can be observed. For instance, in January 1997 Azerbaijan and the Russian Federation decided to restore rail communications, ease customs regulations and increase bilateral trade. Full diplomatic relations have also been established. There still remain disagreement, of course, related to Caspian oil resources, transportation of oil and development of oil and gas transport as well as Russian arms sales to Armenia.

Azerbaijan's relations with Georgia and Turkey are good and reconfirmed with frequent meetings of presidents Aliyev, Shevardnadze and Demirel. Old personal friends, Aliyev and Shevardnadze maintain similar attitudes in their policy towards Russia. Since gaining independence, Azerbaijan has also maintained close relations with Turkey, with which it shares similarities of language, culture and religion. Turkey was also the first country to recognise Azerbaijan as an independent state. To support Azerbaijan against Armenia, Turkey maintains commercial blockade of Armenia.

The attitudes of Western governments and business circles have been changing in favour of Azerbaijan. Obviously, Azerbaijan's moderate political stance drives US and Western European interests in Caspian oil to prefer Azerbaijan. Beyond oil, US foreign policy seeks strengthening of the Caspian states independence vis á vis Russia. One way to do this is to bring Azerbaijan closer to Turkey and strengthen Turkey's status within NATO. The US also would like to keep Iran away from offering its pipeline alternatives along the Caspian South coast for the natural gas from Turkmenistan, and for oil and from Baku to the Strait of Hormuz (Sampson 1999, p. 26).

Turkey, a NATO member with good relations with the United States, today poses a politically and militarily insuperable challenge to Armenia. Rather than confront Turkey, the Armenians, still haunted by their traumatic experiences, redirect their notions of revenge to restoration of the former Greater Armenia. This approach even met with some understanding among the western governments thanks to information spread by influential Armenian emigrant nationalist ("dashnaks") lobbies in the United States, France and elsewhere.

The lobbying eventually succeeded in making the US Government restrict its support to Azerbaijan under Section 907 of the US Freedom Act of 1992. Abolition of this section of the Act is thus a high priority on the Azerbaijani agenda in development of its relations with the US. The Act bans assistance by US official agencies to Azerbaijan's governmental bodies, limiting assistance exclusively to private enterprises and non-governmental organizations. This restriction fosters bitterness in Azerbaijan as most people know that the US government has been rather generous with foreign aid to the Armenian government. In addition, this provision has prohibitively prevented extension of the humanitarian assistance to Azerbaijan because the Azerbaijani government runs most hospitals. The Act has not prevented the US Government from extending its assistance to non-governmental organizations and the private sector in Azerbaijan. American oil firms presently participating in Caspian oil consortia in the Azerbaijani sector have created further flux. European and multilateral aid efforts have been directed indiscriminately towards Armenia and Azerbaijan.

The stiff attitude of the US government led the Azeri authorities to establish relations with the US business circles instead. American oil companies advocated a US delegation that included representatives of the US Department of Commerce. They also promised to lobby for removal of the discriminatory Section 907 of the US Freedom Act of 1992. In line with the course of building democratic, secular and civil society, Azerbaijan seeks a strategic partnership with the United States. This partnership was enhanced during the visit of President Aliyev to the United States in summer 1998. Rapidly grown interests of the US and Western Europe in Caspian oil have changed attitudes towards Azerbaijan.¹⁰

Iran has a large Azeri minority of about 20 million.¹¹ It has maintained moderate and (during the war in 1993) supportive attitudes towards Azerbaijan. A number of new economic and diplomatic accords were signed between the two countries, particularly in mid-1996. Iran has also softened its stand on division of the Caspian Sea.

3 Oil and Gas

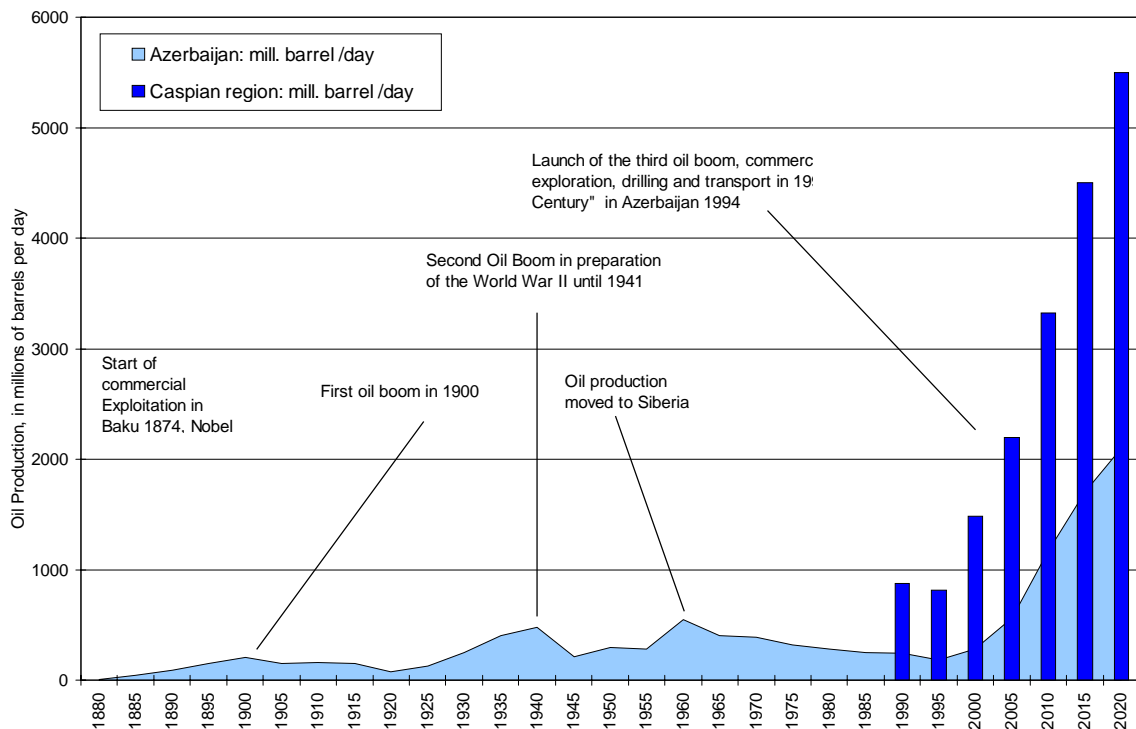
The fire worshipping Zoroastrians are often credited as the discoverers of Caspian oil and gas. About 3500 years ago they found the Caspian shore, with its gas-fuelled bonfires, an opportune place to settle down. The Swedish Nobel brothers launched the world's first oil boom in 1874 (triggered by the land privatisation). At its culmination in 1901, Azerbaijan produced over half of the world's crude (over 10 million tons a year). A second oil boom reached peak output of over 20 million tons a year in connection of the war efforts in 1941. At that time Azerbaijan accounted about 70% of total Soviet crude oil production (see Chart 1.1). New discoveries of oil in Volga and Ural regions, and later in Siberia, led the Soviet Union to move production away from Azerbaijan.

