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Comprehensive Evaluation of Azerbaijan

Azerbaijan is located in Southwestern Asia between Russia and Iran. It is also the largest country in the Caucasus region and borders the Caspian Sea. This republic is home to close to 9.5 million residents and holds its capital in the city if Baku. For comparative purposes, Azerbaijan is marginally smaller than the state of Maine ("The World Factbook"). This hydrocarbon rich nation also has a largely Turkic and Shia Muslim population.

The potential for international business is available, but caution must be exercised due to corruption and stability concerns. This report will highlight several key areas of importance regarding the potential for international business with Azerbaijan.

I. International Trade

A majority of Azerbaijan’s trade centers on the sale and production of oil. Azerbaijan’s capital, Baku, has been nicknamed the “birthplace of the modern oil industry” ("Country Report”). Let us focus on exports first. 92% of Azerbaijan’s exports are petroleum oils. 2% is petroleum gas. Sea vessels and raw sugar account for another 1% each. These products are exported to several key partners, including: 28% to Italy, 7% to France, 7% to Israel, 7% to the U.S., and 6% to Germany (“The Observatory”).

Azerbaijan’s most significant imports are cars at 11%, wood at 6%, machinery at 3%, construction materials at 3%, and cigars also at 3%. These products come from five major partners including: Russia at 24%, Turkey at 17%, Germany at 12%, United Kingdom at 7%, and

Georgia at 6% (“The Observatory”). The total amount of exports for 2011 was $34.49 billion, and imports were valued at $10.17 billion ("Country Report”).

The commercial policy of Azerbaijan is complicated. There are significant non-tariff barriers including an unpredictable legal system, corruption, and very apparent conflicts of interest in regards to regulation. This has led to market inefficiencies and monopoly powers in import/export trade. There are also insufficient protections for intellectual property ("Country Conditions"). According to its 2007 MFN Tariff Trade Restrictive Index (TTRI) of 5.3%, Azerbaijan is marginally more restrictive than its European counterparts. Out of 125 countries, it ranked 62; where 1 was the least restrictive ("Azerbaijan Trade Brief.").

Key to Azerbaijan’s future commercial policy will be its accession to the WTO. Azerbaijan is in negotiations to join the WTO, but must improve legislation to reach WTO standards. In order to join, the aforementioned domestic trade monopolies must be appropriately dealt with, and overall tariffs are set to be reduced by 3.2% (“Azerbaijan May Join”). Azerbaijan currently has no import quotas, and is working to simplify is licensing process. Currently, Azerbaijan’s licensing procedures need improvement to follow the GATT and the Agreement on Import Licensing Procedures ("Quantitative”).

II. Exchange Rate Determination

The exchange system in Azerbaijan is liberal. Funds transfers and conversion are not restricted and there are many outlets to facilitate these transactions ("Country Conditions"). The local currency is the manat. According to the U.S. Treasury Department, the current exchange rate is .80 manats for every U.S. dollar as of Sept. 30, 2012 ("Treasury Reporting”). This rate of exchange has been very stable and has deviated less than 0.0581 manats per dollar for the last five years ("The World Factbook"). Returns on investments take two to three days on average to remit. To further line-up with WTO standards, the local government has also eliminated custom duties on exports of cash ("Country Conditions").

In 2007, the GDP of Azerbaijan increased by 24.7%, but inflation also reached 17% that year as well ("Economy"). In order to stabilize the market the Central Bank of Azerbaijan (CBA) began a comprehensive intervention to ensure exchange rate stability. The CBA claims that Azerbaijan adheres to a floating exchange rate, yet for seven years a fixed exchange rate has been in place ("Monetary”). This has allowed the manat to steadily appreciate against the dollar and inflation to be kept in check. Furthermore, since 2008 the manat’s value has been pegged to the dollar to manage their currency against it ("Monetary”). Given Azerbaijan’s current accession into the WTO and recent reform, one can conclude the future exchange market for Azerbaijan to be reasonably stable.

III. Foreign Direct Investment Policies

Realizing the importance of FDI, Azerbaijan welcomes and encourages foreign investment. Most foreign investment has focused on its rapidly growing energy sector. The aforementioned domestic monopolies outside the energy sector make investments in those areas prohibitive. Nonetheless, in 2009 Azerbaijan was crowned “reformer of the year” by the World Bank ("Country Conditions"). Azerbaijan is making strides to open up to trade. They have cut business registration time and cost in half. Foreign ownership restrictions have also been reduced in key areas of banking and insurance.

