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İSLETME ANABİLİM DALI
MUHASEBE FINANSMAN (ING) BİLİM DALI

THE STRUCTURE AND DEVELOPMENT OF FOREIGN INVESTMENTS IN AZERBAIJAN

Master Thesis

ELKHAN HASANOV

İSTANBUL 2010

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Danısman: Doç. Dr. ASLI YUKSEL MERMOD

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Sosyal Bilimler Enstitüsü Müdürlüğü

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ABSTRACT

THE STRUCTURE AND DEVELOPMENT OF FOREIGN INVESTMENTS IN AZERBAIJAN

Difficulty between countries of having easy trade and the obstacles which was appeared on capital course come to the end by the globalization. At the begining of 1990 It was seen densely stock flowing from developed countries to developing countries. Those flowing capitals have an important role on increasing investments that influence grows of country economy.

In my thesis "The Structure and Development of Foreign Direct Investments in Azerbaijan" first of all I explain the definition of Foreign Direct Investments (FDI) is given, the theories about FDI and FDI types are explained. Portfolio Investments and FDI are compared and the decision process of FDI is explained. Also, factors that affect FDI are studied from the point of view of both foreign and domestic country. International organizations concerning FDI and their functions are explained.

At the second part I betray Economy of Azerbaijan in Soviet Union and latter. Lately I searched economical grows which began by the independece and collaterally accomplished incitement and reforms by the government in order to attract foreign investments.

At the third part closely to globalization I discussed developing of direct foreign investments in Azerbaijan Republic and it's place, stucture and dispersion in Azerbaijan economy. Afterwards factors which effects country preference and encouragements given by government to attract direct foreign investments to country. Following direct foreign investments regional and sectoral distribution.

In the last part, a model study is performed that aims to find effect of FDI on GDP and Export. In the result of the Study it is concluded that FDI has effect on GDP and Export..

GENEL BİLGİLER

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ÖZET

AZERBAYCAN'DA YABANCI YATIRIMLARIN YAPISI VE GEL İŞİMİ

Son yıllarda uluslararası piyasalarda görülen globalle şme, ülkelerarası ticaretin ve sermaye akışının önündeki engelleri kald ırıcı bir etki yapmaktad ır. 1990'lar ın ba şında geli şmiş ülkelerden gelişmekte olan ülkelere do ğru yoğun bir sermaye ak ışı görülmektedir. Çe şitli ülkelere giren sermaye hareketlerindeki art ışlar bu ülkelerdeki yat ırımları art ırarak büyümeyi olumlu bir şekilde etkileyebilmekte.

" Azerbaycan'da Do ğrudan Yabanc ı Yat ırımların Yap ısı ve Geli şimi" konulu araştırmada, ilk olarak Bu çal ışmanın birinci bölümünde Do ğrudan Yabanc ı Yat ırımlarının (DYY) tanımı verilmi ş, DYY'nin türleri ve DYY ile ilgili teorilere de ğinilmiş, portföy yat ırımları ve DYY karşılaştırılması yapılmış ve DYY'de karar alma süreci gösterilmi ştir. Uluslararası doğrudan yabancı yatırımlarını yabancı ülke ve ev sahibi ülke açısından etkileyen faktörler irdelenmiş ve DYY'ye yönelik uluslararası kuruluşlar ve onların görevleri ile ilgili bilgi verilmiştir.

İkinci bölümde, ba ğımsızlık öncesi ve sonras ı Azerbaycan'daki ekonomik yap ı, ba ğımsızlık dönemiyle ba şlayan yukar ıda belirtildi ği gibi 1990'lardan sonras ına raslanan Azerbaycandaki ekonomik gelişmeler ve bu gelişmelere paralel olarak yatırım teşvikleri incelenmiştir.

Üçüncü bölümde, küreselle şme ile ba ğlantılı olarak do ğrudan yabanc ı sermaye yatırımlarındaki geli şmeler, DYY'n ın Azerbaycan ekonomisindeki Yeri, Yap ısı ve Da ğılımı. Daha sonra ise, do ğrudan yabanc ı yat ırımcıların ülke tercihini etkileyen faktörler, ülkelerin daha fazla doğrudan yabancı sermaye yatırımı çekmek için uyguladıkları teşvik politikaları ve doğrudan yabancı sermaye yatırımlarının bölgesel ve sektörel dağılımı yer almaktadır.

Uygulama kısmından oluşan dördüncü bölümde DYY'nin Gayri Safi Yurt İçi Hasıla (GSYİH) ve İhracat üzerindeki etkisini bulmay ı amaçlayan model çal ışması yap ılmıştır. Çal ışma sonucunda DYY'nin GSYİH'i ve İhracatı etkilediği sonucuna varılmıştır.

FOREWORD

This thesis couldn't have been prepared without existence of some precious people surrounding me. I am grateful to my family for their endless patience and support, to all my friends for just their existence and my supervisor Assosiate Professor Aslı Yuksel MERMOD for her strong contribution in my thesis research.

Elkhan Hasanov

ICONTENT

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INTRODUCTION

The main target for the developing countries is the progress. Progress is equivalent to structural changes and especially to industrialization and the industrialization of these countries depends on the rate of increase in investments that will grow year by year. No doubt that the realization of these investments is a matter of financing, because the main problem of these countries is the insufficiency of domestic funding. If the domestic funding of the country is not sufficient to provide necessary investments for the economic growth the only option left is to find ways for benefit from foreign funding.

Foreign sources of finance can be listed as foreign loans, foreign aid, foreign investment and portfolio investments. Of all these alternetives, Foreign Direct Investment is considered as the best in developing countries for it is a financial source as well as a effective way to increase the technological level of the country.

Of course, Foreign Direct Investment will look for an appropriate environment to easily carry out its activities and will not make any investments in countries that will not be able to provide such an environment. Nowadays, foreign investments (especially made by transnational companies) have caused lively discussions about the effects of such investments on the economies of the host country, as well as the source country.

The level of these investments change simultaneously with the world economic trade cycle. At times when the trade cycle expanses the share of the Foreign Direct Investments in world's total source flow increases and vice versa. The most important aim of the developing country is to achieve the biggest share from this buoyant foreign investment flow. On the other hand, it is also very important to appropriately benefit from the foreign investments as well as increasing them,

However the developing countries are the ones who have the biggest and urgent need for the Foreign Direct Investments, some developed countries also compete for hosting these investments. No wonder that most of the Foreign Direct Investments are the ones between developed countries. Especially in last 10 years the progress in

communication, transportation and information technologies made the globalization process faster and caused a decrease in expenditure related to these fields. This made investments infeasible before feasible. Simultaneously with the progress in supply front of Foreign Direct Investments the dissociation of the East Block resulted in new countries entering the competition in the demand front. That kind of countries have followed active foreign investment policies in order to achieve a bigger share in Foreign Direct Investments and have made a great progress.

After gaining its independence in 1991 Azerbaijan adopted free market economy and outward-oriented growth strategy. Azerbaijan became a host of a considerable amount of foreign investments, especially regarding contracts in oil field. On the other hand, the fact that most of the investments are put into energy sector makes the country hinge upon foreign countries and prevent other fields from developing.

The first chapter of this Research focuses on foreign investment types and theories on the Foreign Direct Invesment.Lately, I focused on factors influencing International Foreign Capital Investments in terms of foreign country and host country.

The second chapter of this research focuses on the economic structure of Azerbaijan before and after gaining the independece, the economic crisis and decline in living conditions that started after gaining the independence and the economic reforms, development and economic change in different sectors which came with this development afterwards and finally the present situation of economy in Azerbaijan.

The third chapter of this research focuses on the progress in FDI (Foreign Direct Investments) related to globalization, FDI's Place, Structure and Distribution in Azerbaijan's economy and finally the factors that affect foreign investors' choices regarding the countries, incentive policies of countries in orderr to attract FDI and regional and sectoral distribution of FDI.

The last chapter of this research focuses on theoretical and empirical studies analysing the relation between Foreign Direct Investment (FDI) and economic growth (GDP) ,also between FDI and Export Trade. By using SPSS analyse program I tried to find the relations between FDI & GDP and also FDI & Export in Azerbaijan.

PART I.

1. FOREIGN INVESTMENT TYPES AND THEORIES ON THE FOREIGN DIRECT INVESTMENTS

Foreign investment is the transfer of the investable assets by the persons and organizations into another country.[1]

In a general definition, the acquisition of wealth by the residents of a country out of their countries is called as "international investment" or "foreign investment". The wealth acquired in foreign countries may be either financial or real. The former includes the purchase of securities such as bank deposits, debentures and stock certificates.[2] Depending upon the time aspect of investment, financial investments are divided into two categories: short-term financial investments and long-term financial investments (portfolio investments). Acquisition of tangible assets such as buildings, plants, land, premises etc in foreign countries is called as 'Foreign Direct Investment'.[3]

1.1. Foreign Direct Investments

In spite of varying from country to country, the direct investments are, in general, defined as "the investments made by acquiring such number of shares that is sufficient to have an effective voice in the control of a company in a foreign country in the long run."

