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signed by Ms Patricia BUGNOT, Director

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to: Mr Javier SOLANA, Secretary-General/High Representative

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COMMISSION OF THE EUROPEAN COMMUNITIES

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**COMMISSION STAFF WORKING PAPER**

**Annex to :**

**”European Neighbourhood Policy”**

**Country Report**

**Azerbaijan**

**{COM(2005) 72 final}**

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## 1. INTRODUCTION

On 1 May 2004, the enlargement of the European Union took place with the accession of ten new Member States. It has brought changes to the EU's political geography offering new opportunities to deepen existing relations between the Union and its neighbours to the East and to the South. The Union is determined to further develop partnerships with its neighbours to mutual benefit, promoting security as well as stability and prosperity. The EU's external borders will not become new dividing lines but the focus of enhanced co-operation.

The European Neighbourhood Policy (ENP) sets ambitious objectives for partnership with neighbouring countries based on strong commitments to shared values and political, economic and institutional reforms. Partner countries are invited to enter into closer political, economic and cultural relations with the EU, to enhance cross border co-operation and to share responsibility in conflict prevention and resolution. The Union offers the prospect of a stake in its Internal Market and of further economic integration. The speed and intensity of this process will depend on the will and capability of each partner country to engage in this broad agenda. The policy builds upon the existing framework of co-operation.

Following a recommendation made by the Commission, the Council on 14 June 2004 decided to offer Azerbaijan, Georgia and Armenia the opportunity to participate in the European Neighbourhood Policy, *inter alia* stating:

*“This marks a significant step forward in the Union’s engagement with the region. Each country will be given the same opportunity to develop its links with the EU, including through action plans, and will be treated in its individual merits in line with the general policy of the ENP. The Council also invited the Commission, and the SG/HR for issues related to political cooperation and the CFSP, to report on progress made by each country with regard to political and economic reforms”.*

In this report<sup>1</sup>, the Commission provides an assessment of bilateral relations between the EU and Azerbaijan. It reflects progress under the Partnership and Co-operation Agreement, and describes the current situation in selected areas of particular interest for this partnership: the development of political institutions based on the values – democracy, the rule of law, human rights – enshrined in the Agreement, regional stability and co-operation in justice and home affairs, and economic and social reforms that will create new opportunities for development and modernisation, for further liberalisation of trade and for gradual participation in the Internal Market. The report provides guidance for the Commission recommendation on developing joint ENP action plans and serves as a basis for assessing future progress in the Union's relations with Azerbaijan.

### 1.1. Relations between the European Union and Azerbaijan

The **Partnership and Cooperation Agreement (PCA)** entered into force in 1999 and provides the legal framework for EU-Azerbaijan relations. Respect for democracy, principles of international law, human rights and market economy principles are at the essential elements on which the EU-Azerbaijan partnership is based. The PCA provides for wide-ranging cooperation in the areas of political dialogue, trade, investment, economic, legislative

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<sup>1</sup> For the most part, covering events and developments until 31 December 2004

and cultural cooperation. This dialogue builds upon the shared commitment to promote international peace and security as well as the peaceful settlement of disputes. Through the PCA, which also eliminates trade quotas and provides for the protection of intellectual, industrial and commercial property rights, the parties have accorded each other Most Favoured Nation (MFN) treatment and Azerbaijan benefits from the EU's Generalised System of Preferences (GSP).

Regular **political dialogue** takes place at Ministerial, Parliamentary and senior official level. Cooperation Council meetings, held on an annual basis, began in October 1999 and the first Cooperation Committee was held on 27 March 2000. To date, six EU-Azerbaijan Cooperation Councils have been held, the latest in Brussels in September 2004. A Sub-Committee on Trade, Investment and Energy completes the PCA institutional framework at the technical level.

An **Agreement on Trade in Textile Products** between the EC and Azerbaijan was initialled on 20 September 1993, amended by an exchange of letters on 26 November 1999 and extended to 2004. This area may in future be integrated into the PCA.

At the General Affairs Council of February 2001, the EU confirmed its willingness to play a **more active political role in the South Caucasus** region and its intention to look for further ways in which to support efforts aiming at prevention and resolution of conflicts in the region and to participate in post-conflict rehabilitation. The Foreign Ministers of Azerbaijan, as well as Armenia and Georgia, welcomed the EU's commitment to play a more active role in the region in the Joint Communiqué issued on 30 October 2001 on the occasion of the Cooperation Councils with the three countries.

Pending the opening of a Commission Delegation in Baku, the European Commission decided in 1998 to appoint a Special Envoy to the Republic of Azerbaijan.

In July 2003, the Council decided to appoint the first EU Special Representative (EUSR) for the Southern Caucasus, Mr. Heikki Talvitie. His mandate is, *inter alia*, to assist the Council in developing a comprehensive policy towards the South Caucasus, to contribute to conflict prevention and assist the conflict settlement mechanisms in the region. He has visited Azerbaijan regularly and has paid particular attention to the conflict over Nagorno-Karabakh which he visited in July 2004. The EUSR is in constant contact with the countries of the region as well as other players such as Russia, Turkey, the US and with the Commission.

The Council decision of 14 June 2004 to include Azerbaijan (together with Armenia and Georgia) in the European Neighbourhood Policy marked a significant step forward in the relations between the Union and Azerbaijan. The decision followed the visit of President Ilham Aliyev to Brussels in May 2004 and preceded the visits of Commissioner J. Potočník (July 2004) and of President R. Prodi (September 2004) to the Southern Caucasus.

## **1.2. Community and macroeconomic assistance**

Between 1992 and 2004, the total assistance provided by the Community to Azerbaijan amounted to some €400 million. The three principal Community instruments have been:

- TACIS (€116.5 million in technical assistance);
- the Food Security Programme (€57.0 million);

- humanitarian assistance, food aid, rehabilitation of war damaged areas (€176.2 million).

Azerbaijan repaid on time and in full its €30 million exceptional macro-financial assistance from the EC.

In the framework of the Country Strategy Paper for Azerbaijan (2002-2006), the **TACIS** National Indicative Programme (NIP) 2004-2006 focuses, in the overall context of poverty reduction, on support for institutional, legal and administrative reform, support for the private sector and assistance for economic development. In particular, the cooperation programme encompasses support for the implementation of the PCA, modernisation of public finance and tax systems, social protection, as well as improvement of the judiciary and border management. For private sector development, assistance is targeted at improving the investment climate, at SMEs and regional development, as well as strengthening of higher general and technical education and vocational training. Budget support from the Food Security Programme has been targeted at agriculture and rural development and social protection. Rehabilitation has been aimed at improving living conditions and livelihood prospects of the internally displaced.

Azerbaijan also benefits from the TACIS Regional programme, particularly in the fields of transport and transit (maritime, seaport and rail), energy (oil and gas), environment (EU Water initiative and Regional Environmental Centre), as well as Justice and Home Affairs (fight against drug trafficking). The National Programmes comprise complementary actions in a number of areas such as transport, energy and justice and home affairs.

**Total EC grants to Azerbaijan since 1992** (*in addition to the figures below, Azerbaijan benefits from grants under the Tacis Regional Programme*)

	1992 1994	1995	1996	1997	1998	1999	2000	2001	2002 2003	2004 2006	Total
<b>Tacis National Allocations</b>	20.50	6.00	8.00	8.00	8.00	8.00	7.00	7.00	14.00	30.00	<b>116.50</b>
<b>Exceptional Macro-Financial Assistance</b>					10.00	10.00	10.00				<b>30.00</b>
<b>Humanitarian</b>	31.10			28.82	9.69	6.10	9.66	5.15	1.57		<b>92.09</b>
<b>FEOGA</b>		43.00	22.70								<b>65.70</b>
<b>Food Security</b>			15.00	16.00	14.00	12.00			20.00		<b>77.00</b>
<b>Rehabilitation</b>			3.00	4.00	4.50	3.20	3.67				<b>18.37</b>
<b>Exceptional Humanitarian Aid</b>		8.00						1.50			<b>9.50</b>
<b>Total</b>	<b>51.60</b>	<b>57.00</b>	<b>48.70</b>	<b>56.82</b>	<b>46.19</b>	<b>39.30</b>	<b>30.33</b>	<b>13.65</b>	<b>35.57</b>	<b>30.00</b>	<b>409.16</b>

## 2. POLITICAL ISSUES

### 2.1. Democracy and the rule of law

According to the 1995 Constitution, substantially amended in 2002, Azerbaijan is a **Presidential Republic** based on the principle of separation of powers

The **President**, with executive power, is directly elected for a five-year term; re-election is allowed only once. The President appoints the Prime Minister and other Ministers, who must obtain the confidence of the National Assembly (*Milli Majlis*).

The latest presidential **elections** took place on 15 October 2003. The elections, monitored by about 600 international and 40,000 local observers, were based on a new Election Code largely in line with Council of Europe and OSCE recommendations. According to the OSCE/ODIHR, the elections fell short of international standards in several respects, although some progress was noted in comparison with previous elections. Mr. Ilham Aliyev became president with slightly less than 80% of the votes on a turnout of 71%. The OSCE reported that the second municipal elections since independence, held in December 2004, also fell short of a number of international standards. The next parliamentary elections (to be held in October 2005) will prove a litmus test for the implementation of OSCE/ODIHR election recommendations.

**Legislative power** is vested in the *Milli Majlis*, a unicameral body composed of 125 members elected in single mandate constituencies, who serve five-year terms. The Constitution enumerates the competencies of the Parliament in a well-defined number of issues and sectors. Parliament holds the right of legislative initiative, together with the President of the Republic, the Supreme Court and the Parliament of the Nakhcivan Autonomous Republic.