The assault on the environment from the earlier oil booms is immediately visible on the outskirts of Baku or on the Apsheron peninsula. Grids of rusty, leaking pipes and forests of abandoned derricks and pumps surround Baku. They sit in a goey soil impregnated with sulphurous crude. The surroundings of Baku and Sumgayit, an industrial centre about 20 kilometres north of Baku, are strewn with empty chemical plants and other industries that once helped create one of the world's great ecological catastrophes.¹² They are odd monuments to a Soviet industrial agenda oblivious to environmental concerns.¹³

The development of the new offshore technologies has made Caspian oil more accessible. This technology was not available during the Soviet era, so gradual depletion of onshore oil and gas fields and the bleak political and economic prospects in Azerbaijan led to reduced oil

and gas production after 1990. As the technology infusions proceed, gas production is expected to recover and meet fully Azerbaijan’s own demand as new offshore fields come into production after the turn of the century. Currently, large volumes of natural gas are wastefully flared at the source because the existing gas distribution network and storage facilities are corroded and inadequate to distribute the gas to consumers in Azerbaijan (IFKS, p.6). International oil companies have also resumed onshore oil exploration using effective seismological and geological tools as well as advance drilling technologies.

Chart 1.1 Exploitation of oil resources in Azerbaijan 1880-2020 and Caspian Region 1990-2020

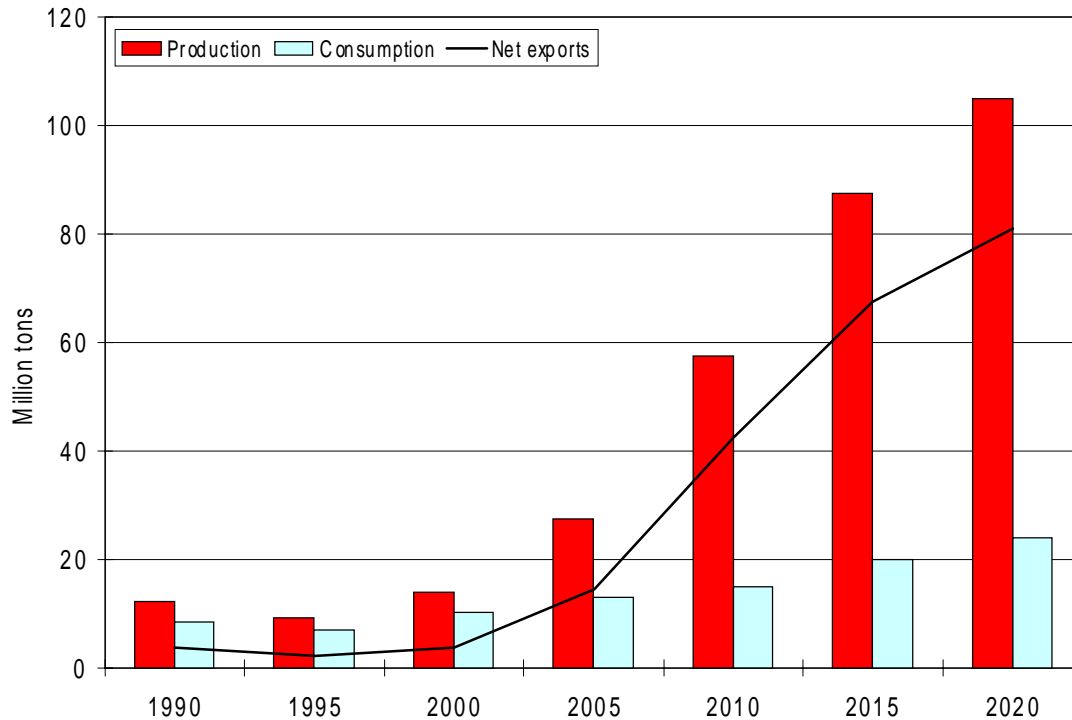


The depletion of producing fields and poor maintenance of existing infrastructure, Azerbaijan’s oil production fell about 30% from 1990 to 1996, reaching an annual output of about 9 million tons in 1997. Azerbaijan exported almost a quarter of that, about 2.2 million tons (see Chart 1.2). Azerbaijan has refinery capacity of 20 million tons a year, although most of that capacity needs refurbishing. Nevertheless, it has been sufficient to take care domestic consumption and exports. About 8.8 million tons of oil was processed in Azerbaijan’s refineries in 1997. More than 80% of the oil came from offshore Guneshli and Neft Dashlary fields operated by the international AIOC consortium in conjunction with the Azerbaijani national oil company SOCAR (IEA 1998, pp. 151-152).

The “third oil boom” started with a “deal of the century” signed in late 1994, when eleven international oil companies signed and ratified a production sharing agreement with SOCAR. The agreement, or PSA, covered Azeri and deep-water Chirag fields and established a consortium “Azerbaijan International Operating Company”(AIOC). The target output was 800 000 barrels per day by 2005. The AIOC committed to invest about USD 7.5 billion. The

largest shareholders are BP (17.13%) and AMOCO (17.01%). The Azerbaijani government expects to earn from the AIOC contract alone about USD 100 million per year from 1998, rising gradually to USD 2 billion a year in 2006.

Chart 1.2 Azerbaijan: oil production, consumption and net exports in 1990-2020



Since the “deal of the century,” twelve more consortia based on PSAs have been established. In aggregate, these other consortia commit to investment over USD 40-50 billion in exploration, field development and transportation of oil and gas. There is also a joint technical steering committee to coordinate the interests of the companies participating in consortia with SOCAR. Total oil production in the Caspian Region is expected to reach 3 million barrels a day by 2007 (Chart 1.2).

Active oil exploration is now conducted in Azerbaijan; production of offshore oil started in 1997. Nationally, oil production in 1997 was still only at a level of 200-300 thousand barrels a day (or 9 million tons a year of which 83% took place offshore). The expected and planned full capacity of nearly 1.2 million barrels a day (or nearly 60million tons a year) is expected to be reached by 2010. There are no assurances, however, that the envisaged production levels will ever be reached.

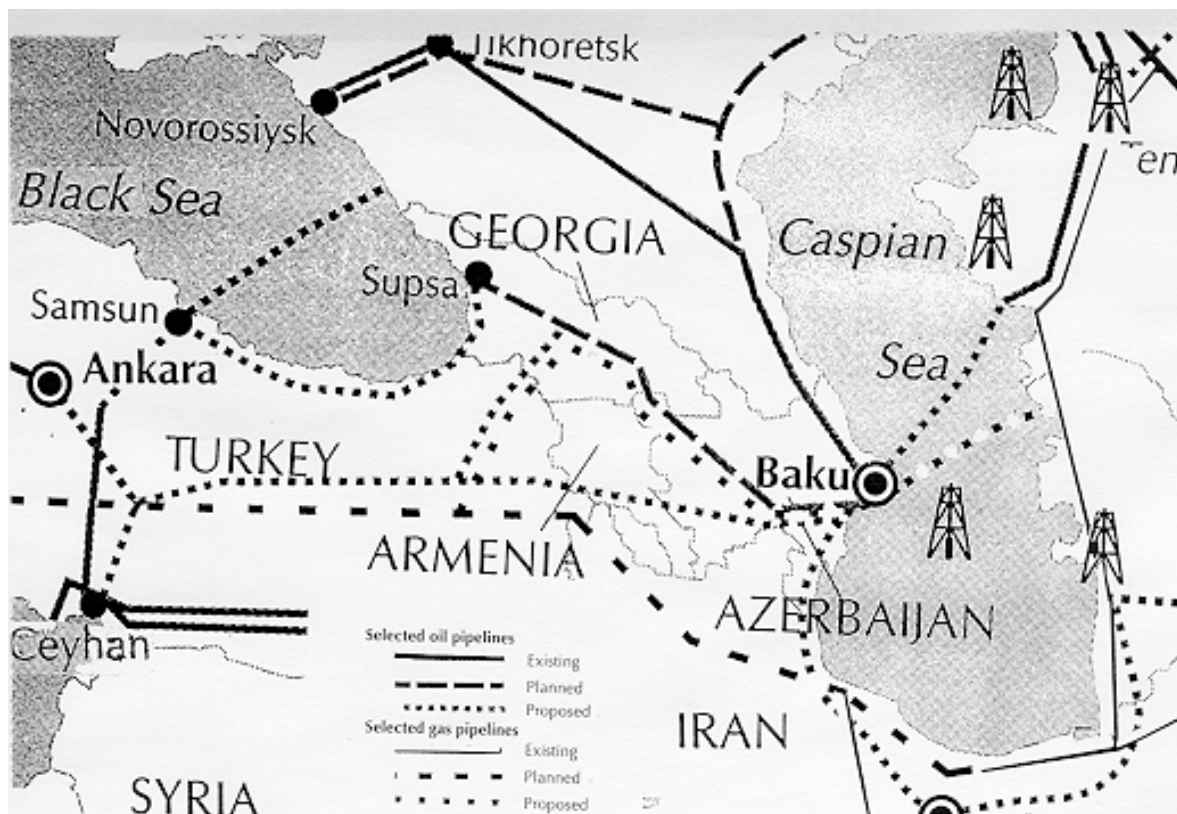
Proven oil reserves in the Caspian region (Central Asia and Southern Caucasus) are estimated to be between 15 and 40 billion barrels, about the same as those of the North Sea (Sampson 1999, p. 26). Azerbaijan’s proven oil reserves are estimated at 3-11 billion barrels and proven gas reserves at 300-800 billion cubic meters. In per capita terms this is less than the Gulf countries’ reserves, but more than the reserves of Russia or the United States. About 90% of Azerbaijan’s oil reserves are offshore (IEA 1998, p. 151). SOCAR is in charge of oil