[1] State Planning Organization, **Dogrudan Yabancı Sermaye Yatırımları Ozel İhtisas Komisyonu Raporu,** Ankara, 2000, p.13
[2] Halil Seyidoglu, **Uluslararası İktisat** 7th ed.., Istanbul, Guzem Yayınları, 1990, p. 550.
[3] Aykan Candemir, **Turkiye'de Dogrudan Yabancı Sermaye Yatırımlarını Etkileyen Faktorler** Yased Yayınları Istanbul, 2006, p.18

The multinational companies make investments in the countries other than those in which their headquarters are located and take an active role in the management of the companies in which they invest.[4]

And IMF defines the foreign direct investment as "the international investor's holding of more than 10% of the shares of any local company" for using in the statistically purpose studies.[5]

The foreign direct investments consist of three types of investments: equity, invested earnings and internal borrowings.[6]

• Equity; is defined as a foreign direct investor's acquiring of the shares of an enterprise in a country other than the home country of the foreign direct investor. This is also called as 'initial investment'.

• Invested earnings; includes the earnings which are the direct investor's interest in the profit and are not distributes as dividends, that is, those which are not drawn by the direct investor.

• Internal borrowings mean the transfer of the short or long term liability and receivable funds between the direct investors and the relevant affiliates (partnerships, subsidiaries etc)

The foreign direct investment stock is the total value of the investor's reserves including their capital share in the investment and their accumulated dividends plus the liabilities of the enterprise to the foreign investor. In this point, the foreign investor may be either a natural or a legal person.

In order for a foreign investment to be considered as a foreign direct investment, it is not necessarily for all means of production to be hold by the foreigner. The acquisition of the controlling shares of a enterprise by the foreign investor is sufficient for the investment to be classified as foreign direct investment. Different

[4] Ilkay Capraz, Ipek Demircioglu,**Turkiye'den Yurtdısına Dogrudan Yabancı Sermaye Yatırımları ve Turk Yatırımcıları**, Istanbul, İTO Yayınları No: 4, 2003, p. 3
[5] Ibid, p 3

countries apply different criteria for defining the realized investments as foreign direct investments. According to the definition by UNCTAD (United Nations Conference on Trade and Development):

It is stated that 10 per cent of the equity ownership of the enterprise can be considered as a threshold value for controlling the assets.[7]

1.1.1. Types of Foreign Direct Investment

Foreign direct investment may enter into a country in many different ways such as:

• Mergers and acquisitions,

• Investments made by way of privatization,

• Fixed investments ,

• Expansion of existing operations,

• New investment modes (joint ventures, strategic partnerships, licensing and other investments).

Only last two out of the five investment types above meet the traditional definition of the foreign direct investment.[8]

• **Mergers and Acquisitions:** Mergers and acquisitions are effected by acquiring or merging with a company existing in foreign countries.

International databanks, in general, do not differentiate the mergers and acquisition from the direct investment styles. This is misleading in evaluating the direct investment performances of the countries.

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[6] UNCTAD, **World Investment Report 1999 New York, United Nations**, 1999, p.465.
[7] Op.cit. p. 465
[8] Istanbul Chamber of Industry, **Uluslararası Dogrudan Yatırımlar ve Turkiye Durum Tespiti ve Stratejik Plan**, Istanbul, 2002, p.17

Most mergers and amalgamations are effected by and between the companies operating in developed countries, especially in those countries which have similar capital market structures (ie, UK and USA). Recently, the direct investments in certain countries such as Germany and France were also effected by way of mergers and acquisitions.

Mergers and acquisitions rarely lead to increase in the net domestic investment or production. Mostly, a decrease can be seen in the investments due to the synergies created in the company merged in an international investor. This, from the point of view of the invested company, should not be perceived as a disadvantage. Such investments of the international investors traditionally bring along all advantages (such as technology, having a global marketing and management network etc) gained from the direct investment while usually enable the local company to survive and compete.

Calculating the inward direct investment ensured by mergers and acquisition is accompanied by difficulties. In some cases, the amount paid to the local shareholders by the international investment may be kept out of the country as portfolio investment and therefore may not be added to the total domestic capital stock.[9]

• **Direct Investments By way of Privatization:** The primary characteristic of the calculation of the privatization revenue included in the direct investments is that the investments effected by way of privatization are recorded separately from the other direct investments. In the international comparisons, the total direct investment amount in which all investments modes are not reflected in detail allows to study in which investment types the countries effect more successfully. The studies evaluating the success of the countries in attracting direct investment should take into consideration the investment types, as well. However, it may be difficult to access such records for each country.

Most of the direct investments in the Middle and Eastern Europe were effected by way of privatization. The privatization-based direct investments consisted of the nearly entire of the direct investments made in Czech Republic by 1995 and of

[9] Capraz I. Demircioglu I. op.cit., p.17

nearly 50 per cent of those made in Bulgaria in 2000. It is seen that nearly 15 per cent of the direct investments made in Turkey between 1988 and 1995 were privatization-based. [10]

• **Fixed Investments:** Fixed investments are made by directly establishing a new plant or business in that country.

• **Expansion of the existing operations:** It is the expenditure which is made in addition to the existing investments in order not to modify the capital investments but to improve some aspects of them. These investments may be for making the existing products more quality as well as for producing, selling or developing totally new products.[11]

• **New Investment Modes:** The most rapid developing investment modes are joint venture and strategic partnerships. These modes of investments usually may not seem as investment amount in the official records since they include not just capital transfer or capital placement. Even if an increase is observed in the capital expenditure, the local partner of the joint venture may increase the capital by the funds from the domestic market and the foreign partner thereof only effect the technology transfer.[12]

1.1.2. Comparison of Portfolio Investments and Foreign Direct Investments

The portfolio investments consist of long term debentures (the more than one year forward agreements excluding pledge agreements) and the acquisition of the company shares that are not classified as foreign direct investment.[13]

The most important difference between foreign direct investments and portfolio investments relates the management and ownership of the investment made in the foreign country. The foreign direct investment is under direct control of the

[10] Ibid p.18
[11] Orhan Goker, **Yatırım Projelerinin Degerlendirilmesi Teori ve Uygulama**Istanbul, 1996, p. 9
[12] Capraz I. Demircioglu I,**op.cit**., p.3

company established abroad and the parent company. Most of the time, the top management of the company consist of persons from the foreign company. In other words, when said foreign direct investment, it means the effectiveness of the foreigners in the management of the company.[14]

The effectiveness of the foreigners controlling power passing into other hands may not always be in favour of the host country. According to Krugman, if the transfer of control takes place in the middle of a crisis, this will not be in favour of the host country.[15]

Foreign direct investments are flexible in crisis periods. For example, the foreign direct investment in the Asian countries survived in the crisis between 1997 and 1998. However, portfolio investments may show negative reactions especially during the crisis periods. The flexible structures of the foreign direct investment during the crisis periods (their easily adaptation to the changing economical conditions, their not immediately leaving the country) were also observed in Mexico crisis between 1994- and 1995and Latin America crisis in 1980s. This aspect of the foreign direct investments leads the developing countries to want to attract this type of investment at most.[16]

Another difference relates to the qualifications of the investors. While portfolio investments can be made by the saver natural persons, almost all of the foreign direct investments can be made by the multinational companies. One more difference between the foreign direct investments and portfolio investments is in connection with the returns on the investment. If the portfolio investment includes debentures, the payment conditions for principal and proceeds are predetermined. If it includes stock certificates, the return thereon will be in the form of dividends and capital gain. As for the foreign direct investment, the return varies from the dividends and capital gain to

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[13] Candemir A., **op.cit.**., p. 18
[14] Aydın Nurhan, **Uluslararası Dogrudan Yatırımlar ve Ortak Girisimler**, Eskisehir, Anadolu Universitesi yayınları, 1997, No: 1002, p.7
[15] Prakash Loungani, Assaf Razin, "How Beneficial is FDI for developing Countries?", **Journal Finance and Development**, Vol. II, No: 38, June 2001, pp. 1-7.
[16] **Op.cit..,** p.1

royalties, servicing charges, commissions, transfer pricing etc.[17] Another important difference is that in the case of the foreign direct investment, the investor brings along not only the capital but also the production technology and business management know-how. In the portfolio investments, the investor makes no contribution other than the capital.

1.1.3. Theories on Foreign Direct Investments

The importance in the world's economy gained by the foreign direct investments requires a close examination of the subject. The reasons for the inter-country division of labour and exchange have been tried to be explained by the Conventional Foreign Trade Theories. However, the Conventional Foreign Trade Theories based on the static assumptions have fallen short in explaining the international investment and production phenomenon in an atmosphere in which the international trade has started to develop. No sooner than the multinational companies become widespread in international trade, the inter-country mobility of capital and labour increased. In the world's trade undergone such changes, new foreign trade theories has been developed for explaining the international production and capital activities. Here below are some theoretical approaches to foreign direct investment:

-Mercantilist Approach: Pursuant to the fundamental principle of Mercantilist Approach, if a country has vast gold and silver resources, this country should be considered as an affluent country. According to Mercantilist thought, international trade is required to ensure national affluence and achieving the desired national affluence by international production is contrary to the mercantilist approach. It is clearly obvious that the companies carrying out commercial activities acquire the skills that they have and use in their field of activity from the economical power of the country in which they operate. According to the Mercantilist Approach, the direction of the world's economy will be determined by the mutual interests of the nation states and the multinational companies the overlap and non-overlap of these mutual interests will directly affect the world's economy. To the Mercantilists, the significance of the

[17] Aydın, **op.cit.**., p. 8

multinational companies in the world's economy as well as the interdependence of the countries will diminish as foreign direct investments increases.[18]