The Azerbaijani constitutional system formally provides for a separation of powers. However, according to the Parliamentary Assembly of the Council of Europe, the executive remains clearly predominant over the legislative and judicial branches. The **court** system of Azerbaijan is structured in accordance with the Constitution and the Law on Courts and Judges of 10 June 1997, which envisage a four-tiered system of courts of general jurisdiction: (i) district courts, (ii) a Court of Appeal, (iii) the Supreme Court of the Nakhcivan Autonomous Republic and (iv) the Supreme Court of the Republic of Azerbaijan. General jurisdiction is supplemented by specialised economic courts and military tribunals. At present, there are 346 judges of general jurisdiction (including 38 each in the Supreme Court and the Court of Appeal). The judges of the courts of first instance are appointed by the President for a 5-year term after passing an examination. Judges of the Court of Appeal and of the Supreme Court are appointed by the Parliament, on the basis of presidential recommendations. The Constitutional Court has jurisdiction over matters related to the constitutionality of laws, government and parliamentary regulations, presidential decrees and international treaties. The nine judges of the Court are appointed by the Parliament on the basis of presidential recommendations, a procedure that has been criticised by the Council of Europe

Azerbaijan is divided into 59 regions (*rayonlar*), 11 cities and the Autonomous Republic of Nakhcivan (*Naxcivan Muxtar Respublikasi*). The President appoints and dismisses Governors, who head the *Rayon* governments. At **local level**, over 2,650 municipalities have been created since 1999; they can approve local taxes, adopt and implement local development programmes. Their powers are determined by the Constitution and by State regulations. Side-by-side with municipalities, a *Local Executive Authority* is the direct emanation of the central executive power. The precise division of tasks and responsibilities between the central government and municipalities, as well as that between municipalities and local executive authorities, is ill-determined. The financial basis of the municipalities' autonomy is provided by both central government transfers and local tax collection. However, municipalities still depend very much on state transfers, as local taxes do not guarantee sufficient revenue.

**Civil service** reform began in July 2000. It is difficult to provide an estimate of the number of civil servants. According to the State Statistical Committee of Azerbaijan, they were 265,000 in 2003 (some 7% of the total workforce) but this figure includes also "defence personnel" and those working in the "compulsory social security". Azeri citizens join the civil service

through competition and are obliged to fulfil certain anti-corruption requirements, such as a declaration on incomes and properties acquired during their service in state bodies.

**Corruption** remains a serious problem. In 2004 the Transparency International's *Corruption Perception Index* ranked the country at the 140<sup>th</sup> place which indicates that there is perceived to be very high level of corruption. In 2004, Azerbaijan ratified the CoE Criminal Law Convention on Corruption and Civil Law Convention on Corruption and in June 2004 joined CoE GRECO (Group of States against Corruption), whilst the UN Convention against Corruption was signed in February 2004 but not yet ratified. A positive step was taken by Azerbaijan in 2003 by deciding to implement the recommendations of the Extractive Industries Transparency Initiative (EITI) and the November 2004 Memorandum of Understanding between the Azerbaijani authorities, oil and gas companies in Azerbaijan and national NGOs, aims to ensure that revenues from the oil and gas industry in Azerbaijan which flow into the Azerbaijani oil fund should be transparent and accounted for.

The government of Azerbaijan has developed an anti-corruption legal framework, adopting decrees on the enhancement of the fight against crime and the strengthening of law and order, and on the fight against corruption. It has also adopted a State Programme on Fighting Corruption, which covers the period from 2004 to 2006. Among the principal provisions of these acts figures the creation of an anti-corruption department within the Prosecutor General's Office. A specific anti-corruption department has been established within the Ministry of the Interior. Despite the significant strengthening of the legal framework, there has so far been limited progress in reducing the level of corruption; many of these shortcomings can be explained by the complexity and fragmentation of the system dealing with corruption (detecting, investigating and prosecuting). Civil society and NGOs should also be involved in this important process.

The Azeri Criminal Code contains a number of provisions criminalising corruption; however, the definition of criminal acts does not fully meet the requirements of international standards (such as the UN Convention on Corruption, the CoE Criminal Law Convention on Corruption and the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions).

## **2.2. Human rights and fundamental freedoms**

The Constitution of the Republic of Azerbaijan provides for freedom of thought and speech, conscience, association and assembly.

Azerbaijan is also party to most UN conventions and protocols on human rights, including the International Covenant on Civil and Political Rights, the Convention against Torture and Other Cruel, Inhuman or Degrading Treatment or Punishment, the Convention on the rights of the Child.

Azerbaijan acceded to the Council of Europe (CoE) in 2001 Azerbaijan has signed and ratified several CoE International Conventions, in particular the Convention for the Protection of Human Rights and Fundamental Freedoms. Many of these provisions still need, however, to be properly implemented.

Some improvements have taken place concerning **freedom of expression and speech**, even though cases of harassment or detention of journalists are still reported. Several journalists were physically attacked and detained during the rioting that followed the 2003 presidential



elections. One of them, also leader of an opposition party, was sentenced to five years in prison in October 2004, after a trial deemed unfair by international observers.

**Press and media freedom** still faces challenges of an economic, financial and legal nature. According to the OSCE, opposition newspapers are denied access to printing houses or to press distribution channels, directly or by means of high prices or purported technical problems. Journalists can be easily convicted of defamation or insults, which remain criminal offences. As a partial alleviation of this situation, a self-regulatory body for the media, the Press Council was set up in March 2003 and mediates between the press community and the authorities, especially regarding accusations of defamation. A working group comprising journalists and MPs was set up in spring 2004 to revise relevant legislation on defamation. Two drafts of new legislation (one from NGOs, the other from the President) are now before the Parliament; both of which promise significant improvements of the current situation.

In September 2004, a Law on the Public Broadcasting Service was adopted, incorporating all of the proposals made by Council of Europe experts. A Presidential Decree was adopted in November 2004 to implement the provisions of this law and, *inter alia*, foresees the transformation of the second State television channel into a public broadcaster. State Television will continue to exist together with public television, a solution criticised by the CoE.

The Constitution provides that persons of all faiths may choose and practice their **religion** without restriction. The Law on Religion expressly prohibits the Government from interfering in the religious activities of any individual or group, except when a religious group "threatens public order and stability." Religious groups are required to be registered with the Ministry of Justice, which then enables them to act as a legal entity. Lack of registration makes it difficult, but not impossible, for a religious group to function. There are frequent, lengthy delays in obtaining registration. Religious groups are permitted to appeal registration denials to the courts.

The Constitution and laws provide for **freedom of association**, including the right to form labour unions, but some classes of workers are prohibited from forming unions. According to the International Confederation of Trade Unions, unions in Azerbaijan do not have the resources to carry out their activities effectively. Azerbaijan has ratified all ILO fundamental conventions (forced labour, freedom of association, child labour, collective bargaining and discrimination in employment.) but many of these provisions still need to be properly implemented. The Law on Trade Unions and the Labour Code prohibit antiunion discrimination. Laws provide for collective bargaining agreement to set the wages in state enterprises, but they do not produce an effective system of collective bargaining between unions and enterprise management. Government-appointed boards ran the major state-owned firms and set the wages in accordance with the Unified Tariff Schedule. Unions do not effectively participate in determining wage levels. The Constitution and the Law on Trade Unions provide for **the right to strike**; however, the Criminal Code restrict that right by imposing penalties of up to 3 years' imprisonment on striking workers who aim to disrupt public transportation. Some classes of workers are prohibited from striking.

According to some estimates, there are approximately 1,500 **NGOs**. They mainly operate in sectors such as human rights, democratisation, environment and legal education. NGOs are required to register, but the procedures are cumbersome, despite the adoption of a more liberal law in 2004 providing for automatic registration in case of failure to respond to an NGO's application within 45 days. No public funding is available for NGO activities and funding

from international donors must be registered with the Ministry of Justice. Foreign-funded NGOs experienced difficulties in performing election monitoring. Legislation is presently under discussion to exempt NGO revenues from taxation.

The situation in Azerbaijan's forty-six **prisons** remains a matter of concern and reform has been recommended by CoE Committee for the Prevention of Torture (CPT). Important activities are also carried out by the International Committee of the Red Cross, including visits to prisons, seminars on humanitarian law and treatment of TB in the Azerbaijani prison system. An Action Plan on the reform of Azerbaijani prisons is being jointly implemented by CoE and government experts. Specific allegations of **torture and ill-treatment** in prisons and police stations (mostly in the Baku area) have been made in the recent past, especially as regards people imprisoned following the 2003 presidential elections. Lengthy pre-trial detention also remains a serious problem. The authorities recognise the need for human rights education and training for police and security forces

The situation concerning alleged **political prisoners** has much improved. The Council of Europe concluded that, on the 104 cases assessed, 45 were political prisoners, all of whom were either released following presidential pardons, or re-tried.

In 2002, Azerbaijan has ratified CoE Protocol 6 to the Convention for the Protection of Human Rights and Fundamental Freedoms concerning the Abolition of the Death Penalty, but has not signed Protocol 13.

To date, Azerbaijan has not acceded to the **Rome Statute of the International Criminal Court** establishing the International Criminal Court (ICC), but has signed an Article 98 agreement with the United States in March 2003.

**Women** nominally enjoy the same legal rights as men. However, traditional social norms and poor economic conditions continue to restrict their role in the economy. Representation of women is significantly lower in the higher levels of the work force. The Labour Code protects women from heavy and dangerous working conditions. Violence against women, including domestic violence, remains a problem, especially in rural areas. The Criminal Code prohibits rape, which is punishable by up to 15 years in prison, but no laws exist regarding spousal abuse or spousal rape. There are approximately 50 registered NGOs addressing women's issues.

The Constitution and laws protect the **rights of children** to education and health care. However, the Government's ability to carry out these commitments has been weak. Public education is compulsory, free, and universal until the age of 17. The Government provides minimum standards of health care for children, although the quality of medical care is low. The Criminal Code mandates severe penalties for crimes against children. Under the Labour Code, children at the age of 15 may be legally employed. The law prohibits the employment of persons younger than 18 years old in jobs with difficult and hazardous work conditions.

Azerbaijan has taken positive steps to combat racism and intolerance and to improve the protection of **minorities** *inter alia* by ratifying international conventions, such as the CoE Framework Convention for the Protection of National Minorities. The rights of national minorities are protected on the basis of the relevant constitutional provisions. These provisions are reflected in the 1999 Criminal Code which stipulates that offences committed on the basis of racial, national or religious hatred are considered to have been committed under aggravating circumstances. A Constitutional Law establishing the Office of the Human

Rights Commissioner (Ombudsman) was adopted in 2001. Despite these positive developments, discrimination is reportedly still present in Azerbaijan's society, as stressed by CoE's European Commission against Racism and Intolerance (ECRI). The rights of particularly vulnerable groups such as ethnic Armenians, refugees or small religious groups need more effective protection.

### 2.3. Foreign relations – General

Azerbaijan is a **member** of the UN, the Council of Europe, OSCE, Organisation of the Islamic Conference (OIC), the Commonwealth of Independent States (CIS), the Black Sea Economic Cooperation (BSEC), the GUUAM (Georgia, Ukraine, Uzbekistan, Azerbaijan and Moldova) regional grouping as well as the International Monetary Fund, the World Bank and the European Bank for Reconstruction and Development. In 1992 it also became a member of the Economic Cooperation Organisation that includes Afghanistan, Iran, Pakistan and Turkey. Azerbaijan has observer status at the World Trade Organization and is currently seeking membership.