and gas production from the existing fields.¹⁴ SOCAR and AIOC plan to produce jointly 14.6 million tons crude and 6.1 billion cubic-meters natural gas in 1999. The actual size of the gas and oil reserves remains still unknown. Recent failures to hit oil (the CIPCO failure and withdrawal, Financial Times, 24 February 1999) combined with high drilling costs have made other oil companies cautious in their expectations. The wide margins of the above estimates about proven oil reserves reflect uncertainties which, combined with the volatility of oil prices, give an idea about the level of risk assumed by the PSA participants.

In this context the major problem for the Caspian oil is transportation. Oil gets its value once it has been transported and delivered to the consumers. The profitability of the construction of oil pipelines depends, whether the Caspian reserves are large enough to fill the pipelines over a number of years. Moreover, the Caspian oil is landlocked and competes with other fields free of this obstacle. Thus the price of Caspian and Central Asian oil and gas will have to include the fees levied by countries, territory of which will be used for transit. The transit fees on Baku-Ceyhan pipeline through Georgia and Turkey are predicted to be around 4 US dollars per barrel and on Baku-Supsa through Georgia 2 US dollars per barrel.

As the production of Chirag platform builds up, a Western Route pipeline will become necessary. The existing pipeline from Baku to Supsa has been recently repaired at a cost of 560 million US dollars, substantially more than the 315 million originally budgeted. The AIOC has since November 1998 exported about 70 000 barrels a day “early oil” from Baku to Russian Novorossiysk. The Baku-Supsa pipe-line will allow to export about 100 000 barrels a day more of “early oil” to Georgian port Supsa to be shipped further to the Western European markets by the end of 1999 (Reuters News Service 10.12.1998: “Azeri consortium starts filling Georgia pipeline”).

Map 1.2 Existing, planned and proposed pipelines for the Caspian oil and gas



The Western and Northern pipelines need to be further upgraded. A 42-inch "Main Export Pipeline" (MEP) will be necessary by the end of 2003 to carry the full production of the oil consortia in the Azeri sector. According to the preliminary estimates the 850-kilometre MEP from Baku to Supsa should cost roughly USD 1.8 billion, the line to Novorossiysk USD 2.5 billion and the 1730-kilometre Baku-Ceyhan route USD 3.7 billion (see Map 2). All routes have capacity of at least 1 million barrels per day. However, no MEP will be built without firm commitment from oil producers to keep it full.

The early offshore oil started to flow through the Northern Route pipeline to the Russian Black Sea port of Novorossiysk in 1997. The oil from the Chirag platform flows via a 28-inch pipeline to the shore and the terminal of Sangachal. From the Russian border it is pumped to the Black Sea port of Novorossiysk where it is loaded onto tankers. Despite transport delays, about 2.5 million tonnes of AIOC and SOCAR oil was transported through Novorossiysk in 1998 (Reuters, 10 December 1998).¹⁵ Politically unstable Chechnya jeopardises the reliability of such oil transports, making the construction of western routes all the more urgent. Notably, the Ceyhan route also passes through politically troubled areas in eastern Turkey.

There are also plans to construct oil and gas pipelines across the Caspian Sea. The American oil company AMOCO established a new pipeline joint venture with GE Capital and the Bechtel Group in June-July 1998 to construct a 1200-kilometre transcaspian gas pipeline via Turkmenbashi from Turkmenistan, Baku and Georgia to Erzurum in Turkey. The estimated cost of the project is USD 2.5 billion and the implementation will take three years (Zerkalo, 18 July 1998, p. 14). Shell is also exploring a transcaspian alternative with possibilities to construct a gas pipeline from Turkmenistan via Iran to Turkey. Turkmenbashi considers, however, that both pipelines will be needed to transport the Turkmenistan's huge reserves so as to meet the great natural gas demand of Turkey (Caspian Investor, August 1998, p. 7).

Russia and Iran are against of construction of such a pipeline because of its strategic value. It would also potentially reduce the volumes transported through their territories and foreign exchange earnings derived from them. Russia already agreed with Kazakhstan to divide the seabed but not the waters. From the Azerbaijan point of view a pipeline through Iran or Russia is excluded. The American companies would not be able at present to work in Iran. Russia again offers the worst conditions for transportation of gas and oil.

In 1994, Russian authorities who could not accept that the former colony would try to secure its independence with Western capital did not welcome the "deal of the century". The Russians asserted that the Caspian Sea was a sea due to its large size and salty water and under international law joint property of all states surroundings. Subsequently, the Russians proposed in Ashgabat in November 1996 that the Caspian should be divided into sectors comprising territorial waters up to a limit of 75 kilometres (45 sea miles) and the rest should remain the common property of all littoral states.

Azerbaijan and Kazakhstan, supported by Turkey and the United States, have assumed a common stand. According to them, the littoral states should divide all – the seabed, water and its surface – by stretching their national borders to the central line, that divides the Caspian Sea in two half in North-South direction (Zerkalo, 1 August 1998, p. 8). Since the large offshore oil fields are located in what would have been joint property, the Russian proposal never came up for serious consideration.

Azerbaijan did not accept the Russian variant because it would leave the door open for Russia and Iran to intervene in the plans to construct pipelines across the Caspian Sea. Azerbaijan and Turkmenistan have not been able to agree on the location central line dividing the Caspian Sea.¹⁶ Iran appears in agreements with Soviet Union dating back to 1920 and

1941.¹⁷ It would like to divvy up the Caspian Sea in five equal 20% shares. This approach favours Iran, Russia and Azerbaijan, and hurts Kazakhstan and Turkmenistan.¹⁸ Azerbaijan accuses Russia of imperialist intransigence; Moscow accuses Baku of inconsiderate greed.