-Classical and Neo-Classical Approach: The classical theory assumes that the production functions and demand pattern are identical in every country, that factors of production are mobile within the country but immobile between the countries, and that the production is achieved by constant cost. As a result of all these assumptions, the classical theory falls short in explaining today's international capital movements and international production.[19]

-According to the Neo-Classical Approach, technology is distributed homogeneously among all countries and only labour and capital are considered as input. With such an approach, the poorest countries would have attracted most foreign direct investment and thus had the highest return on investment. Thus far, it is obvious that it is impossible to address the concept of foreign direct investment within the context of the traditional international trade theory.[20]

- Keynesian Approach: This approach tries to explain the international production and international capital movements by the differences in the profit rates. The investors try to maximize their profits by expanding their investments to different countries. In the motivation of the companies, the most siGNPficant role is played by the profit maksimization.[21]

-Marxist Approach: The general opinion of the Marxist economists is that the capital will flow to the more profitable fields because of the decreasing profit rates in the developed capitalist countries. In other words, there will be capital flows from the developed countries in which the profit distribution rates decreases to the countries in which the labour is suitable for being exploited. Traditional Marxist thinking maintained its prestige up to the late 1930s but in the post-war period, especially as a result of the rapid and intense foreign direct investments made in United States of

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[18] Candemir A., op.cit.., p. 22.
[19] Rıdvan Karluj, **Turkiye Ekonomisi: Tarihsel Gelisim, Yapısal ve Sosyal Degisim**, 6th ed., Istanbul, 1999, pp. 12-15.
[20] Harm Zebresg, "Can the Neo Classical Model Explain the Distribution of FDI Across Developing Countries?", **IMF Working Paper**, 199, pp. 14-18.

America, Marxist thinking lost its validity. It is seen that in the period up to the World War I, the changes in the capital movements supports the Marxist theory. However, it was noticed in post-war period that the direction of the capital flow is not from the affluent countries to the poor countries.[22]

-Product Life Cycle Theory: Vernon, with his article published in 1966, tried to explain the production process becoming multinational by the Product Life Cycle Theory. According Vernon, the product cycles should be examined in three stages: the release of the new product, maturation of the product and standardization of the product consist of the three stages of the product life cycle theory. At the first stage, a product integrating a technological innovation starts to be produced in a country. In the beginning, it is produced in small quantities and released only to the domestic market. When it is convinced that the product satisfactorily matured, it is produced in increasing quantities and starts to be exported. The innovative company prefers to retain the product technology at this stage, as well. Once the new product becomes standardized, the company owning the new technology product not only starts to grant licenses in its home country and in foreign countries but also switches the production to the less developed countries in which the wages are lower on the account of the fact that production amount increases and the research and development activities and high cost labour are no more needed. The country in which the headquarter of the innovative company is located has already become the net importer of the new product owing to the fact that both the companies to which it has granted licenses and the company which owns the innovative product produce the same product at lower cost in another country. At the end of the process, the new product is no more produced in the country of the innovative company and the country imports the new products when needed. At the first stage, the innovative technology product has already become a product which is freely produced anywhere. Following this stage, new technologies and products are required to be invented.[23]

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[21] Lizondo J. Saul, **Foreign Direct Investment**, M.I.T. Pres., 1995, p.88
[22] Deniz Ulke Anbogan, Kabileden Kuresellesmeye Uluslararas İliskiler Dusuncesi, Istanbul, Sarmal Yayınevi, 1998, pp. 126-127.
[23] Tugrul Gover, "**Dogrudan Yabancı Yatırımların Uluslararası Ticarete Etkileri: Turkiye Degerlendirmesi**". Specialization Thesis. Foreign Capital General Directorate, 2005, pp. 190-207.

- Monetary Approach: According to the theory developed by Robert Aliber (1970), once the company is convinced that the monetary value of the country in which it intends to invest is lower than that of its home country, it would think that it is the right time to attempt in foreign direct investment. In the monetary approach, the value of the national currency of the home country of the investor is higher than that of the country in which it invests and it is expected to maintain that level, it would have the opportunity to borrow from the local companies at low interest rate. Then, the local companies would have to pay an additional interest at a rate at which it is estimated that their own currency decrease in value. Consequently, while the foreign direct investments would be attracted by the countries which have a lower value of currency and are unstable, the countries having a higher value of currency would turn towards investment.[24]

-Oligopolistic Reaction Approach: In 1973, Frederic Knickerbocker developed "Follow the Leader Theory" for foreign direct investment theories for defense purposes. According to Knickerbocker, if one of the companies in an oligopolistic industry enters into a foreign direct investment, the other competitive companies would make defense investments in the same market. This is a reaction to the investments of the leading companies by the companies operating in oligopolistic market. The fundamental characteristic of the oligopolistic market is the interdependency of the companies. Since in oligopoly, there are so less company that they can influence each other, the decisions of any company regarding the production, price, sales etc are of particular concern to the other companies. In oligopolistic industries, if one of the competitors makes an investment, it is because of the oligopolistic reaction that the other companies operating in the same industry turn towards investments following the leading company. The approach suggested by Knickerbocker does not explain why the leading company turns towards the foreign direct investments. However, it investigates the reasons why the investments are

[24] Candemir A., **op.cit.**, p. 24

responded in the same way. Considering this approach in general, the automotive industries of USA, Europe and Japan invests in each other's markets.[25]

-Theory of Dynamic Comparative Advantages: This theory is developed by Kojima (1976) and explains the contrasts between the patterns of American and Japanese investments. This approach views the pattern of American investments as 'anti-trade-oriented' while describing that of Japanese investments as 'trade-oriented'. The theory of dynamic comparative advantages emphasizes that the American economy has a structure that consists of such companies having oligopolistic and technological advantages as well as the price-competitive companies. American companies make effort for foreign production since they plan to maintain their oligopolistic structure. [26] According to this model, the American model is trade destroying and includes such investments inhibiting the operation of the comparative advantages.[27]

As to Japanese companies, it invests in the fields in which it has no comparative advantages of the host country where it will make the foreign direct investment; in other words, the foreign direct investments are made in the industries in which the source country has comparative disadvantages. [28]

-Industrial Structure Approach: To explain the transnational foreign direct investment flows, industrial structure approach argues that the classical perfect competition assumptions are not valid. In Hymer-Kindleberger (1976) theory, the reason for the international direct investments is the oligopolistic industrial structure of the markets. The theory is based on the thinking that the companies in the country in which the investment is made is more advantageous. The companies entering into the international investments face risk and uncertainty. Therefore, the companies which intend to make foreign direct investments in foreign markets should have some advantages, as summarized below, over the companies of the host country, in order to

[25] Lizondo**, op.cit..,** p.99
[26] Lizondo, op.cit.., pp.100-101.
[27] Alan M. Rugman, **Inside the Multinationals: The Economics of Internal Markets**, New York, Colombia University Press, 1981, pp. 47-48.
[28] Jeremy Clegg, **Multinational Enterprise and World Competition**, England, The Macmillan Press, 1987, p.

be able to succeed in those markets. Kindleberger lists the advantages of the investor companies as follows: [29]

- Any kind of activity which interrupts the perfect competition conditions in the commodity markets of the investee country would provide oligopolistic power to the investors. These activities include product and price differentiation, private marketing and advertising methods.

- And the developments such as the patented new technologies of investors, the opportunities to easily raise capital and the managers' knowledge and skills cause deviation from the perfect competition in factor markets.

- Providing external economies by way of horizontal and vertical integrations.

- The host country's policies that minimize the government actions in entering into the foreign markets and facilitates the transfer of the revenues (such as profit and royalties) gained by the companies

The investor companies having the above-listed advantages over the host countries would benefit from these advantages by making foreign direct investments. To keep the technical secrets confident, the investors prefer the direct investments over the license agreements.

- Internalization Approach: This approach assumes that the transactions effected by way of trade in the market may sometimes be high cost due to the difficulties encountered in fixing market prices. In such cases, the company's internalization of such transactions is more cost-effective. The company internalizes the transactions by employing horizontal and vertical integration to avoid the costs arising from the market transactions. From a historical perspective, it is seen that in the period in which there was an increase in the number of the multinational companies (ie, up to the end of World War II), the large companies and developed countries, with the need of controlling the future supply amount, resorted to internalization concentrating on the

[29] Sahin Afsin, **Cok Uluslu Sirketlerin Davranslarınının Genel Acıklamaları ve Teorik Yaklasım**, 2004, (Online) www.stradigma.com/index.php?sayfa?=makale_liste, 11.06.2008

vertical integration. In this period, to procure the raw material, the multinational companies in the developed countries invested in the countries in which such raw materials were found. In this point, the presence of the raw materials in the foreign countries necessitates the international direct investments. This kind of investments is made in, in the order of priority, the petroleum, mines and agriculture industries. In the second growth stage (ie, post World War II) the need of the companies to largely benefit from the technological and marketing know-how became the most important factor of their internalization. The desire of the innovative companies to make the most out of the advantages they have leads them to internalization by way of horizontal integration. The technical information, such as design of the goods, production technology, marketing, business management, which the company has generated from its past production experiences provides advantage to the company. And the exchange of this information in the market is extremely difficult. Neither an exact market price can be estimated for it nor the companies wish the other companies to get hold of it. The companies turn towards horizontal integration in order to internalize these advantages.[30]