Since independence, Azerbaijani foreign policy has followed a “multi-vector” and balanced approach in the relations with the EU, Iran and other its Caspian Sea neighbours, the Russian Federation and the US.

The **Russian Federation** plays a major role in Azeri foreign policy and, more broadly, in the Southern Caucasus, including with respect to regional disputes such as the delimitation of the Caspian Sea and the Nagorno-Karabakh conflict. Moreover, about a quarter of Azeri nationals work and live in Russia and Russian gas is still needed *inter alia* for heating and domestic consumption.

Azerbaijan has also developed strong relations with the **United States**.

Relations between Azerbaijan and the **European Union** and its Member States are also an important part of Azeri foreign policy.

Mainly for historical and cultural reasons, Azerbaijan has very close ties with **Turkey**, the first country to recognise Azerbaijani independence in 1991. In the short and medium-term, the state of relations between Azerbaijan and Turkey will be shaped by several factors, including the opening of the Baku-Tbilisi-Ceyhan and Baku-Tbilisi-Erzurum pipelines and Turkey's EU aspirations. Good relations with **Georgia** are equally important for Azerbaijan's access to international markets. There has, however, been no progress over the past year on the issue of possible repatriation to Georgia of approximately 50,000 Meskhetian Turk refugees.

The presence of more than 15 million ethnic Azeris in **Iran** has periodically led to tensions between the two countries. The notion of Azerbaijani reunification, or "one Azerbaijan", which was popular in the 1940s and re-emerged under Heydar Aliyev's leadership of Soviet Azerbaijan, was raised again after independence by the Popular Front government and created tensions in the Iran-Azerbaijan relations. Iran continues to monitor nationalist sentiment carefully in its Azerbaijan province.

Azerbaijan is a participating State of the UN Programme of Action to Prevent, Combat and Eradicate the Illicit Trade in Small Arms and Light Weapons in All its Aspects (UNPoA). Azerbaijan became a member of the Convention on Conventional Weapons (CCW) in February 2000. Despite being very much affected by the landmines problem, Azerbaijan has not acceded

to the 1997 Ottawa Convention on the Prohibition of the Use, Stockpiling, Production and transfer of Anti-Personnel Mines and on their Destruction, in part because of regional issues.

Azerbaijan has so far acceded to twelve international and nine European conventions and has signed 13 bilateral agreements, 15 protocols and 2 memoranda on **counter-terrorism**. Azerbaijan acceded to the Treaty of Non-Proliferation in 1992, ratified the Comprehensive Nuclear Test Ban Treaty in 1999 and the Convention on the Prohibition of the Development, Production and Stockpiling of Bacteriological (Biological) and Toxin Weapons and on their Destruction in February 2004.

#### **2.4. Territorial and other conflicts/disputes**

Ethnic tensions over **Nagorno-Karabakh** increased in the period 1988-1991. Following the collapse of the Soviet Union in 1991, war broke out between Armenia and Azerbaijan over the region. The two countries agreed on a cease-fire in 1994 after a war which had resulted in the deaths of more than 30,000 people and created numbers of refugees on both sides. Estimates put the numbers of Azeri refugees and Internally Displaced Persons (IDPs) from Nagorno-Karabakh, adjacent occupied districts and Armenia at 800,000 and of Armenian refugees from Azerbaijan at 300,000. Portions of Azerbaijan's territory remain under Armenian occupation. Although the cease-fire has held since 1994, significant numbers of incidents along the "line of contact" take place each year: in 2004 alone there have been more than 30 casualties.

As a consequence of the Nagorno-Karabakh conflict, Azerbaijan is very reluctant to engage in any co-operation with Armenia, either on a bilateral basis or within the framework of international organisations. There is very limited regional co-operation in the Southern Caucasus.

Since 1992, the Organisation for Security and Co-operation in Europe (OSCE) has been the primary forum for mediation efforts, led by a subset of OSCE members - the Minsk Group, co-chaired by Russia, the US and France. Dialogue between the Presidents of Armenia and Azerbaijan led in 2001 to a high-level meeting in the US that did not result in a breakthrough. Following the elections in the two countries in 2003, dialogue was resumed. The Armenian and Azerbaijani Foreign Ministers meet regularly in the context of the so-called Prague Process. Presidents Robert Kocharian and Ilham Aliev had a long bilateral discussion in the margins of the September 2004 CIS Summit held in Astana (Kazakhstan). The Minsk Group co-chairs are continuing to assist the parties in their dialogue.

The European Union, including through the EU Special Representative to Southern Caucasus, continues to provide strong political support to the mediation efforts of the OSCE Minsk Group.

**Caspian Sea border demarcation** has not yet been determined between Azerbaijan, Iran and Turkmenistan. Although Azerbaijan, Kazakhstan and Russia have signed bilateral agreements demarcating their respective sectors of the Caspian Sea, no multilateral agreement has been concluded among the five littoral states, and the southern part of the Caspian, in particular, still remains disputed.

Azerbaijan protests against Georgian constructions at the Red Bridge Azerbaijan-Georgia border crossing and several other small segments of boundary remain unresolved until delimitation is agreed.

## 2.5. Justice and Home Affairs

The situation of **refugees** and internally displaced persons (IDPs) remains problematic. According to the UNHCR, there are around 1 million refugees and IDPs in the South Caucasus region (some 580,000 IDPs in Azerbaijan alone).

Azerbaijan is also a transit country for illegal migration from Afghanistan, Iran, Iraq and Pakistan to Western countries. A national **migration** plan, the State Migration Management Programme, has been developed by a Commission established by the government in 1998, but has not yet been adopted. Most migration-related issues are currently dealt with by a 1998 state law, which also includes specific rules on expulsions. No readmission agreements are currently in force between Azerbaijan and other countries. The TACIS 2004-2005 Action Plan for Azerbaijan includes the first EC-funded migration project to be implemented in the Southern Caucasus.

As regards **asylum**, the requirements of the 1951 Geneva Convention and its 1967 Protocol relating to the status of refugees (to which Azerbaijan acceded in 1993) are reflected in the 1999 Law on refugees and IDPs and a 2000 Presidential Decree. According to the International Organisation for Migration (IOM), there were 3,528 applications for refugee status in 2000, 3,522 in 2001, 1,834 in 2002 and only 878 in 2003 (of which only 326 were accepted). Some 10,000 Chechens have fled to Azerbaijan and the UNHCR is urging the Azerbaijani authorities to clarify the legal status of their children, born in Azerbaijan, as soon as possible.

Following a preliminary visit to Baku in September 2002, the OSCE is planning a €1.4 million assistance programme in the field of **police reform**, aimed at the introduction of community policing methods at a 'Model Police Station' site in the town of Mingechevir, the strengthening of intelligence-led drug investigations supported by a police operational information system and linked to work by the United Nations Office on Drugs and Crime (UNODC) and the modernization of the curriculum of the Police School for non-commissioned police staff.

As far as **international judicial cooperation** is concerned, Azerbaijan has ratified the 1957 European Convention on extradition, the 1959 European Convention on Mutual Assistance in Criminal Matters and the 1978 Additional Protocol to the Convention on Mutual Assistance in Criminal Matters. Azerbaijan has not yet signed the 2001 Second Protocol to the Convention on Mutual Assistance in Criminal Matters. On civil matters, Azerbaijan is a party to the 1993 Hague Convention on Protection of Children in respect of Inter-country Adoption.

Azerbaijan shares **borders** with seven countries, with a total length of 3371 km, including 713 km of sea border. Established in 2002, the State **Border** Service (SBS) is still in a process of demilitarization and modernisation. In total, there are 220 border posts in 10 regional centres. The SBS has limited border control capabilities, mainly because the most advanced equipment was taken over by the Soviet Border Service upon Azerbaijan's independence and the budget of the SBS is now almost entirely devoted to salaries, leaving little for the procurement of equipment. A number of border cooperation agreements and protocols are in force between Azerbaijan and neighbouring countries, notably Georgia, Iran, the Russian Federation and Turkey.

In 2003 Azerbaijan ratified the two protocols to the UN Convention against Transnational Organised Crime which concern **human trafficking** (the so-called Palermo Protocols). These

protocols form the basis of Azerbaijan's National Action Plan Against Trafficking in Human Beings, adopted by Presidential Decree on 6 May 2004. However, trafficking is not in itself criminalised in the Criminal Code. Slavery, rape, coercion into prostitution and inducing a minor into prostitution are used to prosecute trafficking crimes. Azerbaijan does not have efficient mechanisms for protecting and assisting victims. Azerbaijan is a country of origin and transit for trafficked men, women, and children for the purposes of sexual exploitation and forced labour.

Azerbaijan is on a **drug** transit route for heroin originating in Afghanistan and running from Central Asia into Western Europe, and from northern Iran into Russia and Western Europe. Azerbaijan emerged as a narcotics transit route several years ago because of the disruption of the Balkan route due to the conflicts there. Cannabis and poppy are cultivated illegally, mostly in southern Azerbaijan. Azerbaijan is a party to the 1988 UN Drug Convention. Parliament adopted a law aimed at strengthening the police mandate to combat drug sales and trafficking in 2002. 18,000 persons are reportedly registered in hospitals for drug abuse or treatment in Azerbaijan. In 2003 the State Commission, supported by the European Commission Southern Caucasus Action Programme on Drugs (SCAD), established a resource centre and information network that provides access to a central database of information pertaining to narcotics control. SCAD also conducted an epidemiological survey of drug use and abuse in Azerbaijan. Azerbaijan cooperates with Black Sea and Caspian Sea littoral states in tracking and intercepting narcotics shipments, especially morphine base and heroin. Caspian Sea cooperation includes efforts to intercept narcotics transported across the Caspian Sea by ferry.

In 1996, Azerbaijan joined the 1949 Convention for the Suppression of the Traffic in Persons and of the Exploitation of Prostitution of Others and in 2003 ratified the UN Convention against Transnational **Organised Crime**. Azerbaijan has not yet signed the Protocol against the Illicit Manufacturing and Trafficking in Firearms, their Parts, and Components and Ammunition.