The dispute about the legal status of the Caspian seems to be fading. The steps taken by the Russia in spring 1998 set the ball rolling. In bilateral negotiations with Kazakhstan and Azerbaijan, they offered to leave the waters of the Caspian as common property, splitting only the seabed and resources beneath it. Currently Azerbaijan, Russia, Kazakhstan and Turkmenistan have already agreed on the sub-sea split. Only Iran, the clear loser in this deal, remains hostile to the suggestion (Labyrinth 1/98, pp. 35-37). Although the views of the partners converged, they are still far from reaching final agreements (Zerkalo No. 32, 15.8.1998, pp. 4-5, No. 33, 22.8.1998, p. 8, Labyrinth Vol. 5, No. 1/1998, p.36). All parties, however, unanimously support keeping the Caspian Sea demilitarised agreements (Zerkalo No. 32, 15.8.1998, p. 5). It is possible that reduced profitability caused by the fall oil price may trigger controversies and again increase the political risks. Azerbaijan recently protested the attempts of a new consortium (Britain's LASMO Plc, Anglo-Saxon Royal-Dutch Shell and NIOC) to start explorations on the disputed area in the South Caspian (Reuters, 15 December 1998).

The oil boom in Azerbaijan created a 'critical mass' powerful enough to force other littoral states seek positive solutions. Perhaps unexpectedly, the Russians themselves took the initiative in proposing new alliances.¹⁹ Russian Lukoil now participates in several consortia. The National Iranian Oil Company (NIOC) also entered the picture. Conceivably, successful mobilisation of Caspian oil and gas could increase the willingness of Russia to shift its foreign policy towards development of oil transport and, in turn, challenge Western plans to transport Caspian and Central Asian oil and gas through Russian territory. Given the shortage of Russia's funding, Western oil and construction companies would likely be involved.

The principal problem in determining the future economic growth of Azerbaijan appears to be the unpredictability of the fluctuations of oil prices, adequacy of the Caspian hydrocarbon resources, and marketability of future oil revenues. Large, long-term investment plans typically fail to perform as expected, because the market projections failed to account for global uncertainty and volatility. There is a tendency make plans for projects too large to implement, leading to a fragile situation where oil revenues turn out to be less than expected. The actual priorities may differ from anticipated ones once the oil revenues are really available.

The fall in the oil price from USD 20 a barrel in 1997 to less than USD 10 a barrel at the end of 1998 led the oil companies to modify their plans²⁰. Oil refining declined because more crude oil was stored instead of processed. Available storage facilities are fairly limited (AET 2/98, p. 26). The low oil price has made some of the oil companies to moderate their plans by concentrating on a few big reservoirs. The AIOC is replacing expatriate staff with Azeri staff having had them trained to take over the management positions (Reuters News Service 15 December 1998).

The US investors and Turkey favour the Ceyhan alternative, while the European Union supports the Supsa route. Provided that the Caspian oil resources turn out to be adequate and production profitable, both pipelines are likely to be constructed. However, the volatility of oil and gas prices on world markets and the high price of the Ceyhan pipeline have made the oil companies in the AIOC reluctant, leading to postponement of major decisions.

However, the current ups and downs of the oil and gas prices may serve as a useful reminder to Azerbaijani government about the volatility of the trade. Having been taught the lesson at an early age, they might listen to caveats and modify their plans accordingly and

establish buffer funds to meet future uncertainties. Possible postponements might also provide the Azerbaijan government with time to consider, how to use the earnings from oil to benefit its citizens and the economy.

The oil business, however, is risky and costly; not only in Caspian region, but in most places. The currently over-tuned expectations of Azerbaijani officials and politicians will doubtless cool to hoping for the best and preparing for the worst. Some oil companies may leave and new ones may move in. Like the prices of many strategic merchandises, the price of oil remains highly volatile. On the other hand, the oil price is likely to experience several ups and downs during the repayment period for the current investments and have a modifying effect on their profitability.

4 International initiatives

Azerbaijan has joined numerous international organizations since its independence. It is a member of the UN, the EBRD, the World Bank, the IMF, the Asian Development Bank, Interpol, the Black Sea Region Countries' Cooperation Union as well as other international and regional establishments. Azerbaijan has a special guest status at the Council of Europe and observer status in the WTO. Azerbaijan has ratified the Conventional Forces in Europe (CFE) Treaty and also joined Nato's "Partnership for Peace" program.

IMF programs have been very much at the core of international support. Azerbaijan has successfully implemented macroeconomic stabilisation of its economy, with the support of series of structural adjustment credits and facilities from the IMF and World Bank. In 1994, the government of Azerbaijan requested a Systemic Transformation Facility (STF). In 1995, it requested a Stand-By Arrangement. Two tranches of the STF of USD 88.9 million and one tranche of the Stand-By of USD 90 million were provided in 1995 following the government's liberalisation of prices and unification of the exchange rate. To support the further progress on privatisation and macroeconomic stabilisation, the IMF approved two ten-year credits in December 1996. The first credit, an Enhanced Structural Adjustment Facility (ESAF) of USD 135 million, was followed by an Extended Fund Facility (EFF) of USD 84 million. The medium-term programme for 1997-99 envisages widespread financial sector reform to cope with the inflow of oil revenue and assure its profitable use by the private sector.

By virtue of these successive IMF programs totalling about USD 250 million, both the budget deficit and inflation are under control. A stabilisation program reigned in the twin sources of inflation - unsustainable budget deficit and excessive extension of bank credits to state enterprises. Money supply growth has been consistent with low inflation and an appreciating exchange rate. Azerbaijan has liberalised its trade and payments system sufficiently to obtain the Article VIII status under the IMF articles. The country's application for WTO membership is also under preparation.

The EU is the NIS' most important Western trading partner. For time being the NIS does more trade with the EU than all the rest of its trading partners (including the US and Japan) combined. Ultimately, the purpose of the international efforts in Azerbaijan - and the Caucasus and Central-Asian countries in general - is to increase trade between them as well as develop trade and financial cooperation with EU, US, Japan and Far-Eastern economies (EC 1997, pp. 5-10). The bilateral **Partnership and Cooperation Agreements** between the **European Union** and the individual partner countries also support these aims by sustaining the development of trade, investment and harmonious relations between the EU and NIS.

Since 1991, the EU has been Azerbaijan's biggest donor (see the table below). To date, the EU has provided technical and humanitarian assistance of about ECU 208 million in grants and ECU 51 million in loans that are now fully repaid. The major part, 166 million ECU, of these grants have come through food aid. In 1998, the EU extended ECU 10.9 million in humanitarian aid for 1998-2000 to the Azerbaijan Government (Reuters News Service 15 December 1998).

International financial, technical and humanitarian assistance to Azerbaijan	
Accumulation to end-1997 from the beginning of 1991 in USD billions	
World Bank Group	334
International Monetary Fund	205
EBRD	251
Tacis	286
UN and bilateral (estimate)	320
Total	1396

The **EBRD** has operated in Azerbaijan since 1992. In that time it has approved eight investments amounting to ECU 229 million. More than half of the funding went to private sector investments. EBRD keeps focusing on power and infrastructure projects.

The World Bank Group is equally active in Azerbaijan. By the end of 1997, it had spent USD 334 million dollars in Azerbaijan, mainly to finance infrastructure projects. The World Bank has supported the IMF program. Having implemented one structural Adjustment credit it is designing a second one. Azerbaijan has fully met the performance criteria of the World Bank consistently during the four year 1995-1998.

The bilateral assistance has been funnelled mainly through the UN organization to humanitarian purposes. Lately the bilateral financing with conciliatory terms from foreign governments (e.g. Japan) has been directed to investments in energy sector.