Another important reason for internalization is that the transaction costs sometimes may reach substantial amount in exchange. Transaction cost includes the costs arisen, apart from the price, during trade. More clearly, it consists of all cost elements which are not directly involved in the physical production process. According to this theory, the internalized transaction costs include the agreements made for the supply of inputs, the costs for transportation and coordination with the foreign seller or purchasers, the tariffs imposed by the foreign governments and discriminatory quotas. In order to eliminate these costs, the companies resort to internalization by way of horizontal or vertical internalization. [31]

-Eclectical Paradigm: Asserting that the companies carrying out economical activities in more than one country have to bear more additional costs compared to those showing activity in only one country and should have some specific advantages such as advanced technology, economies of scale etc over their competitors in order to be able to sustain production in spite of these costs, Hymer (1976) can be considered as

[30] Candemir A., **op.cit.,** p. 26

the developer of the theory of multinational companies. However, developing the thesis of Hymer in his study in 1977, Dunning, as the first researcher trying to comprehensively explain what are the conditions necessary for a multinational company to make foreign direct investment, is considered as the original developer of the theory of multinational company. [32]

According to the theory which is known as "OLI (standing for (Ownership, Location and Internalisation) Paradigm" or "Eclectical Paradigm", three essential advantages should exist together in order for a multinational company to make a foreign direct investment: Ownership Advantage, Locational Advantage and Internalization Advantage

1. Ownership Advantage (O): The multinational company's intellectual-industrial property rights, technological advantages, organization and management models, trademarks, distribution channels, the advantage of access to information and financial sources, the opportunity to be able to provide cheap input and to benefit from the economies of scale due to the scale size of the company provide advantages to the multinational companies over against the companies of host country.

2. Location Advantages (L): These are the advantages determining the country in which the foreign direct investment would be made. The multinational companies decide the countries or regions in which they invest taking into consideration the properties of the investment and the advantages provided by such countries or regions. The advantages in connection with the location of the investment place include the elements such as the factor costs and productivity, the distance between the investor country and investee company, market size, the abundance of natural sources, customs tariffs, the membership of the host country in a regional economical integration, the adequacy of infrastructure, investment incentives, social structure and cultural similarities.

3. Internalisation Advantages (I): It is the preference of a multinational company to operate in the local market by establishing a subsidiary instead of making

[31] Seyidoglu H., **op.cit.,** p. 556

their assets available to the companies in the host country by granting license or way of license or franchise agreements. Although entering into license agreements with the companies of host country provide such advantages as adapting to a different legal and administrative structure, keeping the market-entry costs low, the foreign direct investment is preferred over licensing due to the factors such as the

licensee's risk to imitate the technology licensed by the multinational company in case of a dispute between the parties, the requirement of the licensed technology or know-how to be used by the qualified workforce etc.[33]

4. The above-listed advantages which are deemed as a whole by the multinational company are effective factors in the foreign direct investments made in a country by the multinational company. When we take the ownership advantage (O) as a data, the internationalization strategy of a multinational company varies depending upon whether there are a locational advantage (L) and internalization advantage (I) or not. Depending upon the advantages they hold, the multinational companies prefer exporting, entering into a license agreement with a company from the host country, establishing a distribution company in the host country or making a foreign direct investment.

As shown in Table I.1, if only ownership advantage exists (1st case), the multinational company prefers exporting. If the multinational company have the internalization advantage (2nd case), as well, it establishes a company – selling the products that have produced in the investor company in the host country without establishing any production plants in host country – which is not considered as a direct investment, for marketing, sales and distribution purposes. In the 3rd case in which there is a locational advantage in addition to the ownership advantage, the multinational company opts to enter into a license agreement with a company in the host country. Thus, the multinational company desires to benefit from the locational advantage while avoiding from the cost of a new investment. As specified above, a multinational

[32] Gover, **op.cit..,** pp. 5-7.
[33] Gover, **op.cit.**, pp. 269-292.

company holding all of these three advantages, in the 4 th case, prefers making foreign direct investment over the other internationalization strategies.

Table I.1. Internationalization Strategies of the Company (as the Ownership Advantage is data)

	L-Locational Advantage (-)	L-Locational Advantage (+)
I-Internalization Advantage (-)	1) Export	3) License Agreement
I-Internalization Advantage (+)	2) Distribution company	4) Foreign Direct Investment

Source: Tugrul Gover, "'Dogrudan Yabancı Yatırımların Uluslararası Ticarete Etkileri: Turkiye Degerlendirmesi", Specialization Thesis. Foreign Capital General Directorate, 2005, p. 5.

OLI paradigm explains the factors taken into consideration by the multinational companies in making foreign direct investment by emphasizing the company-specific advantages of the multinational companies. This theory is useful to understand why the multinational companies opt the foreign direct investment over trade.

-New Theory of Foreign Direct Investment: The new theory of foreign direct information investigates the effects of the investments on the foreign trade of the investor company and the host company by dividing them into two categories by the

predictive factors affecting the investment decisions. This theory suggests that the foreign direct investment is not only substituting but also complementary for foreign trade. The complementariness of the relation between the foreign direct investment and trade can be defined as the qualitative and quantitative increase of the trade by and between the investor company and the host company following the foreign direct investment. The trade between the two countries increases directly due to the foreign direct investment but the equilibrium between the import and export and the foreign trade composition vary depending upon the type of the foreign direct investment.[34]

• Horizontal Integration Investments (HII): HII's, in general, mean the investments made by a multinational company to produce the same product in more than one country.

While opting between the foreign direct investment and trading, the multinational companies compare the advantage of production cost resulting from making production in a single factory and benefiting from the economies of scale and the advantage of being closer to the market and reducing the costs arising from trade such as the transportation costs, customs tariffs etc. If, as a result of this comparison, the multinational company decides to make the investment, such investment will be called as "HII". The higher the trade barriers between the investor country and the host country and the transportation cost are and the less the investment barriers are, the more the foreign direct investment will be preferred over the trading and HII will be made. The customs tariff increases to take place following the HII will increase the ratio of the sales of the affiliate to the sales of the multinational company. With the HII decision, the multinational company not only relieves from the trade costs but also is able to actively operate in the local market and rapidly and easily adapt to the changing market conditions and consumer preferences. Besides, it is known that HII leads the multinational company's other products not manufactured in the host country to be more demanded in this country and thus has positive effect on the total sales of the multinational company. In general, HII's providing an advantage of being closer to the market is considered as the most important reason for HII. Due to this property of HII's,

[34] Gover, **op.cit.**, p.7

they are considered as the export-substituting investments. The size of the market of the host country strengthens the export-substituting property of HII for two reasons. The first reason is that the fixed cost per unit output would decrease due to the increased production volume. And the second reason is that a large number of suppliers are needed to make production and the competition between these suppliers will decrease the prices of intermediate goods. Therefore, with the decrease in the production costs, the affiliate will gain the price advantage in the market.[35]

It is fairly difficult to determine the net effect of HII on the foreign trade of the host country. First of all, it is anticipated that HII would substitute for the final merchandise export from the investor company and that the final merchandise import of the host country would decrease. However, in the initial years of the investment, the affiliate imports the capital goods, raw materials and intermediate goods it needs to produce final goods from the investor company due to the fact that the quality standards and the suppliers in the domestic market are not adequately known. Fort his reason, the entire of the export of the host country from the investor country is expected not to be replaced by HII. The investing multinational company, over time, establishes good trade relations with the raw material and intermediate goods suppliers and gradually starts to meet its needs domestically. Consequently, it may be expected that the relationship between HII and the export of raw material and intermediate goods would weaken and the final goods import of the host country before HII would be completely replaced by domestic production. Eventually, it can be anticipated that the HII - trade relationship which was complementary in the beginning, would become substituting. [36]

• **Vertical Integration Investments (VII):** VII's are the investments which are made in several countries in order to produce a good as a result of the division of the production process of the final goods into several stages. The advantages resulting from the difference in the factor prices such as the abundance of the natural sources, abundance of raw material, cheap labour plays an important role in an investment made by multinational companies by way of VII. In addition to these factors, the lower cost of

[35] Gover, **op.cit.**, p.8.
[36] Gover, **op.cit.**, p.8.

transportation between the investor country and the host country and the free foreign trade are also siGNPficant for VII. It is a good example for VII that the components of a product put on USA market are manufactured in USA but assembled in Southern Asia due to the cost advantages there. [37]

• **Knowledge Capital Model (KCM):** The last theory trying to explain the foreign direct investments is KCM which consists of a combination of HII and VII as described above. As in HII and VII, KCM theory is also based on the assumption of two countries, two products and two factors (qualified and unqualified workforce). However, the difference of this theory is that it incorporates six different company types two of which are local companies, two are multinational companies made HII and the last two are multinational companies made VII, into the model. According to the theory, assuming that the trade cost consists of 20 per cent of the incremental production cost, if the investor country and host country have similar economical and demographical size and are similar in terms of factor endowment, the production of the affiliates is realized at the highest level. In case the countries have similarities, the multinational company opts HII. Saving the above-mentioned incremental cost assumption, when the assumption that the total fixed costs of the multinational companies which made HII and those which made VII would be equal to each other is incorporated into the model, it is observed that the multinational companies tend to make HII in the countries which have similar the economic size and factor endowment. Given that the trade cost is lower and the multinational companies making HII bear two times more total fixed costs compared to the local companies, it is concluded that the multinational companies make VII in the countries having different factor endowments and thus, different factor prices. [38]

1.2. Decision Making Process in Foreign Direct Investments

International investors conduct a series of analyses and investigations in investment process. Conclusion of investment process depends on a number of factors

[37] Gover, **op.cit.**, p.8.
[38] Gover, **op.cit.**, p.10.

such as positivity of the investigations performed and continuity of negotiations. It is observed that many investment decisions came to the point of ceasing at the beginning of this process, yet relatively a small number of investments were realized by completing this process.