Taxation in Azerbaijan is very straight forward. There is a flat corporate tax rate of 20% and there is a treaty between Azerbaijan and the United States to prevent double taxation ("Taxation"). To help encourage FDI the Law on Protection of Foreign Investments was enacted and provides “equal treatment” for foreign investors. This same law also prevents nationalization of foreign investment. To this date, no foreign investment has been nationalized ("Country Conditions"). Furthermore, the right to private property is legally protected and there are no special procedures or registration requirements to FDI ("Taxation"). One area of concern is land ownership. Land ownership is not allowed by foreign investors. Foreign investors must instead lease the land ("Country Conditions").

IV. Economic Structure and Performance

In 1995, Azerbaijan began a mass privatization program. This program, with support from the IMF, converted more than 20,600 companies from state control over to the private market. Since 1998, Azerbaijan has grown its GDP at an average rate of 10%. The country also has a current-account surplus of $17.1 billion in the most recent fiscal year (2011) and a surplus to GDP ratio of 27% ("Country Report"). The nation has also entered into bilateral agreements with dozens of nations around the world. Most notable, is the 1995 bilateral trade agreement with the U.S. that bestowed Azerbaijan the status of "most favored nation" ("U.S.-Azerbaijan Relations.").

The nation's infrastructure is in poor condition. Roadways, ports, railways, irrigation systems, electrical grids, telecommunications, and internet infrastructure are all lacking and in need of modernization ("Country Report"). The state still owns the telecommunication grid and has not invested in it adequately. Only 2.42 Million, or ¼ of its population, have internet ("The World Factbook"). The deteriorating infrastructure poses a significant challenge to establishing and growing an investment.

Prior to independence, Azerbaijan was a part of the Soviet Union and ran a command economy. Azerbaijan has since decentralized the economy, reduced its tariffs, and embraced many free-market principles ("Azerbaijan Trade Brief."). The macroeconomic performance of Azerbaijan is now comparably strong, especially for the region. GDP per-capita (PPP) reached $10,200 and inflation was 8.1% in 2011 ("The World Factbook"). Azerbaijan experienced a recent "growth-spurt" in GDP from 2006-2008. In 2007 alone, GDP increased by 24.7%, but inflation also reached 17% for the same year. Oil production has seemed to hit a plateau. GDP slowed to 0.2% in 2011 ("Economy").

With Azerbaijan in negotiations to join the WTO, I do expect further growth and stabilization in these economic indicators. Furthermore, Azerbaijan is attempting to enter the WTO as a “developing nation.” This status will enable it to receive distinct rights aimed at helping it grow. Vugar Bayramov, chairman of Azerbaijan’s Center for Economic and Social Development, has stated that Azerbaijan may be admitted to the WTO in 2013 (“Azerbaijan May Join”).

The labor market in Azerbaijan is strong. There is a large pool of both skilled and unskilled labor available at competitive rates. Recent reports do cite a decline in the quality of education and unemployment rates as high as 20%. Official unemployment numbers are much lower at 7% ("Country Conditions."). In 2011, the average monthly income hit 363 manat ($462 US Dollars). This was a 9.5% increase from 2010. Furthermore the government is pursing rapid minimum wage increases. This has been done partly to garner political support ("Country Report: Azerbaijan."). Azerbaijan is also member of the International Labor Organization (ILO) and in 1999 passed the Labor Code. Labor strikes are allowed, and a 40 hour work week in standard. As of today, over 50 ILO Conventions have been ratified ("Country Conditions.").

Environmental issues in Azerbaijan are of great concern. DDT and other toxic chemicals are present in the soil and the huge industrial complex surrounding petrol production has ravaged the air, land, and sea ("Economy."). Furthermore, some scientists consider the Caspian Sea area to be the most ecologically ravaged region in the world. Toxic defoliants used in cotton farming are still in the soil (The World Factbook). Environmental regulation is very weak. There are no incentives for corporations to reduce pollution. The current Azerbaijani laws regarding the environment have been carried over from Soviet principles ("Environmental Policy”). The main culprit for air pollution is oil production. Water pollution mainly comes from city waste water, discharges from local industry, and agricultural runoff. These environmental concerns are worth considering when deciding on inward FDI.

V. Cultural Complications

The national language for Azerbaijan is *Azebabaijani*, which is linguistically derived from Turkish. 89% of the country speaks Azerbaijani. 93% of the country is Shia Muslim and much of their culture branches back to the Turkic people ("People."). Education expenditures as a percentage of GDP are just 2.8%. While the educational funding in comparatively low, literacy is still very high at 99.8% (The World Factbook.). Azerbaijani is still socio-economically an emerging economy, yet the recent economic growth and accession into the WTO could help spur an increased pace of development ("People.").