While acknowledging the importance of the other international efforts, the technical assistance provided through the EU's **Tacis** Program (Technical Assistance for CIS) deserves a special attention, because it prepares blueprints to be financed and implemented by other organizations, like the World Bank Group, EBRD or commercial banks. In an economy like that of Azerbaijan, expecting major inflows of capital, there is a special call for advice, how to use this money to support balanced and sustained growth of the economy instead of loosing it for other purposes. Within the framework of the Tacis program, the EU pays European experts to prepare bankable blueprints requested by the Azerbaijan government and non-governmental organizations.

The Tacis program consists of interstate projects, where two or more states participate, and national projects to be implemented only within a territory of a single state. Azerbaijan's national projects during 1991-1997 amounted to about ECU 51 million. The structural reform projects (restructuring of state enterprises and private sector development, public administration reform, social services and education, policy advice and small project programmes) was 46%

of the total ECU 51 million ECU. The rest was allocated to energy, agriculture, telecommunications and humanitarian aid to IDPs and reconstruction of Fizuli and Agdam regions which have been freed from the Armenian occupation (Tacis 1998, pp. 9-10).

The funds allocated to national projects benefit the Azerbaijan alone. These projects are imbedded in 2-years Action Programs, which in turn are based on 4-year Indicative programs giving the priorities agreed between the European Union and the Azerbaijan government. The **Action Program 1998-1999** for Azerbaijan builds on the achievements of the previous Action Programs and the Indicative Program. It makes available ECU 16 million to implement 10 projects and 7 small projects (facilities) in:

- energy,
- transport,
- enterprise sector,
- food production, processing and distribution, and
- human resources development.

Azerbaijan's participation in the **interstate projects from 1992 to 1997** was estimated to amount to about ECU 20 million or about 7% of the Tacis commitment to the Inter-State program of 1992-1997.²¹ Although the share of these funds is only 27% of all Tacis funds allocated to Azerbaijan during 1991-1999, these projects are particularly important for Azerbaijan in terms of transport, trading and, not least, dealing with environmental problems.

The inter-state projects of particular interest for Azerbaijan are included in the Transport Corridor Europe Caucasus Asia ("Traceca") program. This program aims at rehabilitation of the historical "Silk Road" and improvement of the transport and trade possibilities between the new small independent republics and Western markets.

The other important Inter-State program for Azerbaijan is the program on oil and gas pipelines (INOGATE). This program aims to support efforts aimed at rehabilitating, rationalising and modernising regional gas transmission systems and oil and refined oil products supply system. It also aims to assess the possible alternative options for the transport of hydrocarbons from the Caspian and Central Asia regions to European and Western markets. The aim is to produce a number of large-scale bankable project proposals that the necessary investments can take place. These assessments include, for instance, the realisation of oil pipeline Baku-Ceyhan as well as transportation of the natural gas from Baku to Turkey via Azerbaijan and Georgia.

Traceca and INOGATE are vital in promoting the future commerce between the Caucasus and Central Asian countries and between these regions and the West. The emergence of new commerce and trade relations would also most likely activate trade between these regions and the Russian Federation. Conservative Russian politicians consider these programs as a threat to Russia's transport monopoly and hostile political intrusion to Russia's sphere of interest. In contrast, the European Commission and West tend to stress the mutual commercial and material benefits in harmony with the political aims as defined, for instance, in the PCA.

Azerbaijan also participates in a number of inter-state projects on environmental protection and harmonisation of legislation to promote foreign trade. One important step has been the decision to apply the WTO membership.

Within the Tacis programme, European experts are hired to prepare bankable blueprints and recommendations for the Azerbaijani government. The government is expected to use them to attract financing from international and commercial financial institutions and to get them implemented through contracts with qualified enterprises. Although Tacis has not

financed projects directly in the 1990s, institutions such as the World Bank and EBRD have extended substantial technical assistance while financing their projects. The major financiers and investors to implement the projects designed by the Tacis programme have been and continue to be the World Bank and the EBRD.

5 Through Commitment and Stability to Economic Growth

Azerbaijan regained its independence lost 28 May 1918 through a constitutional act “On State Independence of Azerbaijan” on 18 October 1991. The first constitution of independent Azerbaijan on 12 November 1995 installed formal democracy with a legal state based on multiparty elections. The democratic principles are codified in the constitution. It prescribes the free election of 125 members of parliament and a president every fifth year. President Heydar Aliyev, elected in 1993, was re-elected on 11 October 1998.

The transition to a market economy was officially launched in June 1991 when the Law on Basic Economic Development came into force. Price liberalisation started in 1992 led to hyperinflation in 1993-1994. This was mostly the result of an inflationary fiscal-monetary stance. Prices started climbing rapidly in the second half of 1991 and reached an annual rate of 1 664 per cent in 1994.

Serious economic reforms only started in 1995, when the government introduced a comprehensive stabilisation program supported by the IMF’s systemic Transformation Facility. With the assistance of World Bank and IMF credits, the stabilisation program was adhered to during 1996-1997. In June 1997, the IMF approved a three-year program under the External Structural Adjustment Facility.

The recovery of the economy since late 1996 economy was supported by the continuation of the stabilisation policy of the Government and the Azerbaijan National Bank. It was fuelled by the foreign direct investment to the oil sector. Oil-related growth was seen mainly in services and construction. The political system of Azerbaijan can be formally characterised as presidential democracy. Mr. Aliyev took power in June 1993 after an armed insurrection by the country’s elected president, Abulfaz Elchibey. Although the rise of Aliyev was first believed to be a Moscow engineered coup,²² the new president turned out to have a good grasp of oil politics and US and Western interests in Caspian oil. He openly supports the principles of democracy, free market economy and the importance of attracting foreign investment²³.

Power is highly concentrated in the hands of the president and the administrative elite in Baku, where informal connections and kinship with the president matter. There is virtually no delegation of responsibilities in the governmental structures. The president nominates the prime minister and the cabinet of ministers. He oversees the activities of the National Bank of Azerbaijan, and alone decides through presidential decree (even on fairly small issues). Strong leadership has long traditions in this part of the world and is widely appreciated and supported.

Corruption, of course, is the inevitable outcome of such an institutional set-up. It is facilitated by large and inefficient governmental structures that control and regulate most business life. Through such powers the government maintains cronyism and accepts bribes. Low salaries legitimise bribe-taking at the lower levels of the hierarchy. The most corrupted institutions are the police, tax administration and customs administrations. The higher the hierarchical levels, the higher and better hidden the stakes. Without taking stand, who are more corrupted, those who accept bribes or those, who offer them, it suffices here to note, that the business community must, at least to some degree, accept the rules of this game.

President Aliyev's 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 (most of the CIS leaders are); dictatorial and paying only lip service for democratic, corrupted and allowing corruption. Much of this being true, he is a prisoner of time, political traditions and historical situation. Since the end of the Nagorno-Karabakh war Azerbaijan has had only 5 years to establish structural and political reforms the Western European countries have had 50 years to accomplish. His principal political merit is to maintain political stability despite of the nationally humiliating and economically crippling outcome of the Nagorno-Karabakh war.

President Aliyev's policy is clearly dictated by national self-interest. Memories of collective sufferings, injustice and atrocities committed by the Armenians in the Nagorno-Karabagh war and in the January 1990 Baku massacre committed by Soviet troops cement Azerbaijani national feelings. Constant reminding about these events carries the message to the Western governments, non-governmental organizations and international institutions to continue their presence and extension of humanitarian aid.