Realization process of investment is generally requires a period of time which is not short. It is observed that this process is minimum three months and it may be as long as a few years in direct investments. Since it lasts longer than estimated especially in the event of that companies that are short of liquidity seek for investors for the purpose of compensating finance shortage, it may have negative consequences for parties.

Naturally, characteristics of the investment to be made will have influence on decision process. That is; when decisions designating the investment place are taken, there will be alternatives that will cause the company to take strategic decision and be influential.[39]

In Table I.2, decision process of an international investor intending to make investment in a foreign country is coarsely summarized.

Table I.2. Decision Making Process in Foreign Direct Investments

STAGE	PRIMARY CRITERIA	SECONDARY CRITEIRA
Issuance of Long Lists of Countries	1st STAGE · Entering the market · Understanding of Working Condition · Stability in Growth	· Financial Regime (Taxes, Incentives) · Labour Issues · Communication Opportunities

[39] Capraz İ. Demircioglu İ., **op.cit.**, p.23

Issuance of Short Lists of Countries	· 2nd STAGE · Local Working Conditions · Former Experiences in Sector · Reaction of Responsible Institution	· Communication Opportunities · Reaction of Responsible Institution · Investment Place
Designation of Countries	· 3rd STAGE · Local Working conditions · Former Experiences in Sector · Reaction of Responsible Institution · Communication Opportunities	· Communication Opportunities · Reaction of Responsible Institution · Investment place
Comparison of Countries/Regions	4th STAGE · Reaction of Responsible Institution · Specific Problems - Investment place	· Labour's - Skills - Costs - Availability · Specific Logistics and Communication Problems

	- Incentives - Supports - Costs	
Final Place Selection	5th STAGE · Incentives · Investment place · Recommendations of Responsible Institution	· Capacity in All Other Criteria

Source: Hakan Ozy ıldız, ‘’Dogrudan Yabanc ı Sermaye Yat ırımlarında Karar Alma Proseduru’’ (‘’Decision Making Procedure in Foreign Direct Investments’’), **Hazine Dergisi**, 11 July 1998, p.4-5.

Characteristics of the investment to be made in designated process will have influence on decision making process. When decisions designating the places of many investments are taken, there will be alternatives that will cause the business to take strategic decision and be influential. This process might be explained as follows:

1 st Step: Issuance of Long Lists of Countries: In country selection, generally five to nine countries may be selected. Two most important criteria of this stage are entering the market at working conditions. Entering the market plays an important role in investment place selection. Transportation possibilities and positions of siGNPficant clients are also factors. In addition to these, discussing and widely reviewing elements such as a stable economy and exchange rate, inflation rate, laws, unionizing and costs may also be evaluated as primary elements of working conditions. Secondary criteria used in this step for evaluation may be designated as taxes, conditions of labour market and transportation possibilities. In this step, works are

performed generally at desk.

2nd Step: Issuance of Short Lists of Countries: In order to decide on investment place, number of countries must be reduced. As research is made deeper, number of candidate countries must be reduced to two or three. When reaching to this number; issues of working conditions, former experiences and especially labour may be investigated in details.

3rd Designation of Countries/Regions: Information to emerge as a consequence of detailed researches to be performed may be evaluated being discussed together with issues necessary to be put forward. In this stage, the investor must accomplish an efficient work in order to obtain satisfying results in all primary criteria of selection. Final short list must be formed with comparisons to be made. In this stage; works of public institutions responsible for the promotion of direct foreign capital investment play a very crucial role, and the institution responsible for foreign capital investments in issues such as permission procedure, substructure incentives and attitudes of concerning institutions in negotiations for other incentives is in a sense subject to a test. Beside these; all factors related to costs along with incentives will be important factors in decision making in this step.

4th Step: Final Place Selection: When it comes to the last stage, making comparison between two investments areas that have similar characteristics will generally be the case. In this step, the leading factor among the factors to designate the selection between two candidate places is generally incentive measures.[40]

Privileges granted to businesses behind incentives, incentives in real estate procurement, labour and incentives in direction of labour training, communication and availability of other necessary substructure.

1.3. Factors Influencing International Foreign Capital Investments in terms of Foreign Country and Host Country

Factors that facilitate or accelerate the realization of Foreign Direct

[40] Candemir, **op.cit.**., p.82.

Investments are evaluated in terms of source country and host country. Foreign Direct Investments are designated both by factors of aspect of demands related to host country and factors of aspect of supplies related to source country. In other words; for Foreign Direct Investments to be realized, source country is supposed to have some propulsive factors and host country to have some appealing factors.

1.3.1. Designating Factors for International Foreign Capital Investments in Terms of Foreign Country

From the point of foreign investor, the most important designating and propulsive factor is probable profit anticipated to be gained in the future. However; considering only profitability when investment decision is taken is not sufficient. Other propulsive factors other than profit maximization in source countries are reducing costs, avoiding tariffs and quotas in countries with which trade is made, creating new markets or keeping existing markets, creating monopolistic power, increasing competitive power or maintaining it and intents for diversifying investments internationally and making use of production flexibility.

Profit Maximization: It is the most significant factor that allows investments to be realized and encourages businesses for investments. The factor with highest power of encouragement for foreign investors is the profit anticipated to be gained when investment is made. However; it is necessary to be aware of that risk factor increases in investments made from areas with low profit rate to areas with high profit rate. If profit anticipated to be gained when investing in countries where there are risks and obscurity is capable to overcome the negative effects of risks and obscurity, the investment will be realized. When decision on investing in another country is taken, continuity of profitability is demanded as much as such profitability. The most important factor that maintains is the continuity of profitability.[41]

Cost Minimization: Cost is an important factor in taking investment decision. With the realization of investment; if type of direct foreign investment is opening a new branch or establishing a new facility rather than purchasing or merger, stable costs such

[41] Candemir A., op.cit.,p. 60.

as new production equipment, distribution system etc. may emerge. High stable costs that emerge with Foreign Direct Investments entering the country make exit of Foreign Direct Investments more difficult. On the other hand, drops may be observed in variable costs. Reason for such drops may be as follows: scale economies, cheap labour, making use of tax differences, ease in raw material procurement and low transportation costs.[42]

Scale Economies: A scale economy is defined as reduction in unit costs due to the increase in production volume of a business. Scale economy is the reduction of average cost of products of a business while outcome is increasing. The reason that allows this to happen is putting a factory with a higher capacity in order to reduce production costs. A bigger factory results in a bigger division of tasks. Similarly, scale economies of marketing, management and finance are also provided.[43]

Cheap Labour: Due to the rapid increase in population, labour in developing countries is cheaper in developed countries. Cheaper labour creates a cost-decreasing effect on investors' business costs. Such regions have relative attraction in terms costs. However; cheap labour does not make much difference in investment place selections for foreign investors in some situations. One of such situations is Foreign Direct Investments attempting to dominate local market as aforementioned; because what matters for investments aiming at local market is labour quality. Another situation is that in the event of that foreign investor designates the target mass of the new investment as higher echelons, in other words he is intending to develop products appealing to the individuals in upper segments and thinking of supplying them rapidly to the market in which he has invested, cheap labour may not be of primary importance.

Purpose of this type of direct foreign capital investment in search for strategic value is to supply valuable goods produced to the markets with higher level of income.[44]

Differences in Taxes and Legal Legislations: Tax rates vary from country to country and this variation is an important factor which has influence on decision of a

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[42] John H. Duninng, **Multinational Enterprises and the Global Economy**, New York, Addison-Wesley Press, 1992, p. 60.
[43] İlker Parasız., **Modern Ansiklopedik Ekonomi Sozlugu**, Bursa,Ezgi Kitabevi Yayınları,1999,p.281
[44] Deepak Lal, **Appraising Foreign Investment in Developing Countries**, London, Heinemann Press. 1975. p. 34.

business that will make direct foreign capital investment. High taxes will have a competitive-power decreasing effect when the business exports its goods. Therefore; a country with lower tax rates will be preferred unless there is political instability. In cases of political instability; if the rate of profitability to be gained due to low tax rates is capable of compensating the negative effects of the political instability in host country, than the investment is continued.[45]

Raw Material Procurement: In early 19th century, Foreign Direct Investments were made for the purpose of meeting raw material needs of developed countries.[46]

Purpose of Foreign Direct Investments in this period is to use valuable raw materials such as mines and to producing foods for consumption. As raw material sources have no equilibrium distribution over the world, abundance of sources is a determinant in making investments.[47]

That foreign capital investments were made just to run cheap and abundant natural sources and provide raw materials for main business is actually a reality. Foreign capital investments in countries that are rich in terms of underground and overland sources such as Mexico, Philippines, Nigeria and Peru are best examples of this situation. Yet, this situation changed in time following World War II. Manufacture of multinational businesses aimed at providing supplies for economies of industrialized countries and markets that cannot be reached through export. When evaluated in the wholeness of the investment, raw material procurement which used to be of vital importance formerly is presently not considered as an important advantage solely.