The Government of Azerbaijan criminalized **money laundering** relating to narcotics trafficking in 2000. Additionally, Parliament has adopted amendments to its banking and currency laws to prevent money laundering activities. In May 2003, the Government established an inter-ministerial expert group responsible for drafting anti-money laundering and antiterrorist finance legislation. This group, led by the National Bank of Azerbaijan, is preparing a proposal to the government on anti-money laundering legislation, including the establishment of a Financial Intelligence Unit (FIU) and broadening the definition of predicate crimes for money laundering beyond narcotics trafficking. Azerbaijan is not considered a major centre for international **money laundering**, given its small, limited banking sector and financial sector. However, as the Azeri economy expands, and the financial sector develops, the potential for money laundering will increase. While the economy is still cash based (80% of transactions are performed in cash), the main sources of money laundering are primarily corruption, financial crimes and smuggling of goods. Azerbaijan ratified the UN International Convention for the Suppression of the **Financing of Terrorism** in 2001 and the Criminal Code criminalizes the financing of terrorism. In 2001, Azerbaijan signed the Council of Europe Convention on Laundering, Search, Seizure and Confiscation of the Proceeds of Crime and 2003, Azerbaijan was the subject of a mutual evaluation by the Council of Europe's Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures (MONEYVAL), of which it is a member.

### **3. ECONOMIC AND SOCIAL SITUATION**

#### **3.1. Macro-economic and social outlook**

##### *3.1.1. Recent economic developments and outlook*

Azerbaijan is a lower-middle-income country of 8.3 million people with moderate population growth. Average living standards are improving and real per capita income in purchasing power parity terms, which stood at approximately US\$3390 in 2003, will soon be twice the 1996-level. Poverty is, however, still widespread with 45% of the population living below the national poverty line in 2003. Real GDP growth has averaged 10% annually since 1998, driven mainly by oil-related foreign direct investments.

The economy is highly dependent on oil and gas related activities, accounting for 86% of total exports, 31% of GDP and contributing 36% of fiscal revenues (56% of fiscal revenues if energy related tax credits are included). Several large-scale investment projects in the oil and gas sector are currently in full progress. The major projects are the Baku-Tbilisi-Ceyhan (BTC) oil export pipeline, which should be completed in early 2005, the South Caucasus natural gas pipeline running in parallel to the BTC oil pipeline from Baku to Erzurum in Turkey and projected to be ready in 2006, the Azari-Chirag-Guneshli oil field and the Shah-Deniz gas field, which are expected to start flowing in 2005 and 2006 respectively. These investments are expected to lead to a quadrupling of oil and gas production within the next five years. As a result, the economy is projected to show real GDP growth rates close to or above 10% in 2005-2006 and almost as high in the following years. These windfall gains are, however, relatively short-lived as oil production is projected to fall already from 2010 and dry out in 2025. There is a risk of the traditional non-oil tradable sector being crowded out by an appreciation of the real exchange rate. A state oil fund (SOFAZ) has been set up in order to invest in the non-oil sector and save for future generations. The fund will be crucial in managing the oil boom and securing smooth and equitable medium-term growth.

The non-oil sector has displayed real growth above 10% annually for the last four years. Total employment has in the same period increased a modest 1.1% and industrial employment is unchanged, indicating a substantial non-oil labour productivity increase. The non-oil manufacturing sector suffered in the first years of independence due to its high costs and low quality products, and is now struggling to get on track.

Construction grew 70% in 2002 and 61% in 2003, and accounted for 12% of the booming economy in 2003. When the oil driven construction growth returns to a more modest level, it is thus expected that the non-oil sector growth may fall substantially. The service sector has experienced rapid growth since independence and grew 8% in 2003. Growth was particularly high in hotels and restaurants (32%) and communication (28%). The service sector including public services accounts for 30% of GDP.

Agriculture and forestry account for 13% of GDP, but employ 39% of the labour force (1.5 million people). Employment in the agricultural sector increased significantly in 1999 as a result of land reform which allocated land plots to most of the rural population. In 2000-2003 agricultural output increased by 23%, while employment in agriculture decreased slightly. Agricultural labour productivity thus improved considerably, albeit from a very low level. Agriculture is the second largest export sector and the main crop is wheat.

Azerbaijan has been fairly successful in bringing down **inflation** after years of hyperinflation in the early 1990s. Inflation has been kept relatively steady and at a low level, although signs of pressures appeared in early 2004, when inflation reached the highest level since 1997 (6.8 %). Large capital inflows and growing money supply is pushing prices upwards, although so far mainly food product prices have accelerated. In October 2004, inflation increased sharply due to one-off factors e.g. the termination of the VAT exemption for imported grain. (proposal HG delete: and price increases ahead of the planned increase in domestic energy prices.) Annual consumer price growth (end of period) stood at 8.5% in October 2004.

**Azerbaijan - Selected Economic Indicators, 1997-2003**

	1997	1998	1999	2000	2001	2002	2003
<b>Real GDP growth (in %)</b>	5.8	10.0	7.9	10.3	9.6	9.7	10.8
<b>Unemployment rate (ILO definition)</b>							10.7
<b>CPI inflation (in %) annual average</b>	3.7	-0.8	-8.5	1.8	1.5	2.8	2.2
<b>Average monthly wages (annual average; % change)</b>	58.5	18.9	9.5	20.2	17.3	21.2	22.8
<b>Broad money (end of year; % change)</b>		-13.3	8.7	27.1	31.7	14.4	29.8
<b>Consolidated government balance (% of GDP)</b>	-1.6	-3.9	-4.7	-0.6	-0.4	-0.5	-1.2
<b>Current account balance (% of GDP)</b>	-23.1	-30.7	-13.1	-3.6	-0.9	-12.3	-28.3
<b>Net international reserves</b>							
<i>In millions of US dollars (end of period)</i>	201	126	264	344	428	441	543
<i>In months of non-oil GNFS</i>				2,5	2,7	2,4	2,6
<b>External debt/GDP</b>		15,9	19,0	19.8	20.2	20.1	20.1
<b>Debt service (in % of exports of GNFS)</b>				4.6	4.9	4.4	5.2
<b>Exchange rate (Manats/US dollar) (end of year)</b>	3888	3890	4378	4565	4775	4893	4923
<b>Real effective exchange rate (annual change in %)</b>				-9.8	-6.1	-7.5	-11.3
<b>Population (million)</b>	7.9	8.0	8.0	8.1	8.1	8.2	8.3

Sources : IMF, EBRD, ILO.

### 3.1.2. Fiscal management, monetary and exchange rate policy

**Public finance management** has improved substantially in recent years and the budgetary system is being brought closer to international standards, although transparency and accountability need to be improved. The draft budget for 2004 was the first to be published



after submission to the Parliament and the first to be cast in a medium-term expenditure framework. Reform of public finance management will be an ongoing process for some years to come.

The consolidated government budget showed a minor deficit in 2003 and may have moved into surplus in 2004, partly as a result of high oil prices and restrained spending. Increasing energy revenues will help to gradually improve the budget. The non-oil budget deficit stood at 11% of GDP in 2003. The sustainable non-oil deficit ceiling in 2004-2007, based on conservative oil price projections, is well above this level. This leaves some room for additional investment in health care, education and infrastructure, which is much needed. General government debt, which has decreased slightly from 25.7% of GDP in 2000 to approximately 24.5% of GDP in 2003, is sustainable and will soon start to decrease as a result of increasing energy revenues. Public external debt has stabilized just above 20% of GDP.

Government budget expenditures increased modestly to 29% of GDP in 2003 and significant wage increases – 50% in education, health and several other public sectors - were given in the summer of 2003.

Total government revenues equalled 27% of GDP in 2003. More than half of government revenue accrues from the oil and gas sector, and these revenues will increase substantially in the coming years. Income tax from both the state oil company (SOCAR) and new oil and gas fields are paid to the state budget, while government profits from the new oil and gas fields are transferred to the state oil fund (SOFAZ – under Presidential control) established by presidential decree in December 1999. The main purpose of the fund is to save oil- and gas related revenues for future generations. Under the current regulations, oil fund expenditures may not exceed inflows in any given year. SOFAZ total assets amounted to US\$ 858 million at end-September 2004. Azerbaijan joined the Extractive Industries Transparency Initiative (EITI) in 2003. Measures have been taken to rationalize the tax structure and broaden the tax base. The non-oil tax system was reformed in 2004 (*see* 3.3). Cash collection ratios in the energy sector remain low and domestic consumers of electricity and gas continue to receive huge implicit subsidies. Domestic retail energy prices were increased in November 2004. The magnitude of the explicit and implicit energy subsidies was one-tenth of GDP in 2003.

**Monetary and exchange rate policy** is carried out in a managed floating framework. The National Bank of Azerbaijan aims at keeping inflation low and the exchange rate stable. The Manat is informally pegged to the US dollar with an exchange rate of 4903 Manat/US\$ at end 2004, and allowing for moderate exchange rate fluctuations within a narrow band. To counter increasing inflationary pressures, a minor appreciation of the Manat has been allowed during 2004. Official reserves continue to grow, due to considerable foreign exchange inflows from FDI and increasing exports, and gross reserves amounted to US\$0.89 billion at the end of 2003. Broad money supply (M2) grew by 32% in 2004 and monetary depth (M2/GDP) rose from 0.07 by end 2003 to approximately 0.08 by end 2004. The stock of money and credit to the economy remain low compared to other transition economies, though bank lending growth was very strong during 2004. The economy is heavily dollarised. The Central Bank has kept its refinancing rate unchanged at 7% since September 2002 and market interest rates have fallen. Real interest rates are low and contribute to investment growth and the risk of pressures building up in the booming economy. Azerbaijan accepted the obligations of the IMF's Article VIII section 2, 3 and 4 with effect from November 2004. Residents need the consent of the Central Bank in order to open a bank account outside Azerbaijan.

### 3.1.3. External situation

The current account has, in recent years, deteriorated temporarily due to the large-scale oil sector imports of goods and services (mainly for construction) standing at 37% of GDP in 2003. The current account deficit is more than fully financed by foreign direct investment net inflows, which amounted to 32% of GDP in 2003 and are likely to have been almost as high in 2004. The completion of the Baku-Tbilisi-Ceyhan oil pipeline and the first phase of the Azeri-Chirag-Guneshli oil field in early 2005 will prompt the start of sizeable oil export increases and consequently reductions in the current account deficit. Remittances are an additional source of capital, especially outside Baku. Balance of payment figures show that inward remittances amounted to US\$ 160 million in 2002, though actual figures could be higher due to underreporting. Oil and other hydrocarbon products make up 86% of Azerbaijan's exports. The main non-oil export commodities are food and associated products, metals and textiles accounting for 4.9, 2.1 and 1.6% of total exports in 2003.

External debt amounted to 20% of GDP in 2003. The external debt share is projected to decline gradually due to current account improvements and the double-digit GDP growth rates expected in the coming years.