Time will work for Azerbaijan provided that the exploitation of Caspian hydrocarbon resources continues successfully. Maintenance of political stability and promotion of commercial cooperation are in harmony with this policy. The main responses seem to come - with the sole exception of Turkey - from Western Europe, the United States and Japan. The presence of these actors and cooperation with the international oil companies seems to be necessary in mobilising the wealth of Caspian oil and gas.

The presence of the international organizations and bringing together and harmonising competing commercial interests also seem to help guarantee peace. Furthermore, economic growth from the liberalisation and stabilisation policies can hardly be sustainable unless it supported by enhanced structural reform work. Here, international organizations can help in accelerating structural reforms with emphasis on the law enforcement, securing ownership rights, improving the rule of law and payment discipline. International organizations also have good reason to promote structural reforms and commercial interests within the free market framework when they contribute to peace in the southern Caucasus.

An interesting example of economic and commercial integration in Azerbaijan is the participation of the Russian Lukoil and Iranian oil companies in the international consortia exploiting the oil resources in the Azerbaijani sector. If Russian Lukoil and Iranian oil companies want to explore and exploit undersea oil and gas resources within the Azerbaijan zone it is in their interests to avoid conflict concerning the division of Caspian Sea (Goltz 1998, p. 449). The AIOC now also uses the Russian oil pipeline via Novorossiysk to transport the oil to world markets. Russia's railways have for several years now transported Caspian oil to different parts of Russia and Western Europe. In this way, internationalisation contributes in establishing regional balance. Over the longer term, this approach may also ameliorate more general regional problems in the southern Caucasus. Rather than squander oil wealth to equip national armies for internecine aggressions, commercial cooperation of Caucasus governments would pave the way for greater opportunities for private firms in all three southern Caucasus countries.

Political stability or the lack thereof, is in part determined by the US and European political and commercial interests in the region, and in part by Russian interests to preserve the region within its sphere of influence. US and European political interests aim at opening the Caucasus and Central Asian Republics for economic and commercial cooperation, which of necessity implies the break-up of old monopolies.

The Azerbaijani and Georgian governments see the cooperation with Western governments and international business as the most attractive alternative. The vacuum left by the collapse of the Soviet command system is to be replaced with a commercially oriented private sector grown from scratch. The government has reoriented its own activities to promote orderly, disciplined growth of the private sector. This implies elimination of corrupting influences on the economy and economic decisions. It also implies decentralisation and delegation of decision-making by governmental bodies to ensure a disciplined continuity of governmental administration after Aliyev. Finally, political leaders must support the advancement of civil society and democratic practices necessary to allow structural reforms.

The Armenian government nevertheless remains politically close to Russia. Officially, a state of war still prevails between Armenia and Azerbaijan, and there has been no advancement in peace negotiations. The Armenian media fosters surprisingly hostile attitudes against Azerbaijan and Islamic nations and gives an enticing dream of a Greater Armenia. The Azerbaijani media, in turn, seem to take a more pragmatic stand. Obviously, Azerbaijan is not preparing war or accumulating weapon arsenals, and prefers seeking allies. The Armenian military threat is felt in Azerbaijan, and as mentioned Azerbaijan has already joined to Nato's "Partnership for Peace" programme. Azerbaijan's cultural neighbour, Turkey, is a NATO member. Alarmed by the missile deliveries from Russia to Armenia, Azerbaijan has even proposed establishment of a NATO base on its territory to counterbalance Armenian firepower. Turkey has also indicated that it would not remain as passive bystander should Armenia launch new military operations against Azerbaijan. Given the substantial Azerbaijani minority with its territory, Iran is likely to back Azerbaijan in the event of an Armenian-Russian attack.

Commercial interests are related to the access and mobilisation of the Caspian hydrocarbons. The work of international oil consortia needs political stability. Also Russian and Iranian oil companies are working with the oil consortia exploring in Azerbaijan sector of the Caspian Sea to mollify these neighbours.

Ultimately, Western aims must go beyond access and mobilisation of hydrocarbons to the creation of new markets to fill the vacuum left by the fallen Soviet "socialist divisions of labour" among the regions in its territory. The EU aims to create conditions that create trade among southern Caucasus and Central Asian states and increase trade substantially between the entire CIS and EU member countries.²⁴ This means establishing disciplined market economies with harmonised rules of trade.

In replacing Moscow-centred economic ties, new economic structures must serve the interests of free markets and international trade - not only with Europe, Japan and the US, but also with neighbouring countries including Russia. Particularly in the area of transport of hydrocarbons, goods and passengers, Russia must give up its monopolies. The purpose here is to establish competition, not exclude Russia. In fact, a substantial part of the present production of oil goes through the northern pipeline and by rail through Russia precisely because the Russians can offer competitive terms.

Russian policy objectives aim at political and economic reintegration back to Moscow by trying to persuade these countries join under the umbrella of CIS and customs unions. Russia, as an energy exporter itself, does not need the Caspian gas and oil to satisfy its own energy supply. Instead, it is keen to earn money from trading and transporting hydrocarbons to Western markets. Therefore, Russia emphasises the importance of improvement of the North-South transport links, and criticises East-West improvements such as the Traceca and INNOGATE programs.

Although the Russian Federation suffers from grave economic problems and Caspian oil resources may turn out to be less than expected, Russia seems determined to maintain a military presence in the southern Caucasus. It exerts political influence using its own minorities in the “near abroad” as leverage. Where Russia does not have its own minorities, it adjusts policy using other minorities or controversies between them. Russian policies in Nagorno-Karabakh, Abkhazia, South Ossetia can all be explained on this basis. The typical pattern of *divide et impera* repeats itself. Step one is to stir unrest or provocation; step two is to send in troops to stabilise the situation through *mirnoye uregulirovaniye* (peaceful regulation); and step three, push for reconciliation on a diplomatic level while Russian troops remain in the area.

As mentioned Vinnikov held that ethnic, religious or national differences do not endogenously create conflict, but rather power-hungry political leaders mobilise support for their cause by pursuing superiority of one group at the expense of another. Most Caucasian ethnic groups live together peacefully and are linked through cross-marriage and everyday life routines. Perhaps it is worth of mentioning in this context that Azerbaijan has a Russian minority of about 5% (in Baku, the share of Russians is about 30%). The Russians are fairly well assimilated with the Azerbaijani population.

Armenia has pushed Russia to destabilise the situation using the Nagorno-Karabakh as a pretext for pushing certain political themes. There are therefore several reasons to believe that the solution of Nagorno-Karabakh was never an end in itself, but only a means to further territorial expansion. Solving the needs of 130 000 Karabakh Armenians by joining Nagorno-Karabakh with Armenia, scarcely begins to justify the exile of 1.2 million Karabakh Azerbaijanis. The continuing armament of Armenians and the stand-still in the Minsk negotiations imply that no final solution has been achieved.

The weak economic situation and lack of political leadership, as well as continuing political problems in northern Caucasus have forced Russia to moderate its manoeuvres in southern Caucasus. Also the increased presence of American and European interests in southern Caucasus in the form of oil investments and other commercial opportunities, the affinity of a militarily strong Turkey and Russia’s financial dependence on the West appear to have cooled the situation. Despite of the state of war between Armenia and Azerbaijan and the fragility of the cease-fire, the political situation has remained relatively stable in Caucasus.