Reason for businesses to turn their direction of production to the countries with raw material sources are primarily prevention of entrance of raw material used in production of goods into the country by means of importation through political

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[45] Lall Sanjaja, ''Monopolistic Advantages and Foreign Involvement by U.S. Manufacturing Industry''. **Oxford Economic Papers.** Vol. 32 No:1, March 1980. pp. 102-122.

[46] Dunning, **op.cit..,** p. 38

[47] Lal. **op.cit..,** p. 28.

or commercial restrictions. Even if importation of concerning raw material is not prevented; in the event of that the business sells the goods that it manufactures with dense raw material to consumers in foreign countries, it may be more advantageous for the business to establish its place of manufacturing in such countries. Even if the products are to be sold to other countries, importation of raw material may not be appropriate. For instance; for an automobile manufacturer from USA who buys steel from France and exports cars to Germany, it may be more suitable to establish a manufacturing facility in France or Germany.[48]

Avoiding Tariffs and Quotas: World Depression which started in 1929 affected the whole world; and drop in production and rise in unemployment reached to levels that had never been experienced before. Liberalization works were replaced with protectionism for a while in the period between World War I and World War II. Due to the declination of demands from industrialized countries, raw material prices dropped in world markets and economies of many countries from Latin America to Asia collapsed. Leading industrialized countries reacted to such crisis by increasing the demands for goods manufactured domestically and therefore employment and providing job opportunities by imposing restraints on importation.

Following the end of World War II, liberalization trends all over the world were re-accelerated. However; stagflation where economic stagnation and high inflation are together was experienced in 1970s. With this stagflation fact, protectionism trends became common again in industrialized countries. Yet; protectionism trends applied this time were restraints defined as trends of neo-protectionism that led to the removal of transparency and increased obscurity in global trade. Although countries abandoned protectionist foreign trade policies and adopted liberal foreign trade after World War II, we do not generally see any examples of international trade of goods and services that were not subject to any restrictions in practice.

Governments interfered in international trade in order to realize various purposes. There might be social and political purposes beyond this interference as well

[48] Candemir A.**,op.cit..,** p. 62.

as economic purposes.[49]

Due to the restraints imposed on importation for the purpose of saving foreign exchange reserves for domestic industry, the risk of losing the market may emerge for the business which is trading with such country. In this case, the best way to be protected from tariffs and quotas or new-protectionist tools is to start manufacturing in concerning market via direct foreign capital investment. The actual reason for American investment to flow into Western Europe in 1960s is based on this situation.[50]

Maintenance of Existing Market or Searching for New Markets: Direct foreign capital investment of a business can be categorized in two groups. Offensive and defensive direct foreign capital investments. The first one aims for the business that makes Foreign Direct Investments to gain an advantage against its rivals; and the other one aims to be protected from the advantages its rivals might gain. One of the siGNPficant reasons why investor countries turn their directions directly to Foreign Direct Investments is the insufficient investment opportunities in their own countries. That is because profitability of many businesses manufacturing in markets of developed countries has dropped due to the increase of satisfaction and productivity in markets. In other words, revenues that businesses gain from investments have decreased. Considering the insufficient investment opportunities in their own countries, decrease in revenues gained from investments and profit obstruction created by advanced level of satisfaction and abnormally high capacities especially in basic industries; expansion to new markets through Foreign Direct Investments may provide high profit opportunities for businesses.[51]

Creation of Monopolistic Power: According to the industrial organization theory, businesses holding production information and skills which their rivals do not have are in an advantageous position in terms of expanding to foreign markets.

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[49] Yarbrough B.V. and Yarbrough R.M.,**The World Economy: Trade and Finance,**London, 1994, pp. 180-200.

[50] Candemir A.,**op.cit..,** p. 63.

[51] İnan Ozalp, **Cok Uluslu İsletmeler: Uluslararası Yaklasım,** Anadolu Universitesi Yayınları, No:1022, 1998, p. 32.

According to this point of view; if all information, sources and goods were completely mobile and they could be owned any time, there would be no monopolistic structures in any market. However; these conditions are impossible to maintain in real markets. Certain businesses in a market gain superiority when compared to others due to some privileges of theirs. For instance; when technology is the case, if a business is the only one business using one certain type of technology, it can use this advantage in domestic market and foreign markets. Technology might be related to a new product, manufacturing process, marketing or financing method. Therefore; a business holding superiority in such fields against its rivals may expand to international markets more easily by using this advantage of its.[52]

International Diversification of Investments: Foreign investments indirectly provide diversification in portfolio for shareholders. In the event of that manufacturing is limited to only one market, cash acquisitions show a relative instability. Business may attempt o balance through portfolio diversification to a certain extent. Yet; it is normal for selling conditions of all products in the same country to be affected likewise. In other words, systematic risk cannot be removed with diversification. However; the business may reduce this risk by diversifying its manufacturing at an international level. That is because economies of all countries do not fluctuate in the same direction.[53]

Maintaining or Increasing Competitive Power: Together with rising globalization in the world, the importance of competition rises as well. Businesses will have technical information accumulation in time. Businesses are not willing to share their valuable information on issues such as technology, marketing and management with other businesses. This information which businesses are not willing to share with other businesses are called informal information.[54]

Consequently, foreign businesses will prefer to enter the market through Foreign Direct Investments in order to maintain their direct control power. These businesses and their equivalents do not have positive reactions to licence agreements as

[52] Halil Seyidoglu, **Uluslararası Finans,** İstanbul, Guzem Yayınları, 1994. p. 304.
[53] **Ibid.,** p. 301.
[54] Lall. **op.cit..,** p. 22.

they are willing to hold the power to control.[55]

Direct foreign capital investment might be made in order not to let competitive power vanish as well as increasing competitive power. For this reason; in the event of that a few businesses from a certain branch of industry perform direct foreign investments outside the country, other businesses in the same industry will turn their directions to foreign investments in order to maintain their competition possibilities. One of the reasons why rival businesses go for defensive type of investments is not to lose existing markets and probable markets in the future and to prevent business which has gone for foreign investment to establish superiority in domestic market due to the information and experience it has gained in different markets.[56]

Flexibility in Transportation and Manufacturing: Transportation of goods from exporter to importer through foreign trade will require certain transportation costs. This situation stands as a siGNPficant obstacle for trading especially between countries that are geographically far from each other; because foreign trading of some certain goods depends on the condition of that price difference between countries prior to trading is bigger than costs of transportation required for transporting goods from one country to the other one. Although transportation costs are relatively low due to the rapid technological advancements in recent years, it is still a factor of great importance. Transportation costs may lead to different prices of goods in concerning countries, which means higher prices in importing country and lower prices in exporting country. This situation has negative effects on trade and negative effects of related transportation costs may be tried to be overcome by making direct foreign capital investment. Transporting goods manufactured into the market is more difficult than transporting entries. Therefore; stages following some certain part of manufacturing and generally the final stage are realized in a place where consumers can access goods.[57]

For a business, making investment in a country where there is risk for its

[55] Dominick Salvatore, **International Economics,** New York, Prentice Hall. 1999. p. 350.
[56] Lizondo **op.cit..,** p. 99.
[57] Thomas A. Pugelt, Peter Lindert.**International Economics,**McGraw-Hill. 2000. pp. 60-78.

money to be subject to an anticipated real value loss has cost-decreasing influence. In such situations, change of place of manufacturing may be performed for this country where its money is subject to real money loss in order to make use of this opportunity. The reason for this is that costs are relatively low for commencement. When exchange rate becomes stronger in time, revenues to be transferred to the main business will also increase.

Very strong position in this concerning time interval and therefore relatively reduced costs of forming affiliated businesses in foreign countries might be shown as reasons for this increase. Another reason related to such investments is that demand for goods of the business to be exported is balanced in changes in exchange rates.[58]

Protection of Title and Secrets: Businesses with very positive reputations in commercial life may choose to manufacture their goods themselves in foreign countries as well in order to protect the quality of its own products and images of its trademarks from unjust treatments. As these businesses are of the opinion that their goods might not be manufactured in the same quality when manufactured via license agreements, they choose to manufacture their own goods themselves outside their countries. Although Foreign Direct Investments resulting from this reason create important opportunities of source, employment and exportation especially for developing countries, they are in effective in terms of establishing connections with local businesses in the framework of cooperation and information sharing. In situations where confidentiality of information related to manufacturing process is crucial, preferring Foreign Direct Investments to licensed manufacturing is related to the keeping of secrets. That is because license holder may not be as careful as patent holder about such information to leak out.[59]

1.3.2. Designating Factors for International Foreign Capital Investments in Terms of Host country

Growing importance and mobility of multinational businesses, contrary

[58] Levi D. Maurice, **International Finance: Financial Management of Multinational Business**, New York, McGraw-Hill. 1990. p. 395.
[59] Candemir A., **op.cit..,** p. 65.

to general opinion, do not trivialize local conditions; far from it, they make them even more important. Yet; it has to be kept in mind that increasing freedom does not mean that international manufacturing will be distributed to everywhere equally.

What matters in this point is the existence of supplementary factors. [60]

When examining the determinants for foreign capital investments, it is necessary to take determinants of host country's aspect of demands into consideration. Home countries are already making efforts to be attracted by Foreign Direct Investments by putting forward their existing demand potentials.[61]

In UNCTAD World Investment Report 1998, an analysis was made related to factors influencing direct foreign capital investments. Concerning determinants are categorized under three main captions: They are economic factors, factor belonging to investment conditions and political factors. Moreover; subtitles of economic factors in terms of investment strategies are also indicated.