A dispute worth noting is an ethnic conflict between the majority Azeri and minority Armenian ethnic groups. Nagorno-Karabakh is a primarily Armenian region and was under contention following the nations split from Soviet rule. In 1994, this culminated into a war. There has been some international tension caused by the subsequent occupation of Azeri lands by Armenians, but the number of Armenians has decreased to such a low level that tensions have diminished. While there is freedom of religion, there have been official reports of minority religious groups being harassed ("Country Conditions.").

VI. Social and Political Stability

Azerbaijan won independence from the Soviet Union in 1991. Azerbaijan is now a republic with an executive, legislative, and judicial branch. The legal system adheres to civil law. There is universal suffrage at the age of 18. The president serves a five year term, and is selected by popular vote. There are many political parties, yet many did not participate in the 2008 election due to discriminating conditions.

The Organization for Security and Cooperation in Europe (OSCE) determined the election failed to reach international standards (The World Factbook). The removal of presidential term limits in 2009 is also a source of potential political instability. There was very little public debate on the issue and the OSCE observers noted severe problems with how this vote was held as well. Political instability could also arise from corruption and the suppression of government opposition ("Country Conditions."). The future forecast for political stability is debatable. The 2009 referendum removing term limits and the suppression of opposition voices has led some to call the new government authoritarian (The World Factbook). These new developments should be considered in determining the country as a prospect for FDI.

Azerbaijan has fostered moderate social stability. While there is a civil law system and a democratic system of government, there is potential for social instability in the future. The aforementioned religious tensions and the lack of a strong education system are of concern. Furthermore, since seeking independence from the Soviet Union in 1991, the quality of health care has fallen. Infant mortality stands at a very high 53 per 1,000 births ("Country Conditions."). Sanitation, and basic research and development are also lacking. There is a minimal universal healthcare system, but access and delivery is insufficient. In summation, Azerbaijan has garnered the 98th place out of 177 countries recently survey for the Human Development Index. This places them in the “medium” range in human development ("People."). As of 2008, Azerbaijan also had a 33.7 on the Gini Index. The Gini Index measures income inequality, with 0 being perfect equality, and 100 being perfect inequality. The United States earn a rating of 45 in 2007. Compared to the U.S., one can infer less income inequality in Azerbaijan ("DISTRIBUTION”).

Recommendations

After careful assessment of all mitigating factors, several avenues for investment in Azerbaijan have emerged. Key to this recommendation is Azerbaijan’s accession to the WTO. In lining-up with international standards, Azerbaijan is becoming a more attractive place for foreign investment. Furthermore, business registration has been streamline, the corporate tax rate of 20% is internationally competitive, and there is an abundance of low and high-skilled labor. The bilateral trade agreements between the U.S. and Azerbaijan also make exporting to this rapidly growing nation an attractive option.

A high-risk, high-reward avenue to take would be FDI in Azerbaijan's rapidly expanding energy sector. The abundance of natural resources and local labor make this feasible, but several concerns must be considered. This region is incredibly polluted. While the lack of regulation eases operation in the area, the environment is already severely damaged. Furthermore, the energy sector is controlled by the government. To enter this market, one must sign a Product Sharing Agreement with the local Ministry of Energy and Industry ("Country Conditions."). While the oil industry may have plateaued, other natural resources including natural gas are available for extraction. While entering and thriving in this market may be challenging, the potential ROI is readily apparent.

A lower-risk, but still profitable route would be to simply export to Azerbaijan the products they need to continue their rapid expansion. Azerbaijan demands cars, machinery, construction materials, wood, and cigars. These products account for 25.87% of their imports ("The Observatory"). Their bilateral trade agreement with the U.S., and their lowering barriers for trade, would help facilitate this type of investment. The export of cigars is especially appealing given our location in Kentucky. Kentucky produces 1/3 of the nation's tobacco, with a value of over $339 Million ("Kentucky"). Given our access to regional tobacco and the demand for cigars in Azerbaijan, this looks like an especially profitable low-risk avenue for investment.

Since gaining independence in 1991, Azerbaijan has sought to participate in global business. As legislation within the country further steps in-line with international standards, the potential for investment in the nation will increase. Azerbaijan's possible acceptance into the

WTO in 2013 is especially reassuring. The future for international trade looks bright for Azerbaijan, but the aforementioned political and social instabilities must be addressed for inward FDI to become more favorable.

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