6 Summary and conclusions

Things look good for Azerbaijan at the moment. Azerbaijan GDP probably grew 8-10% in 1998, while inflation remained close to zero. There are prospects to a peaceful settlement of the conflict with Armenia. More generally, the mobilisation of the Caspian oil seems to have softened negative, even hostile, Western attitudes towards the Azerbaijani government. The principal factors contributing the successful economic transition have been

1. Commitment of the Azerbaijani government to promote reforms and to maintain political stability in the region promotes the positive growth and peace. Azerbaijan now has economic and political cooperation with all neighbouring countries except Armenia;

2. The IMF's 1995 comprehensive macro-stabilisation program was adopted, so that fiscal and credit policies were tightened. The EU has provided technical assistance through its Tacis program. The continuation of technical assistance focuses on design and implementation of structural reforms to streamline governmental structures, the financial sector and the emergence of a new private sector. The presence and results of the work as well as good cooperation with the Azerbaijan government all work to stabilise political developments;
3. Involvement of international and foreign companies in the development of Azerbaijan's oil and gas reserves. Total FDI was USD 1.8 billion at the end of 1997; the total commitments of established consortia to invest in the oil and gas exploitation currently have reached some USD 50 billion. Within five years, exploitation of the country's world-class reserves is expected to finance up to 50% of the state budget and guarantee sustainability of fairly large current account deficits and finance further increases in production. Even with low oil prices and some oil companies pulling up stakes, the mobilisation of Caspian hydrocarbons will still help the growth of Azerbaijan's economy;
4. The exogenous factors determining Azerbaijan's possibilities to benefit from Caspian resources are involve the balance of power between a US-Europe-Turkey-Azerbaijan axis on the one hand, and a Russia-Armenia axis on the other. Although current controversies have their roots deep in history, the commercial integration of the all parties including Iran and other littoral states in transport and exploration drilling in the Azerbaijani sector should reduce the likelihood of conflicts.

The continuation of assistance and the presence of the international organizations are extremely important for a transitional and fairly poor country under political tensions. In contrast of the desires of the governmental officials would prefer receiving funds to technical assistance, the technical assistance would be vastly more important the direct handouts, because it contains proper prescriptions how to properly invest the oil revenues once they will be available. Also the structural reforms needed redesign the governmental structures and train and convert corrupted commanding administrators into disciplined civil servants, create law observing credible banking sector and commercial structures require considerable further efforts in the area of technical assistance. Financial assistance in form of loans and grants contains a moral hazard for a receiver government, particularly for a corrupted one, should it free governmental revenues to secondary purposes not in harmony with the national priorities. In addition, part of financial assistance will be directed – and as in the case of Azerbaijan, have been directed - towards sectors and projects where already private initiative exists and therefore could resort to commercial financing (particularly in the area of energy or telecommunications).

There are both a stick and a carrot to guide the speed and direction of economic transition. The stick is the experience of the Nagorno-Karabakh war and an awareness of Armenian and Russian intentions vis-à-vis Azerbaijan and southern Caucasus. The carrot is a dream of a prosperous future paid for by successful mobilisation of the Caspian oil. The oil and gas would confer Azerbaijan with the wealth necessary to maintain its national identity and defend itself against external political and military threats. Azerbaijan can find support from NATO-member Turkey and international oil companies backed by business circles of the US. Iran with 20 million Azerbaijanis in its territory represents a trump card. There are also deeply rooted memories about violent clashes between oriental Muslim and Western Christian worlds

in this region. These tensions may contain risks, but they also help in maintenance of political stability, through promoting private business and economic reforms. Indeed, they may even explain the relatively rapid pace of Azerbaijan's transition.

To illustrate and stress the importance of stability and governmental commitment in reforms supporting transition, here are two extreme scenarios based on the present and past experience.

The stable future scenario implies

- Continuation of the reasonably successful mobilisation of the Caspian oil brings the southern Caucasus countries politically and commercially together. The spillover effects from the growth of the Azerbaijani economy benefit the entire southern Caucasus. Georgia and Turkey, and even Armenia, turn out to be natural markets for Caspian oil. The emergency of economically and politically strong and independent Caucasus foster mutually advantageous commercial cooperation between the Southern Caucasus and Russia, Iran and Turkey, and stabilise the situation in northern Caucasus (IEA 1998, p. 94).
- Political stability together with the mobilisation of the Caspian hydrocarbons warrants lucrative markets, given adequate prices and sufficient crude reserves. Beyond consumers in Europe and Asia, Turkey would appear to be a natural market for Central Asian and Southern Caucasian crude oil exports.
- Landlocked and economically weak Armenia benefits most in relative terms from commercial cooperation with Azerbaijan and Turkey. Considering the current state of war with Azerbaijan and the trade embargo by Turkey, opening commercial cooperation will call for political U-turns in all three countries and resolution of the Nagorno-Karabakh problem.
- Caspian crude has higher quality and is cheaper to exploit and transport than the crude from Siberia. Russia benefit from cooperation with Azerbaijan in exploring, producing and transporting oil and natural gas. Notably, Lukoil already participates in AIOC and most other consortia. In addition, the AIOC has started to use the northern pipeline via Novorossiysk.
- Armenia observes that the possibilities of Russia to provide support are weakening. Meanwhile, the Western and international presence increases in Azerbaijan and improves Azerbaijan's relations to Russia. Armenia will avoid the risk that the cooperation and support from the US and Western Europe will suffer due to the military assistance it receives from Russia.

The destabilisation and disaster scenario implies

- Conservative or reactionary politics win out in Armenia and Russia. Russia decides to restore Soviet-era territorial hegemony. Armenia gains compensation by expanding its territory to Azerbaijan. Russia pursues its traditional policies in maintaining its influence in Caucasus by destabilising the situation in the region.

- The use of military power deters foreign investors from the area. Unrest and military interventions water down transition and democratisation and jeopardise the continuation of the economic growth in the southern Caucasus. As a consequence of large-scale military operations, the southern Caucasus region becomes impoverished, the need for humanitarian aid increases and the results of transition reforms are mitigated.
- As it holds the westward pipelines, Russia uses its access to existing oil platforms and other infrastructure to continue alone with exploitation and transport of Caspian crude. As Russia naturally needs significant capital injections and changes in the regulatory environment to maintain its oil production even at the 1996 level (IEA 1998, p. 88), a take-over of existing infrastructure alleviates the situation temporarily. The flow of funds from the West are cut and mobilisation of Caspian oil slows.
- The international community fails to solve the conflict due to fears of widening the conflict. The presence of the international news media turns out to be inadequate in preventing these developments. To deal with an atrocity-unfriendly audience, the perpetrators deny responsibility and blame ethnic local conflicts and international terrorism. This gives conflicting information,²⁵ which is then transmitted through the international news media to confuse the international community and paralyse decision-making. Meanwhile Russia reinforces its military presence in southern Caucasus.

Neither imaginary scenario is likely. The consequences of power policy would be disastrous for the people in southern Caucasus. Fortunately, the stability scenario is closer the present situation. President Aliyev has been able to create an atmosphere of stability, which is reinforced through commercialisation. The mutual interests gained through commercial cooperation should tempt parties to give up their power policies in the area. However, further postponement of serious structural reforms and continuation of economic mismanagement could lead to disaster in the management of the Azerbaijan economy. Nevertheless, if the expected Caspian oil wealth only brings modest prosperity, it will still be easier for Azerbaijan to manage its economic growth and stay on a balanced, sustainable path.

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Notes

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** This paper is the first in a series focusing on Azerbaijan. It will be followed by paper on economic development (Singh and Laurila, BOFIT Discussion Papers, "Azerbaijan: Recent Economic Developments and Policy Issues in Sustainability of Growth") and by a paper on transition and structural reform (Laurila, forthcoming BOFIT Discussion Papers, "Feasibility of Timely Structural Reform: the Case of Azerbaijan").