### 3.1.4. Social situation and human development policies

Azerbaijan embarked on a **poverty reduction strategy** – the State Programme on Poverty Reduction and Economic Development (SPPRED), initiated with an interim report in 2001. The SPPRED describes the macroeconomic, structural and social policies that will be pursued to promote broad-based growth and reduce poverty. It addresses several key issues including social policy and human capital, regional policy, institutional reform and capacity building, and the participatory process. The SPPRED was published in 2003, and the first PRSP progress report was in 2004. Azerbaijan has also committed itself to achieve poverty reduction and promote human development within the framework of the Millennium Development Goals.

Public expenditure on health care is extremely low and fell from 1.4% of GDP in 1995 to 0.8% of GDP in 2003 and to 0.7% of GDP in the period from January to August 2004. The main source (90%) of official **public health** funding comes from the State budget that supports the Ministry of Health and its subordinate facilities as well as district/municipal facilities. In reality, patients have to pay for many of the treatment costs.

Recognising the need for increased reform of both sectors, the State Programme for Socio-Economic Development of the Regions, approved in February 2004, encompasses measures to support the health and education sectors. **Poverty** is widespread with 45% of the population living below the national poverty line, which is defined in the PRSP progress report as 179,000 AZM (US\$36) in monthly consumption expenditures for 2003. Daily incomes are below the international US\$1 (in PPP terms) poverty line for 3.7% of the population and 9.1% earns less than US\$2 a day. Inequality in the region is high. The Gini-coefficient for consumption stood at 0.36 in 2001, with the lowest and highest quintiles consuming 7.4% and 44.5% of total consumption respectively. Poverty is highest in the smaller towns and for households with many children.

Average living standards are improving as average real wages increased 20% annually in 2001-2003 with monthly wages reaching an average of 383,000 AZM (US\$78) in 2003. The minimum wage was raised from 60,000 AZM to 100,000 AZM per month in July 2004 and

again to 125,000 AZM (US\$26) in January 2005. The current social assistance reform aims to gradually reduce the number of benefits, rationalize administration and target the poorest groups of the population. Most benefits are currently not means-tested. The poorest deciles do not receive substantially more in social benefits than the average population. Social benefits are very low, (e.g. average pensions were 120,000 AZM per month in 2003) far below the national poverty line. Reform of the pension system (transferred from the Ministry of Labour and Social Protection to the State Social Protection Fund) was undertaken following an October 2003 Presidential Decree and has been supported by UNDP and the World Bank. Official **unemployment** stood at 1.4% in 2003. However, a survey conducted with UNDP and ILO support in 2003 shows that the real unemployment rate is around 10.7%. In addition there is substantial underemployment in the public sector. Unemployment is highest in urban areas and for women and youth. The age group under 35 years make up 69% of the unemployed. For 20-29 year old higher education graduates, an unemployment rate of 26% indicates a mismatch between skills acquired and the needs of the private sector. 47% of internally displaced persons are unemployed. A Programme of Regional Development, approved in February 2004, is centred on job creation in the regions, with an ambitious target of 600,000 jobs in three years.

Primary **education** is universal and the literacy rate is 99%, but the quality of education is a problem. It is a key task to bring both primary and secondary education up-to-date and to bring the educational system closer to the needs of the private sector. Improving the quality of basic education is a strategic objective of the PRSP. Enrolment rates are almost gender-equal both for primary and secondary education. The Vocational Education and Training system is being reformed, albeit slowly.

#### *3.1.5. Sustainable Development*

As regards **sustainable development**, Azerbaijan has developed in 2003 a National Programme on Environmentally Sustainable Socio-Economic Development. It determines the main areas to contribute to more sustainable development such as environment, industry, agriculture, tourism, education, science and culture. It includes an action plan for 2003 – 2010. The Ministry of Environment and Natural Resources is responsible for the provision of necessary guidelines and scientific data to support the implementation of the Strategy. No sector-specific strategies have so far been adopted to integrate environment considerations into other policy areas.

### **3.2. Structural reforms and progress towards a functioning and competitive market economy**

#### *3.2.1. State involvement in the economy and privatisation*

The private sector share of the economy increased from approximately 55% of GDP in 1998 to 73% of GDP in 2003.

The privatisation process in Azerbaijan has been underway for 8 years, in two stages, with 30,000 small enterprises being privatised and 1500 medium and big enterprises turned into joint stock companies. As part of the 1999 land reform, all state-owned farms have been privatised. The “second wave” privatization laws, enacted in 2000, allow for privatisation of remaining large-scale state enterprises, but overall progress remains slow. There is a strong need for privatisation of large and inefficient state companies, especially in the utility sectors. Improving transparency and accountability is an important first step.

A handful of state enterprises, primarily hydropower plants and mining, were privatised in 2003. A few joint ventures were also fully privatised. Entities in the telecommunication sector are being prepared for privatisation, and privatisation tenders for the two large fixed-line telecommunication companies, Aztelecom and Bakutelecom, are likely to be announced in 2005. Mobile telecommunication is for the most part privatised. Railway and shipping companies are planned to be turned into joint-stock companies ahead of privatisation. The state-owned power supply system is insufficient and ill-functioning with power cuts and should be improved ahead of privatisation. There are no plans to privatise the state oil company (SOCAR), but improved accountability and transparency is needed. The Tariff council regulates a range of prices including the public utilities: electricity, heat, telecommunication and water. A programme of price rises for domestically-sold oil and gas products should gradually bring these retail prices closer to world market prices. Azerbaijan has until recently offset the increase in energy prices by cuts in taxes on energy.

Private ownership of land is allowed, though it is limited to Azerbaijani citizens and Azerbaijani legal entities. Foreigners may only lease land, and if a foreigner inherits land, it must be sold within one year. Certain areas are owned by the state or municipalities and can only be leased to private persons.

### *3.2.2. Regulatory framework and private sector development*

Corruption remains a significant deterrent to investment and private sector development and may undermine economic growth. Recent progress has been made in building and strengthening anti-corruption institutions and the legal framework in this area. A law “On Fight against Corruption” was passed in early 2004 and a Department for combating corruption has recently been established but enforcement is insufficient. There is a need for increased law enforcement and simplification of a complex and fragmented way of dealing with corruption.

Azerbaijan is continuously working to improve its legislative and regulatory framework and to bring it closer to international standards. A major task still lies ahead as illustrated by the fact that Azerbaijan is ranked 146 out of 189 countries on the World Bank's 2002 Index for Regulatory Quality. The ranking for rule of law is not much better and government effectiveness is even less encouraging. Starting a business is still complicated, procedures are time demanding, contract enforcement is expensive and investor protection limited. As a result, the informal economy is sizeable. According to the recent assessment by the State Statistical Committee, the informal economy is equivalent to 18-20% of Azerbaijan's GDP, though the actual size could be larger.

The only relevant legislation in the field of **competition** is the 1993 Law on Antimonopoly Activity, which governs the behaviour of the state (at all levels, from national to local) and private enterprises having a dominant position, with a view to preventing monopolistic activities. This includes the prohibition of various types of action, including the granting of preferential tax-, credit- or other privileges, and the imposition of ungrounded price- or production-controls (in the case of the state) and price manipulation, refusal to sell or purchase, or discriminatory treatment (in the case of private enterprises). It also prohibits horizontal and vertical agreements which monopolise the market by means of e.g. price fixing, market sharing or creation of barriers to entry. There is currently no uniform **state aid** surveillance or control regime comparable with that of the EU.

### 3.2.3. *Financial sector*

Financial sector development in Azerbaijan has been slow, compared to other transition economies and state ownership still dominates the banking sector. The depth of bank intermediation activity, as measured by the ratio of total banking sector assets to GDP (0.14 in 2003), is lower than the CIS-7 (the seven poorest CIS countries) average, which is in itself deficient. Similarly low ratios of bank deposits to GDP (0.10) and private sector credit to GDP (0.07) signal that the provision of financial services to households and the private sector is very limited, in turn reflecting a lack of confidence in the banking sector. The financial services provided have been focused on the oil sector, construction and trade. As a result, financial services outside Baku are underdeveloped and this impedes rural development. Funding of the agricultural sector has been particularly neglected, though a 57% increase in the volume of loans in 2003 is promising. There is a gradual improvement in the overall level of bank intermediation with an increase in banking sector assets and deposits of 25% and 31% respectively in 2003 and even stronger growth during 2004. The spread between lending rates and deposit rates narrowed from 8.7% in 2002 to 5.9% in 2003, but has increased again during 2004 and stood at 8.6% in November 2004. This partly reflects that more loans are granted to small enterprises, which are considered more risky.

The financial sector is dominated by banks, include microfinance institutions, small credit unions, insurance companies and a few leasing companies, but lacks mortgage institutions. The banking system is currently in the process of privatization, though progress has been slow and the sector has been inadequately reformed. Non-performing loans owed by state-enterprises also complicate financial sector development. Privatisation of the state-owned banks International Bank of Azerbaijan (IBA) and BUS Bank has been planned for some time, but not accomplished. Instead IBA tends to consolidate its near-monopoly power. The privatisation process is crucial for the development of the banking sector and should be accelerated.

The quality of supervision of the financial sector needs to be improved, but the process is currently stalled. The main impediment is the Presidential Decree issued to implement the new banking law, in which control of banking supervision was transferred to the Presidential Office and a banking sector codex was called for. The Banking law itself, which was enacted in March 2004, replacing the 1996 law on Banks and Banking Activities, is in compliance with the Basel Core Principles for Effective Banking Supervision. The minimum capital requirement for banks in operation is US\$3.5 million and for newly established banks it has been increased to US\$5 million. The New Banking Law has introduced a number of provisions designed to strengthen and stabilize the Azerbaijani banking sector. To accomplish this task, however, the National Bank as the supervisory authority must implement a number of measures improving banks' liquidity and management, bringing them in line with international banking standards. This, in turn, would require a higher degree of regulation and supervision over banking activities in Azerbaijan. The New Banking Law more thoroughly regulates licensing procedures and introduces additional licensing requirements. It imposes more stringent requirements on the transfer of shares in a bank by introducing the concept of "significant ownership." Banks are now required to obtain prior approval for a proposed transfer of shares if the transfer results in a shareholder having "significant ownership". The New Banking Law also requires that the National Bank create and maintain a publicly available register of banks, its branches and representative offices registered and operating in Azerbaijan, which should help to improve credit risk management.

Bank governance seems to be improving with introduction of international accounting standards (IAS) and establishment of a centralized credit register. The national payment system has undergone improvements and work on a comprehensive electronic payment system has commenced.