Political Factors: Political determinants have siGNPficant influences on direct foreign capital investments. Primary political determinants are political and social stability, international institutions, taxing policy, liberalization, short-term and long-term political role of the country, membership for economic integrations, privatization policy and bureaucratic procedures.[62]

Political and Social Stability: From the point of a foreign investor, political structure of the country where he is going to choose for investment is of vital importance. Here, the concept of political stability comes into prominence. Conditions where political instability is dominating are serious risks for foreign capital investments foreign investors choose to stay away from such conditions.[63]

Many a time, the most discussed issue by investor businesses during

[60] UNCTAD, **World Investment Report 2001,** New York, p. 14.
[61] Kevin H. Zhang. ''What Explains The Boom of FDI in China''**, International Economics,** Vol. 54, No:2, ay 2001, pp. 251-273

[62] Candemir A.,**op.cit..,** p. 66
[63] Ebid., **p**. 67.

investment decision process is the political situation of concerning country. Political stability means there are no extreme fluctuations in political life of that country. This doubtlessly leads to the minimization of political risks in that country. Danger which is that investments made might be nationalized after a while has deterrent effect on foreign capital.[64]

Taxing Policy: Investors trying to get rid of harsh taxing burden imposed in their own countries try hard to increase their profitability. For this reason, Foreign Direct Investments will be directed to regions where tax legislations are convenient. Therefore; countries which have made themselves attractive for Foreign Direct Investments will be preferred when, for instance, they apply the same taxing procedure for both domestic and foreign investors. Practices such as bilateral taxing agreements with foreign investors also play an important role in direct foreign capital investments.[65]

Developing countries willing to be attracted by Foreign Direct Investments choose the method of imposing low-rate taxes. As competition formed among developing countries willing to be attracted by direct foreign capital investments, taxing rates are gradually decreasing for foreign investments. Thus; foreign investor thinking that tax burden in his own country is rather harsh will realize their Foreign Direct Investments in regions with lower taxing rates.[66]

Political Role of Country: Short-term and long-term role of the country world conjuncture is also another factor that influences direct foreign capital investments. One of the primary motives lying behind direct foreign capital investment movements is naturally profit-gaining desire of the entrepreneur in international area and seeking for new markets where he can improve his competitive power for the purpose of realizing this desire. However; although decision to make an investment in another country improves the competitive power of the entrepreneur, it also lets siGNPficant risks to emerge. For this reason, Foreign Direct Investments are directed also depending on future positions of countries as well as present positions. Rising interests in Foreign

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[64] Daim Demircan, **Turkiye'de Yabancı Sermaye,** İstanbul, Dilek Matbaası. 1971. p. 102.
[65] Buckley Peter. Casson Mark, **Multinational Enterprises in the World Economy,** London, Edward Elgar Publishing, 1992, pp. 65-66.
[66] Sun Qian, Tong Wilson, Yu Qiao, ''Determinants of Direct foreign Investment Across: China'' **Journal of**

Direct Investments in any country is closely related to creating the opinion that concerning country may have an active position in the new advancements in the world. Role that is to be played by host country politically and financially in world conjuncture and the position to be taken are among factors that have influence on direct foreign capital investments.[67]

Membership of Economic Integrations: It can be expressed that foreign investors pay considerable attention to what extent the concerning country participates in the world trade system and the agreements formed within this system as well as political and financial stability. Another factor that is efficient in attracting Foreign Direct Investments is to be included in economic integrations such as EU, NAFTA and MERCOSUR. One of the reasons for regional economic integrations is already to cause rises in direct foreign capital investments.[68]

Privatization Policy: Primary philosophy of privatization is that the state is to undertake costs of procurement of justice and security that are essential tasks of the state and deal with substructure investments that cannot be undertaken by private industry; and that economy is to be managed by market mechanisms.

Along with foreign capital investments, privatization started to gain importance in early 1980s; and its importance has become even greater since 1990 as countries that were in the transition period for market economy turned to comprehensive privatization. Privatization policies that are accelerated with globalization process take important parts in economic agenda of many countries. One of the primary targets of privatization practices is to maintain competition in economy through property transfer. Privatization programmes manipulated Foreign Direct Investments gradually to Latin America and Central and Eastern European Countries.[69]

Bureaucratic Procedures: Administrative procedures and operations are important for attracting direct foreign capital investments. Long duration of such

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International Money and Finance. Vol. 54, No:2, February 2002. pp. 79-113.
[67] Ahmet Zengin, ‘’Turkiye Ekonomisi Acısından Dogrudan Yabancı Sermaye Yatırımlarına İliskin Bir Degerlendirme’’. **İktisat İsletme ve Finans Dergisi** February 2003. p. 52-67.
[68] Candemir A.,**op.cit..,** p. 68.

procedures and bureaucracy may constitute a siGNPficant obstacle for foreign investments for entrance. Many a time, bureaucratic obstacles are unnecessarily lengthening the investment period and increasing the costs. A research conducted by World Bank indicates time, number of operations and costs required in countries for a new enterprise. Issues examined in the research are as follows:

- Registry procedures of a business,
- Time spent for each procedure,
- Cost of each procedure,
- Minimum required capital based on gross national product.

Another factor which is considered in Foreign Direct Investments is the financial conditions of countries. Economic determinants such as size of market in a country, stability of price level, exchange rate, degree of openness for foreign trade, domestic investments, labour costs, investment incentives and substructure are influential in investment place selection.[70]

Size of Market: In the event of that host country's market if sufficiently big, it will be preferred for Foreign Direct Investments to be made rather than making exportation in order to make use of this potential of the country. When average costs of entrance of certain goods into a market through exportation surpasses the average manufacturing costs in the market, manufacturing will be realized through Foreign Direct Investments rather than exportation. Status showing the demand potential of the market is the population of the country. However; national gross product, in other words purchasing power of consumers, being high is also another attractive factor as well as largeness of the market in terms of volume. Low purchasing power also makes the market even smaller as well as the smallness of population which is the indicator of market size. In the event of existence of a consumer group of a country who do not have sufficient purchasing power to buy the goods manufactured in the same country will

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[69] Candemir A.,**op.cit..,** p. 68.

[70] Ibid., p.69

affect the entrance of direct foreign capital investment negatively. [71]

Gross national product (GNP) is used as an indicator of market size which plays an important role in attracting direct foreign capital investments. It is the most crucial determinant for Foreign Direct Investments turning toward the local market and aiming to meet the demand from local market. In the event of that GNP is high enough, in other words the market has grown enough to make use of scale economies, and direct foreign investments will be preferred for exportation.[72]

Growth: In order to conceive the influence of growth on Foreign Direct Investments better, two countries with fast or slow growth rates must be compared. Economies growing faster offer relatively better opportunities to businesses. Namely, they provide better profit possibilities.[73]

Stability of Price Level: Instability of price level may emerge either declination of price level or rise of price level. Inflation levels of host countries have influence on investment decisions; high inflation increases the obscurity and risks in economy and therefore considerably reduces the efficiency of market mechanism. Increase in risk might be a decreasing factor for Foreign Direct Investments to be made. However; if the anticipated profitability to be gained from Foreign Direct Investments is capable of compensating the negativities of the concerning risk, the investors realize their Foreign Direct Investments in spite of high inflation. Yet, investor businesses generally choose to invest in countries that are stable and have lower inflation levels. Consequently, they defend themselves against de facto capital loss and obscurity caused by high inflation and instability.[74]

Exchange Rate: Since valuation in host country's currency may increase the entrance of Foreign Direct Investments aiming at local market as it will increase the purchasing power of consumers in this country. Being a variable influencing real exchange rate, welfare level and labour cost, it may increase the welfare of foreign

[71] Ozalp I., **op.cit..,** p. 180.
[72] Candemir A.,**op.cit..,** p. 70
[73] Ibid., p.70
[74] Kemal Yıldırım, **Makro Ekonomi,** Eskisehir, Egitim Saglık ve Bilimsel Arastırma Calısmaları Yayınları, 1999, pp. 5-6

businesses and expenditures of foreigners for domestic goods. In addition to this, a real value loss may increase the capital flow into the country with the intention of providing advantage for domestic labour that has become cheaper.