¹ As a counterpart for "Northern Caucasus" containing Dagestan, Chechnya, Northern-Ossetiya, Gabardino-Balkariya and Karabayevo-Cherchessya, we prefer here the notion "Southern Caucasus" when referring Armenia, Azerbaijan and Georgia, to the Russian notion "Transcaucasia" ("Zakavkazye") which refers to land mass south of Caucasus mountain ridge as seen from northern (from Russian) perspective.

² Although often referred to as an enclave meaning a state or part of it surrounded by another state, Nagorno-Karabakh is not really an enclave as a part of Armenia. Yerevan has neither claimed that Nagorno-Karabakh should be considered as a part of its territory, nor to have it recognized as a separate state. It has a status of autonomous region stemming from the Soviet time, when it was "Autonomous Territory of Mountainous Karabakh" (NKAO) with a special representational status in the Azeri Parliament (Goltz 1998, p. xxiii).

³ Vinnikov points out that "— in my opinion, the term "national or ethnic conflict" represents particularly unhappy choice of words because tensions between different nationalities, in general, are not connected to national or cultural differences proper. The power-hungry totalitarian politicians take advantage of these differences only to make them to serve as instruments of their own power politics. —" (Vinnikov 1998, 254).

⁴ In addition to Goltz's eyewitness report, a valuable detailed factual account of events is included to "The Europa World Year Book", Volume I, Europa Publications, UK 1998, pp. 481-484

⁵ In contrast to "refugees," "internally displaced persons" or "IDPs" are persons who flee their homes of fear of persecution, but do not cross an international border.

⁶ Ter-Petrosian and Soso (Josiph) Vissarianovitch Dzugashvili, better known as Stalin, were active in this group.

⁷ The "Minsk Group" is the OSCE negotiation body to bring the Karabakh conflict to a peaceful end. The group was established in the summer of 1992 under the leadership of the Italian diplomat Mario Raffaelli and was supposed to convene a peace conference in Minsk. The group consists of eleven OSCE member countries including Armenia, Azerbaijan, USA, Russia and France.

⁸ Official or semi-official estimates range from 69 to 180 killed civilians and 12 soldiers. In December 1993, a mass grave was found in the Qobustan desert, south of Baku. It contained over a hundred of bodies of persons who had disappeared without trace during the weeks after 'Black January' (Leeuw 1999, pp. 81-82). Black January is allegedly one of the reasons why, unlike in Armenia and Georgia, there are no Russian troops in Azerbaijan.

⁹ According to the Europe World Year Book the Azerbaijani national armed forces consisted in August 1996 of about 70 700 men (army 57 300, a navy of 2 200 and an air force of 11 200 men) and a militia of about 20 000 men under the Ministry of Internal Affairs. Azerbaijan's Naval Forces operate under CIS (Russian) control. In May 1994 Azerbaijan joined NATO's "Partnership for Peace" program of Military cooperation. The 1996 budget allocation to defense amounted to 115 million US dollars (Europe World Year Book 1998, p. 484).

¹⁰ President Aliyev's visit to the US was considered an important turning point in US foreign policy towards Azerbaijan. US companies signed four oil exploration and production deals worth of USD 8 billion and president Clinton committed to repeal the Freedom Support Act.

¹¹ Estimates vary from 15 to 25 million Azerbaijanis, or about a quarter to a third of Iran's total population of approximately 68 million.

¹² The oil industries do not bear all the blame. Contamination of soil, particularly on the Apsheron peninsula, is result of random dumping of industrial waste, much of which could be classified as concentrated toxic waste. The Soviet agriculture relied heavily on synthetic fertilisers and pesticides contaminating the agricultural soil. The state of the Caspian Sea is alarming due to oil residues, dumping of industrial waste or pesticides carried along the Kura river to the sea. The health situation in the population centres on the Apsheron is alarming. Most inhabitants in Sumgayit suffer from respiratory diseases and possibly other consequences including birth defects caused by heavily polluted surroundings (van der Leeuw 1998, pp. 52-53).

¹³ Tacis (Technical assistance for the CIS) plans to assess the dimensions of the oil damage ("Support to the Ministry of Fuel and Energy and rehabilitation of contaminated land"). Some experts feel that replacement of the polluted soil, although technically feasible, is financially unrealistic.

¹⁴ The State Oil Company of Azerbaijan (SOCAR) is de facto the Ministry of Oil for Azerbaijan. It negotiates all oil investments and takes part in every consortium. The Azerbaijan government has decided to establish a ministry of energy and the blueprints are prepared within a framework of one of the Tacis projects, "Support for the Structural Reform to the Fuel and Energy Sector" (Caspian Investor September 1998, p.26).

¹⁵ For instance, Russian customs officials halted the oil flow between 5 and 11 February 1998 due to missing paperwork.

¹⁶ The American Mobil was awarded the production sharing agreement for the Serdar (or Kipyaz in Azeri) field. Rights to this field (as well as the closely located Chyrag and Azeri fields) is disputed by Turkmenistan and Azerbaijan. Mobil has announced that it will not start operations until the dispute has been resolved. Should the dispute be prolonged, Turkmenistan could also put the two other fields out for tender. The AIOC has similar plans on the Azerbaijan side. At the time of this writing, it appeared the disputes were being settled. The fact that the major American oil firms are submitting bids to both sides is likely to expedite achievement of compromise solution (Caspian Investor, August 1998, p.15). Again, a good example of how commercial interests can form the basis of resolving political and territorial disputes.

¹⁷ Treaty of Friendship between Iran and the USSR of 26 February 1921, and Treaty between Iran and the USSR on Trade and Maritime Navigation of 26 March 1940.

¹⁸ The sector division following to the actual length of coastlines borderlines would give Iran 14%, Russia 16%, Azerbaijan 19%, Turkmenistan 22%, and Kazakhstan 29% (Zerkalo, 22.8.1998 p. 4).

¹⁹ For instance, the Russian delegates at a meeting held in Ashgabat in November 1996 made a surprise announcement that they would agree to a division of the seabed, i.e. a partial division of the sea (Labyrinth, Vol. 5, No. 1/1998, p. 36). Russian deputy foreign minister Boris Pastuhov also made efforts to persuade the Iranians to give up their rigid stand "to get all or nothing divided" (Zerkalo No 33, 22 August 1998, p. 4). Both Moscow and Tehran agreed that the Caspian status should be decided quickly to ensure fair distribution of oil and other resources (The Minaret Group, July 22, 1998, p.1).

²⁰ The cut of date of this article was end-March 1999. Since then the oil prices have jumped back to USD 20 a barrel and over.

²¹ According to calculations by the Tacis Coordination Unit, the total allocation to national projects during 1991-1999 amounted to ECU 66 million, with the estimated share of Azerbaijan of the interstate projects at ECU 25 million. Thus, Tacis grants to finance technical and humanitarian assistance would slightly exceed ECU 90 million.

²² The 70-year-old Aliyev formerly served as KGB chief for Azerbaijan. He had served the Soviet Politburo during the Brezhnev period.

²³ We (Laurila and Singh) intend to study these developments in detail in two subsequent papers on the role of consensus in internal and external stability and on structural reforms in Azerbaijan.

²⁴ The EU is the most important trading partner outside the NIS. Moreover, the NIS is the by far most important trade partner of the EU. EU trades with the NIS exceeds all other western partners (including US and Japan) combined (EC 1997, pp. 5-10).

²⁵ The diffusion of news about Nagorno-Karabakh has similar features to recent developments in the Balkans, described by Loza (Loza 1999, p. 17).