Non-banking financial institutions are at a very early stage of development. The **insurance** sector is undercapitalised and poorly regulated. The Law on Insurance was adopted in 1993. The Insurance Law contains provisions in order to guarantee the financial stability of the insurer such as reserves, minimum capital requirements, solvency ratio and rules on accounting and auditing. The State Control Body is the supervisory authority, which acts in accordance with regulations approved by the Cabinet of Ministers. It is empowered *inter alia* to issue licences and rules of formation and placement of the insurance reserves as well as regulatory functions within the limits established by law. The government has undertaken an insurance reform programme, which includes initiatives to tighten the regulatory system and to strengthen the sector by raising levels of capitalisation and reserves and to develop a life insurance sector. A capital increase schedule was adopted for insurance companies in April 2004, according to which all insurance companies must increase their minimum initial capital from AZM 2.5 billion (US\$500,000) of January 2005 to AZM 5 billion (US\$1 million) in January 2010.

The primary law governing Azerbaijan's securities market is the Law on **Securities**, which came into force on 14 July 1998. This law lays down the legislative framework for the issuance, and secondary market for trading, of securities. The principal market regulator is the State Committee for Securities "SCS" created in 1998. The SCS carries out State policy, State control and State regulation of the activities on securities, including the sphere of formation and development of securities market, control over activities of the related organs of executive authorities and co-ordination of their activities, control over activities of professional members of securities market, protecting the rights and legal interests of investors, shareholders and other holders of securities. In addition, the Parliament approved a new piece of legislation "On the Protection of Rights and Interests of Investors in the Securities Market" in June 2000. The law provides for penalties of traders who violate stock market laws, although it does not actually stipulate the fines. Assisted by the Bank, the SCS has prepared a bill to amend the Law on Securities, which is now pending for adoption by the government. Baku Stock Exchange officially opened in July 2000.

#### 3.2.4. *Relations with other donors*

Azerbaijan joined the **IMF** and the **World Bank** in 1992 and has participated in the poverty reduction strategy approach since 2001. Both the World Bank's Country Assistance Strategy (CAS) and IMF's Poverty Reduction and Growth Facility (PRGF) are designed to support the SPPRED. The World Bank and IMF are working jointly in public expenditure management, financial sector reform and reform of electricity, gas and water sectors, including removal of subsidies. The World Bank manages projects in social sectors, agriculture, infrastructure and environment and the IMF leads in fiscal matters.

The **EBRD** had signed 16 projects in Azerbaijan by the end of 2003. EBRD activities are focused on investments in the private sector and infrastructure projects. The EBRD bought 20% of Unibank in 2003. The **Asian Development Bank (ADB)** mainly provides assistance in four strategic areas: internally displaced persons, agriculture and rural development (including flood mitigation), social infrastructure and transport. The Microfinance Bank of Azerbaijan started to operate in 2002 with financial help *inter alia* from ADB and EBRD.

### 3.3. Trade, market and regulatory reform

Due to the unstable domestic situation in 1991-1995, Azerbaijan embarked on economic reforms later than most other CIS countries. Significant progress has been achieved since 1996 in privatisation and land reform; however, corruption remains a major problem. Compared to the other South Caucasus countries, Azerbaijan is well endowed with natural resources, oil and gas in particular. The country also holds a strategic location between the EU and Central Asia.

Azerbaijan applied for membership in the World Trade Organisation (WTO) in 1997 and its accession negotiations are still at the early stages. A second Working Party meeting took place in October 2004. While Azerbaijan has not yet presented a market access offer, this is under preparation, together with the necessary documentation for a next meeting. This documentation will include answers to specific questions of WTO members and a revised Legislation Action Plan. The **WTO accession process** is expected to bring forward significant reforms in the trade and trade-related legislation.

Azerbaijan's trade is very concentrated, both regionally and on a sectoral basis. In general, the country accounts for a negligible share of world trade, underlying an insufficient integration in global trade networks. In particular, its five principal trading partners account for 80% of its total trade.

Azerbaijan is the EU's largest trading partner in the Caucasus although this primarily relates to oil, gas and cotton. Since 1993, trade with the EU has grown steadily, while trade with CIS states has fallen substantially. Exports to CIS States are down to 32% of the 1992 levels and imports down to 66% of these levels.

The EU is by far Azerbaijan's major trade partner, accounting for 51% of its total trade. However, Azerbaijan is only the sixtieth EU trade partner with 0.1% trade share. Russia (10.3% of total), Turkey (6.8%) and China (5.6%) are respectively Azerbaijan's second, third and fourth trading partner. On a regional scale, in addition to Russia, Kazakhstan and Georgia are important partners for Azerbaijan.

EU exports to Azerbaijan have increased steadily since 2001, with annual increases of some 40% in 2002 and 2003. Imports, however, have remained essentially stable, with a small increase in 2002 offset by a contraction in value of 3.5% between 2002 and 2003. Total trade in goods with Azerbaijan stood at €2 billion (figures recomputed for EU-25) in 2003, with imports at €1.3 billion and a consequent negative trade balance for the EU of approximately €0.5 billion.

Energy products (oil and gas) completely dominate EU imports from Azerbaijan, with a share of 95.3% in 2003. Other notable imports include agricultural products (cotton), textiles and some chemicals. EU exports to Azerbaijan are significantly more diversified, yet with machinery and equipment taking the lion's share (40% of total, or € 320 million).

Azerbaijan is a beneficiary country of the general arrangements under the **Generalised System of Preferences** (GSP). Recent available figures indicate that Azerbaijan has strongly improved its rank among EC GSP users. In particular, Azerbaijan's global utilisation rate (eligible imports compared to effective GSP imports) has soared from 3% in 2000 to 50% in 2002, demonstrating an increasing ability to take advantage of the opportunities made available by the scheme. Preferential imports remain heavily concentrated.

Azerbaijan is a fertile country with a good **agricultural** potential with about 4.5 million hectares of cultivable land, much of which is dependent on irrigation. It produces mainly cereals, cotton, potatoes, fruits and vegetables. The country suffered during transition from the state/collective farming system. About 98% of the farming land was privatised. The sector is stagnant, fragmented, inefficient and today mainly subsistence farming. The food-processing industry is outdated and requires important investment to reply to markets quality demands. The main agriculture exports to EU-25 are nuts (62%) and raw cotton (25%), and fruit and vegetables to regional markets.

Regarding **veterinary and phytosanitary issues**, two basic laws regulate producers' rights, food stuffs, food safety and consumer protection. Implementing legislation to these laws provide for public health protection, sanitary and phytosanitary control, new standards, toxicity determination, identification and control on animal and plant diseases, determination of food quality, medicinal and ecologically clean products.

Food standards are based on the intergovernmental standards (GOST) used by the CIS countries. Various Ministries (Agriculture, Health, Economic development, Ecology and natural resources) as well as other administrative bodies (State Agency for Standardisation) are involved in food safety issues, thus leading to conflicts of competences. Public health bodies lack funds and qualified staff for upgrading laboratories, ensuring appropriate control capacities (inland and border) and vaccine coverage of endemic animal diseases. The Government envisages, in its "Program of product safety for the Azerbaijan Republic", increasing the quality of foodstuffs and ensuring product safety and foodstuffs quality in the period 2002-2010. Azerbaijan is a member of the Food and agriculture Organisation (FAO), World Health Organisation (WHO), International Office for Epizooties (OIE) and the International Plant Protection Convention (IPPC), but is not member of the Codex Alimentarius Commission. It is currently negotiating accession to WTOSPS membership. The export of fish products, except caviar, was not approved by the EC in 2002/2003 following a mission of the Directorate-General of the Commission responsible for Health and Consumer Protection which identified a lack of adequate controls.

The State **Customs** Committee (SCC) is, since 1992, the body in charge of the implementation and the enforcement of the customs and customs related legislation in Azerbaijan. The SCC operates directly under the President's authority. Customs officials are bound to a Code of Ethics, which is based on the World Customs Organisation Arusha Declaration. There are specialised departments in the Central Administration in Baku, and Regional Customs Houses and Administration, including customs posts for clearings and responsibility for specific regimes. The SCC has a Central Laboratory. Although the SCC has set up an IT system for statistical purposes, computerisation of clearance procedures needs still to be developed. The SCC has its own training centre. The 1997 Customs Code is comprehensive and based on internationally recognised practises. However, at this stage, there are no implementing provisions to the Code. Moreover, provisions on customs valuation are still not fully in line with WTO requirements. Azerbaijan applies the Harmonised System (HS) to the six-digit level. Several ad-valorem customs charges and fees are applied to export and import of goods in addition to customs duties in order to finance the customs administration. A multi-lingual web-site containing customs-related information and legislation is available to the public.

As far as **taxation** is concerned, a comprehensive Tax Code replacing tax-related provisions in Azeri legislation entered into force in January 2001. The Code contains, *inter alia*, the general principles of taxation, the rules on tax collection, the rights and responsibilities of



taxpayers and of State tax authorities, methods and forms of control as well as infringements and appeals procedures. The Code is also applicable to the Nakhichevan Autonomous Republic. There are no further implementing provisions to the Code, which covers all taxes, including profit tax on businesses, dividend withholding tax and other withholding taxes, VAT and excise duties. Special tax regimes are applicable for oil consortia and export pipelines. All Production Sharing Agreements (PSAs) contains tax provisions, including zero-rate VAT and zero-rate customs duties. A simplified tax system is also applied to small companies. It replaces the general 24% rate of profits with a 4% and 3% rate for companies operating respectively in the Baku area and in the rest of the country. In January 2004 agricultural producers got an additional five years' tax exemption from all taxes (excluding land tax). VAT standard rate is 18%. Excises are applied on alcoholic beverages, spirits, tobacco and petroleum products. Azerbaijan has signed double taxation treaties with 16 countries, including eight EU Member States. Efforts in terms of administrative capacity are still needed, particularly as far as the strengthening of revenue collection and the fight against corruption.

As regards **technical regulations and standards for industrial products**, the Law on Standardisation establishes legal and economic bases of standardisation in Azerbaijan, obligatory for all executive authorities, local self-governing bodies, enterprises, organisations, entrepreneurs, as well as to public associations. The organisation of works and management of standardisation include elaboration and application of normative documents on standardisation, provision to consumers with full and reliable information about these documents, development of standardisation system, determination of rules for application of international standards in Azerbaijan and preparation and improvement of qualification of the personnel in the field of standardisation. Requirements, set by normative documents on standardisation, are to be based on international standards, norms, rules and recommendations on standardisation, progressive national standards of other states, modern scientific and technological achievements. The institution responsible for standardisation certification and accreditation in Azerbaijan is the State Standardization and Metrology Centre (*Azdovletstandard*) appointed by the government. It is independent from the customer and producer. Standards used in Azerbaijan are mandatory concerning ecological and security requirements. Since 1998, Azerbaijan is a member of the International Standardization Organization (ISO).

In the mid-1990s, Azerbaijan began implementing a national system for registering and protecting **intellectual and industrial property rights (IPR)** with the assistance of the World Intellectual Property Organization (WIPO). The PCA requires Azerbaijan to provide for a level of IPR protection similar to that existing in the EC, including effective enforcement means. Azerbaijan enacted modern copyright legislation (Law on Copyright and Related Rights) in 1996, patent legislation (Law on Patents) in 1997, and trademark protection legislation (Law on Trademarks and Geographic Names) in 1998. The State Copyright Agency has formed an anti-piracy commission, with representatives from various ministries. While the Agency has initiated civil court proceedings for violation of copyrights, in practice, there is limited enforcement of intellectual property rights. Pirated software, cassettes and videotapes, as well as counterfeited clothing and luxury items, are widely available in Azerbaijan. IPR protection falls under the responsibilities of the Azerbaijani National Agency for Standardization, Meteorology and Patents (AZSTAND). Azerbaijan is a party to the Convention Establishing the World Intellectual Property Organization, the Paris Convention for Protection of Industrial Property, and the Berne Convention for the Protection of Literary and Artistic Works. In September 2001, Azerbaijan became a party to the Geneva

Phonograms Convention. Further steps are needed to ensure full compliance with the relevant PCA obligation.

The State **Statistical** Committee of Azerbaijan (SSC) has acted on statistical legislation since 1994, based on the UN fundamental principals of official statistics. The confidentiality principle is a sensitive issue, particularly when the authorities request individual data for administrative purposes. The SSC has taken recently the necessary steps to further improve the statistical legislation, but the legislative procedure is still in progress. The state statistical system employs around 1450 people, of which around 450 persons work in the Central Office (including the Main Computing Centre and Scientific Research and Project Technology Centre on Statistical Information). The SSC coordinates the statistical system in Azerbaijan and is responsible for its development. It receives some data from other Ministries and governmental institutions. The SSC has access to certain registers and other administrative sources. There is a permanent exchange of external trade data with Eurostat. The present statistical system needs further assistance in order to make further improvement towards compliance with international standards, with emphasis on those used in the EU.

Concerning **Public Internal Financial Control**, the Chamber of Accounts, the state budget and finance supervising body, started its activities in 2001. On the basis of the existing legislation, the Chamber is an independent body, regulated by the Constitution, the Law on the Chamber of Accounts, and the relevant internal regulation, based on the standards of the International Organisation of Supreme Auditing Institutions (INTOSAI) of which the Chamber is a member. The Chamber carries out audit controls on all public accounts, including budget and extra-budgetary state funds.

Azerbaijan has very recently adopted a new **Public Procurement Law** (PPL) which clarified and consolidated two existing and contradictory pieces of legislation. The PPL is inspired to a great extent by the UNCITRAL model law. Implementing mechanisms were promulgated by Presidential Decree in 2002. The Law also provides for the complaints and review mechanism set out in the UNCITRAL Model, which requires an initial complaint to the procuring entity before review by the relevant executive authority. It also provides for jurisdiction of the national courts over breaches of the PPL and for judicial review of the decisions of the procuring entity and the State Procurement Agency (SPA). The SPA, operational since 1998, is the regulatory agency. It has responsibility for general supervision and monitoring and, despite the absence of a sufficiently systematic and appropriate reporting system, has been able to identify and correct a number of breaches of the procurement rules (those applicable before the adoption of the PPL) by procuring entities. The general functions of the SPA are grouped into the following activities: implementation measures; information dissemination; training; supervision and control. Though preferences for domestic suppliers and restrictions on the nationality of bidders are foreseen in the PPL, the circumstances and conditions under which these may be used are not mentioned. Both requirements should be used only in limited circumstances and these should be made clear in the legislation.

Concerning the **provision of services and the right of establishment**, the Government of Azerbaijan officially welcomes foreign direct investment (FDI). Since 1994, Azerbaijan has attracted significant amounts of FDI to develop further its energy sector. However, bureaucracy and weak legal institutions have severely hindered investment outside that sector. A series of presidential decrees, issued in August-October 2002 to address business concerns, called for a reduction in the number of activities subject to licensing and streamlining of the licensing procedure; creation of an SME Entrepreneur's Fund; and restrictions on harassment of businesses by federal and local authorities. An Entrepreneurs' Council reporting to the

President, consisting of domestic and foreign companies, first convened in July 2003. As a result of these and other reforms, there have been improvements in the business and investment climate. Legislation provides for no discrimination for establishment of foreign companies except for cases such as the 1999 Law “On Mass-Media” and the 2001 Law “On State Duties”. Concerning operation of subsidiaries and branches established in Azerbaijan, some restrictions to participation of foreign capital still exist for banking and insurance activities in accordance with the January 2004 Law “On Banks” and the 1999 Law “On Insurance”.

The Law on Protection of Foreign Investments permits FDI in any activity open to a national investor, unless prohibited by law. Prohibited areas include those relating to national security and defence. A new law on investments has been drafted and recently transmitted to the Parliament for discussion and adoption. The Law on Protection of Foreign Investments provides that the government will accord to foreign investors "not less favoured" a treatment than that accorded to local investors. This law provides for repatriation of profits, revenues, and other investment-related funds so long as applicable Azerbaijani taxes have been paid.

According to a 1997 Presidential Decree, the State issues licenses for conducting service activities. Depending on the kind of service activity, issuance of a licence may be conditional upon meeting ecological, sanitary and other relevant standards. State bodies responsible for issuing the licenses are also responsible for supervising that activity. The strictest requirements are those related to professional services in finance, health and aviation services. Azerbaijan does not have any safeguard measures for trade in services.

### **3.4. Transport, energy, information society, environment, research and innovation, people-to-people issues**

The Ministry of **Transport** was established in 2003 and is still undergoing restructuring. It is to oversee and to set the policy for inland, aviation, maritime as well as inter-modal transport. There are plans to strengthen the institutional capacity of the Ministry, which is needed in order to enable it to develop and implement a national transport policy including a transit strategy. Transport infrastructure rehabilitation is being pursued in order to allow Azerbaijan to profit better from its geographic location as a transit country. The TRACECA initiative (TRANsport Corridor Europe-Caucasus-Asia) has over the past decade played an import role in the efforts to develop this corridor in the region, but substantial further infrastructure and institutional development is needed in order to further facilitate the co-operation across the corridor.

In the **road sector**, infrastructure development and maintenance is entrusted to the road agency “*Yolnaghiatservice*”, which is currently being strengthened. As the road links with Armenia are disrupted due to the unresolved conflict over Nagorno-Karabakh, the connection with the Nakhichevan enclave is ensured via road through Iran or by air travel. The inter-urban road freight and passenger operations are to a large degree privatized and overseen by the road transport regulator *Avtonaghiatservice*. Road safety is an issue of concern. In the rail sector, services are provided by the Azerbaijan State Railway. Both the rail network in general and the rolling stock are in urgent need of upgrading. The upgrading of the most important railway segments is ongoing. Rail is the dominant mode in freight operations and oil transit operations play an important role.

In the **aviation sector**, the State Company of Civil Aviation is responsible for the regulation of the aviation sector under the political guidance of the Ministry of Transport. The state

company controls four private and 15 state-owned enterprises, including the flag-carrier Azal (Azerbaijan airlines), successor of Aeroflot, which was founded in 1992. There are three international airports at Baku, Gyandzha and Nakhichevan. The main airport, Baku's "Heydar Aliyev" international airport, a newly built international air terminal, was opened in 1999. A new cargo terminal is under construction. However, high handling charges remain an obstacle for EU and other foreign airlines.. Air traffic control systems have been upgraded in the last decade and the further modernization of Azerbaijan's Air Navigation Systems is planned. Azerbaijan has recently negotiated a horizontal aviation agreement with the Community, amending bilateral air services agreements between Azerbaijan and EU Member States.

There are plans to create a Maritime Administration Authority, which will act as the regulatory authority in the area of **maritime transport**. At present, there is a lack of separation between the commercial operations of the state-owned shipping company and its regulatory functions. Maritime transport via the Caspian Sea provides vital links and is of particular importance for oil transport. The main activity of the state-owned shipping company, State Caspian Shipping Company, is the transport of oil and oil products, but it also encompasses a whole range of support services. Baku International Sea Port (BISP) is the largest port on the Caspian Sea. Navigation systems have recently been upgraded and there are plans to improve the efficiency of port operations, in particular through the upgrading of the ferry terminal.

In the satellite navigation sector, the Azerbaijan National Space Agency (ANASA) and the Russian Aviation and Space Agency (*Rosaviakosmos*) have signed a protocol covering the development and the production of receivers for global navigation satellite systems (GNSS). In parallel, initial changes of information started within the TRACECA framework in 2004 on the contribution that GALILEO navigation, tracking and positioning services can make to the safety and efficiency of land, maritime and air travel both nationally and regionally.

Azerbaijan is a strategic player in Caspian **energy** (oil and gas) politics both as a producer and as a future transit country.. Oil accounts for a considerable share of total exports and of budget revenues. Insufficient infrastructure prevents gas exports at this stage. Azerbaijan has some coal reserves and produces hydropower. Income from hydrocarbons business are likely to increase in the next decade as the Caspian oil and gas reserves, including the Shah Deniz gas field (operational from 2006/2007), will be exploited and major export pipelines will be completed. The State Oil Fund, established in 1999, aims at using oil and gas revenues for socio-economic development. Its expenditures need to be handled transparently and be directed towards a balanced economic growth through further development of the non-oil sector (see 3.1.1. and 3.1.2). Azerbaijan currently exports oil via Black Sea ports through Russia (Baku-Novorossiysk pipe) and Georgia (Baku-Supsa pipe, but also by rail). Gas is mainly imported from Russia. Recently, agreement was reached with Iran for gas supplies to Nakhichevan. The entry into operation of the oil pipeline Baku-Tbilisi-Ceyhan (on Turkey's Mediterranean coast) by 2005 and the completion of the Baku-Tbilisi-Erzurum (Turkey) gas pipeline by 2006 will be crucial for marketing Caspian energy resources. These developments are also fundamental for the EU's energy supply security, in particular when considering the ongoing gas pipeline projects Turkey-Greece, "Nabucco" (Turkey-Austria) and Trans-Balkan (Greece-Austria); as well as the oil pipeline projects Constantza-Trieste, Burgas-Alexandropolis and the extension of the Odessa-Brody pipeline to Poland and possibly further to the West.

The State Oil Company of the Azerbaijan Republic, SOCAR, participates in all key international hydrocarbon projects and accounts for half of the present Azeri oil output and

exports. It operates two refineries which need to be modernised. SOCAR's restructuring, based on a 2003 Presidential decree is ongoing. The Azerbaijan International Operating Company, an international consortium, is the other key player in the sector. Boosting production involves the development of both old and new oil fields.

The energy sector legal framework includes the Laws "on energy", "on the use of energy resources", "on electric energy", "on power and steam plants", "on gas supply" and decrees and implementing legislation. The bad state of infrastructure and networks leads to occasional power cuts. Insufficient cash collection seriously hampers investment. A 2002 Presidential Decree aims at strengthening financial discipline in the energy sector and to speed up privatisation or concession of distribution companies. Measures include the introduction of transparency regarding subsidies, installing metering, increasing cash collection, reverse the accumulation of arrears, the settlement of debts (eg those of electricity and gas state companies Azerenergy and Azerigas to SOCAR). A Tariff Board analyses and proposes tariffs. In November 2004 energy prices were adapted, which is an important step towards eliminating price distortions. The Ministry of Fuel and Energy's tasks include policy formulation, but it also acts as regulator. The government has prepared a State Programme for energy sector development till 2015 and recently submitted it for approval to the President. This plan includes a programme for energy demand management and energy saving/efficiency. Two very small hydro power plants have been privatised, while seven others will follow. The construction of new power generation capacities is underway. Azerbaijan switches its power plants increasingly from oil to gas. Azeri and Turkish private companies manage, through concessions, four of the five distributors. Azerbaijan exports electricity to Iran and Russia and imports from Iran, Russia and Turkey. Russian United Energy Systems plans to construct networks for more Russian electricity exports. Implementation of the National Alternative Energy Programme for 2004-2013, adopted in October 2004, has started. Azerbaijan does not produce nuclear energy. The control of radioactive sources, including avoiding illicit trafficking, requires attention.

In the area of **Information Society**, the Ministry of Communications and Information Technology is in charge of policy-making and sector regulation. The level of regulation is very limited and there is little competition in the market for fixed line telecommunication and for data communications services. However, in the markets for mobile telecommunication and Internet services, competition is developing more efficiently. The major operator for fixed line telecommunication is Aztelecom and its competitors for local, long-distance and international services are AzEurotel and Caspian American Telephone. Additional local services are provided by the Baku City Telecoms Network and by Terracom Inc. At the end of 2003, there were about 980,000 fixed line subscribers (12% penetration rate). The operator of the Armpac network, Artel, is the main provider of data communications services. The mobile telephony market is dominated by Azercell (80% market share), a previously state owned company which was fully privatised in January 2004 - its competitor for mobile services, Bakcell, is expected to be privatised soon. At the end of 2003, there were about 1.2 million mobile subscribers (14% penetration rate). As for Internet, there were only about 390,000 users at the end of 2003 (5% penetration rate) and broadband access to Internet is very limited. There are about 40 Internet Service providers.

Regarding the **audiovisual sector**, Azerbaijan has both public and private TV and radio stations. Enhancing cultural policy, including the preservation of the country's rich cultural heritage, is a priority of Azerbaijan's Strategic Programme on poverty reduction and economic development. A Law on Culture is in force to underpin cultural development.

As regards **environment**, Azerbaijan has developed and approved a National Environmental Action Plan in 1998, which identifies five priorities: pollution from industrial production; Caspian sea; forestry, land and biodiversity issues; institutional development; and policy issues, but also the need for a policy reform and integration of environmental concerns into other sectors. The State Programme on Poverty Reduction and Economic Development for 2003 – 2005 also contains a section on environmental problems. A National Environmental Health Action Plan has also been drafted, but not yet adopted.

In 1999, Azerbaijan adopted a framework law on environmental protection, amended in 2001. The law is detailed and can in some cases be applied without secondary legislation.. The law defines State ecological expertise (SEE), and environmental impact assessments are applied under the SEE procedures. The law also calls for strategic environmental assessments (SEA), but does not make their elaboration mandatory. Public participation is required under SEE. A law was adopted in 2002 on access to environmental information.

The State Committee for the Environment implements Government policy in the field of environmental protection. The Ministry of Ecology and Natural Resources was established in 2001. A number of other Ministries are involved in environment matters, such as the Ministries of Health, Agriculture, Economic Development, Fuel and Energy and the State Committee of Amelioration and Water Management. A Scientific Technical Council and National Monitoring Service were established in 2001. Strengthening of regional and local environmental structures require special attention.

Azerbaijan has adopted some sector and issue specific legislation on environmental safety and health issues, waste management, nature and biodiversity, forestry, air quality, water quality and mineral resources. The Ministry of Ecology and Natural Resources is at present preparing new legislation on water quality, converging with the Community requirements.

In 2003 and 2004, Azerbaijan adopted national programmes on forests and hydrometeorology development as well as a strategy on hazardous waste management. It is currently] in the process of developing a national programme on natural resources management, a national biodiversity strategy and action plan as well a national action plan for the Caspian Sea .

Azerbaijan has ratified several international and regional environment conventions to which it is party and has in particular acceded to the Kyoto Protocol on climate change.

In Azerbaijan **Research and Innovation** (R&I) activities are extremely modest. There is no national strategy. Planned future cooperation would concentrate on objectives such as the development of Azerbaijan's capacity in technological research and innovation, integration into the European Research Area and into the Community R&D Framework Programmes on the basis of scientific excellence and integration in high level scientific exchanges, with the support, where appropriate, from INTAS (International Association for the promotion of Cooperation with scientists from the New Independent States of the former Soviet Union).

Azerbaijan's **education system** provides for compulsory and free primary (grades 1-4), middle secondary (grades 5-9) and upper-secondary levels (10-11), as well as higher levels. The number of non public institutions is growing. Enrolment rates have considerably declined at pre-school level, but are very high at basic level with decreasing attendance trends in grades 8-11. Enrolment at secondary and higher levels, in particular regarding vocational education training (VET), could be further improved. Drop outs at secondary and higher level, particularly amongst the less privileged, are increasing. Challenges of the education sector generally include: declining quality (e.g. unclear or outdated curricula, teaching methods,

standards, assessments, teacher's training), downward trend of funding availability (for e.g. salaries, equipment including teaching material, buildings), organisational inefficiencies, inappropriate link between education and the labour market needs, declining number of VET institutions and students, growing inequity of access to quality education especially for the poor and quality differences between urban and rural areas.

Azerbaijan has embarked on a major reform of its education sector based on the 1999 Education Reform Programme and the Education Reform Strategy 2003-2013. Education reform aims in particular at improving the quality of education, adapting the sector to the new socio-economic environment and ensuring free access to higher education for the poor students. The poverty reduction programme considers human resource development, in particular VET, as key for the country's future. The 1996 Order on vocational education and training (updated in 2002) and the future Education Law (under preparation) also support reform activities.

Azerbaijan participates in the Tempus programme for the modernisation of higher education, through bottom-up exchange projects and structural measures that aim at reinforcing local reform capacities. Azerbaijan devotes special attention to youth, given the high unemployment rates and the large share of youth among the refugees and Internally Displaced Persons. It participates in the Youth Programme which enhances cooperation in the field of non formal education for young people particularly through multilateral youth exchanges, trans-national European voluntary service as well as training for youth workers and capacity building for youth NGOs. Regional youth activities are conducive to creating a new generation with an open mind towards the region. Current visa requirements and procedures create certain difficulties for youth mobility.

Since independence, the **public health** sector has not seen significant reform and still widely follows the traditional Soviet model in which the Ministry of Health is responsible for central specialised institutions and the regions and cities for all other services. Additionally, various other Ministries run parallel health systems. Private hospitals are appearing, also at district-level, but cannot provide comprehensive and inclusive health care services for all. In the public institutions, accountability is complex as district health administrations report for some issues to the Ministry of Health, but receive parts of their funding from the district administrations. There is no notable insurance industry in Azerbaijan yet. Some private insurance agencies are trying to develop voluntary insurance schemes with the assistance of foreign insurance companies. Public hospitals are compensated through line item budgets, with performance regulated on the basis of "norms". Severe budgetary cuts have made it difficult to meet demand. Official salaries are very low and informal payments widespread and substantial. The salaries of health care personnel hardly provide incentives, apart from fees for additional services that they can provide within the facilities at which they work. The health sector suffers from an excessive number of specialists, a lack of general practitioners, structural unemployment or under-employment, lack of managerial skills and low productivity of health care personnel. The State Medical University provides undergraduate courses for paediatricians and other medical doctors and specialised studies, with subsequent postgraduate training at the Medical Post-Graduate Training Institute. The only teaching hospitals are in Baku, affiliated either to the State Medical University or the Medical Postgraduate Training Institute.

Regarding in-patient care, the number of hospital beds per population has fallen slower than in other ex-Soviet countries, resulting in overcapacity. The concept of integrated primary health care has yet not been developed. The medical system is based on central hospitals in

larger towns with municipal hospitals and polyclinics elsewhere. Drugs and supplies are limited. The pharmaceutical department of the Ministry of Health purchases and distributes drugs to hospitals. However, annual drug supplies are usually insufficient. Over the last decade, a considerable share of medicine, medical equipment and supplies has been provided through international humanitarian assistance. Drugs are free-of-charge for in-patient treatments. Patients are charged for out-patient treatments, except for cancer and some psychiatric diseases.

The country faces malaria, generally of the benign *vivax* form. Sporadic cases have even been reported in the Baku suburbs. Diphtheria occurs predominantly in towns, but increasingly also in rural areas. Shortages of vaccine, antibiotics and diphtheria antitoxins contribute to the spread of this disease. Hepatitis B is considered to be endemic in Azerbaijan, with between 4% and 7% of the population affected. Tuberculosis also constitutes a serious problem. The leading cause of mortality is cardiovascular diseases, followed by cancer, respiratory infections, and accidents. Diabetes mortality rates are high. The incidence of communicable diseases is increasing. Nevertheless, as in other Southern Caucasus countries, life expectancy is relatively high. Access to clean drinking water poses a health-related challenge, both in rural areas, in particular with regard to persons displaced by the Nagorno-Karabakh conflict, and due to pollution of the coastal areas of the Caspian Sea, and linked to oil extraction. HIV/AIDS is present in Azerbaijan