That is because determinants such as comparative manufacturing costs are closely related to the level of real exchange rate.[75]

Openness Level: Openness level of a country is generally measured with the ratio of foreign trade volume/GNP. From the opinion of that investments are directed to tradable industries forth, it is accepted that countries with higher openness levels attract more foreign investments.[76]

Foreign trade policy is an important device of general economy policy. Open economies are economies where importation and exportation are made. Importation of a country constitutes the exportation of the foreign world to this country. What indicates the level of openness is the extent of restrictions towards exportation and importation. No matter how strong liberal trade theory is in theory, we do not generally see any examples of international trade of goods and services that were not subject to any restrictions in practice. Governments interfere in international trade in order to realize various purposes. There might be social and political purposes beyond this interference as well as economic purposes.[77]

Liberal competition adopted in developed countries depending on market economy is among the obligatory conditions of economic efficiency. Nevertheless, protective measures are taken as a consequence of the pressure from domestic manufacturers that cannot compete with importation. Moreover; for the purpose of accelerating their industrialization in less developed countries, they perform various interventions on foreign trade. Many countries imposing restrictions on importation puts realization of Foreign Direct Investments in a more advantageous position in comparison with exportation and it may be seen as a necessary means for the country to

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[75] Candemir A.,**op.cit.,** p. 70.
[76] Avik Chakrabati, ‘’The Determinants of Direct foreign Investment: Sensitivity Analyses of Cross-Country Regressions’’, **Kyklos,** Volc 54, No:1, February 2001, pp. 89-114.
[77] Mustafa Duran, **Turkiye’de Yat ırımlara Saglanan Tesvikler ve Etkinligi,** Ankara, Hazine

increase exportation. There are two opinions on how Foreign Direct Investments affect one country's exportation negatively. As for the first opinion, there are those who think that Foreign Direct Investments affect one country's exportation negatively; and this situation is supporting the idea of direct foreign investments turning towards local market; they are of the opinion that the country's exportation if replaced with foreign direct capital investments. Those who think in direction of the second opinion are of the opinion that Foreign Direct Investments affect the country's exportation in a positive way; exportation is not replaced with Foreign Direct Investments and Foreign Direct Investments made are aiming for exportation, and the investments are made in areas that have never been invested in.[78]

Domestic Investments: Being able to make more investments obliges rises in savings. However; low gross national product in developing countries leads to that only a small part of revenues is kept for savings. For this reason, increasing the investments with domestic sources is becoming even more difficult. Foreign Direct Investments may positively or negatively influence domestic investments in a country. Therefore, it is important how Foreign Direct Investments entering the country will affect the domestic investments and whether such Foreign Direct Investments are supplementary or replacing for domestic investments. If the direct foreign capital investor invests in the same industries using the same sources, then it is of replacing nature; and if he is investing in industries which domestic investors cannot invest due to lack of technology or shortage of capital, then it is of supplementary nature. Local businesses willing to compete with multinational businesses in the market of goods may cease to make investments; consequently the competition may push some certain local businesses out of the market; or else, multinational businesses increasing the competition may lead to increase in efficiency by making local businesses adopt more efficient manufacturing technologies. Thus, rather than the alienation effect, attraction effect will emerge. Attraction effect depends on the degree of backward links and forward links of the

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Mustesarlığı Arastırmaları. 2002. p. 10.

[78] Kwon Y.C., ''Korean Multinationals FDI Projects'', **The International Trade Journal,** Vol. 16, No:2. pp. 203-229

investment realized.[79]

Labour Costs: Amongst the determinants of direct foreign capital investments, the most debated one is wages. It is a generally acknowledged opinion that cheap labour is a factor of attraction for foreign investments. By using the data belonging to Germany and England, Hatzius examined the relation between labour costs and Foreign Direct Investments and came to the conclusion that ‘’unit labour costs have a positive influence on Foreign Direct Investments entering or exiting the country’’.[80]

There are also opinions claiming that wages cannot be influential in attracting foreign investments. First one of these opinions concentrates on reducing the ratio of wages in manufacturing costs. Therefore, attraction of wages for foreign investors is gradually declining.[81]

Second opinion claims that it is not only wages but also productivity to be of importance in order to be attractive for foreign investors. For the chain of wages – productivity – direct foreign capital investments, J.M.C. Rollo summarizes the issue as “if it is possible to find high-quality labour at low level of wages, it will be the key factor for foreign capital.”[82]

However; it is necessary to conceive exportation-oriented Foreign Direct Investments and local market-oriented Foreign Direct Investments separately from each other in order to emphasize the importance of labour costs of labour quality. In terms of exportation-oriented direct foreign capital investments, the most siGNPficant motivation device is labour costs. This type of businesses put exportation-oriented final products in the market. Yet, in terms of local market-oriented direct foreign capital investments, the importance of labour costs is relatively less. That is because entrance purpose of this type of Foreign Direct Investments is to manufacture aiming for domestic market and establish superiority in domestic market. Consequently; in such

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[79] UNCTAD, **World Investment Report 1999, Direct foreign Investment and the Challenge of Development,** New York, p. 172.
[80] Jan Hatzius, ‘’Direct foreign Investment and Factor Elasticities’’**European Economic Review,**Vol. 44. No:1, January 2000, pp. 117-143.
[81] Kotler Philip, Jatusrpitak SOmkid, Maesincee S.,**Ulusların Pazarlanması,** Trans. Bugdayıcı A., İs Bankası Kultur Yayınları, 2000. p. 183.
[82] Candemir A., **op.cit..,** s. 70.

direct foreign capital investments, rather than labour costs, the nature and quality of labour come into prominence.[83]

Investment Stimulus: There was an expectation that the central planning in the developing countries will weaken and the narrowing of scope of the stimulus policies shall take place with the speeding up in the transition to the market economy and thereby its relative power in the general economy policy will weaken. However, the fact that several countries switching to market economy in the later stages became a place of attraction from the perspective of investment and business environment and that they are using the stimulus more intensely in order to receive more shares from the Foreign Direct Investments changes these expectations. In the international arena, the fact that a capital movement is experienced in the factor of countries that catch up superiority from the perspective of investment costs forced the capital providing countries to take certain measures in this way. In this context, stimulus measures are applied for the purpose of either preventing the capital flight, or gaining competitive power in certain fields or protecting their superiority. The discounts, exemptions, exceptions to be made for the liabilities of the enterprise or providing conditional financing suitable for investment at the stage of deciding for an investment or entering business could be used as means for stimulus. The governments may encourage the foreign capital to make investments with the stimulus measures such as investment discount, immunity to the customs duty or installments, or cheap credits. Stimulus measures are not effective alone for attracting the foreign capital. A siGNPficant reason that decreases the affectivity of the stimulus measures is the application of stimulus measures for the foreign capital by the developing country even if it has different scales.[84]

The effects of the investment stimulus show variety among the project types of direct foreign capital investment. Judging from the foreign exchange incomes, the Foreign Direct Investments through exporting has a bigger share in the gaining of these incomes. Therefore the host countries and especially the developing countries present stimulus in a higher rate for the Foreign Direct Investments through exports.

[83] Zhang K. H. **op.cit..,** pp. 270-271

Additionally, it should be noted that with the foundation of the exporting regions that present any type of stimulus such as tariff discounts and tax exemptions, the Foreign Direct Investments through exporting is being encouraged to make investments. As a result, receiving permission for Foreign Direct Investments in a host country becomes easier for the sake of increasing the profitability.[85]

Infrastructure: The fact that the host country has a developed infrastructure that provides ease of communication, transportation and distribution is another determinant factor for the direct foreign capital investments. The fact that organized industrial regions and the transportation network take place in the country becomes effective while taking the investment decisions.

Apart from this, the fact that energy and communication expense rates in the country is high effects the Foreign Direct Investments positively. The Foreign Direct Investments oriented towards the local market gives more significance to the improvements of infrastructure and human capital.[86]

Free Trade Zones: In the global economic system, the countries wishing to gain more shares from the circulation of goods and capital develop new strategies. The application of free trade zones therefore takes place as a siGNPficant alternative among these strategies. The free trade zones, which undertake very siGNPficant logistic functions as effective commercial centers in the developed countries, comes to the fore as means for creating new opportunities to create additional employment fields and utilizing the investment possibilities and international commerce more effectively. The free trade zones, which are utilized as a siGNPficant instrument for economy and foreign trade strategies, show little changes in the legal framework from country to country and they can be defined as private places, where the customs duty operations are suspended and the investments are encouraged in varying rates. Among the applications of free trade zones in various countries, common features such as “being exempt from the customs frontier” and “providing special stimulus” take place and besides the economic and commercial policies of the countries, there can be several

[84] Duran. M., op.cit.., p.11
[85] Kwon Y.C., op.cit., p.214.

differences depending on the social and political conditions.[87]

Local Factors: Local Determinants, which are effective in the selection of the country that is expected to have investments, are the cultural and psychological factors, moral and ethic values, transparency level, geographical condition and the stable corporate structure.

Cultural and Psychological Factors: The product quality of the investor, which is to be presented in the host country's market, must have a compliance with the consumption patterns in the market being mentioned.

One of the problems faced in this subject is the fact that the high priced products created through means of foreign capital investments are not among the products that are expected to be purchased by the consumers, who have love income in the developing countries. However at this point, it is not possible to make certain generalizations.

Yet the consumer preferences in the developing countries could be oriented towards the high quality and expensive products rather than the low quality products.[88]

The goods and services presented to the local markets are obliged to meet the tastes and needs. The Foreign Direct Investments are negatively effect when they aim to sell consumer goods to these regions without obtaining information about the conventions and traditions of the host country, and their laws and language, and faces major risks.[89]

Psychological Factors: They effect the foreign capital investments considerably. These factors cause certain anxieties aroused from the past and the expectation of pessimistic results for the future. The negative campaigns of the ideological movements concerning the foreign capital make the foreign capital

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[86] Zang K.H., op.cit., p. 252.
[87] Candemir A., op.cit., p.74
[88] Lal D., op.cit., pp.35-36.
[89] Ozalp I., op.cit., p.68

discontented. Since these enterprises fear the reaction of the public in the countries, where they will make investments, they have either decreased their project or left the country. The public opinion about the foreign capital is very siGNPficant for the enterprises. [90]

All the anti-foreign capital ideas faced in these developing countries increases the risk rates in the new investments and prevents the involvers working with fear and anxiety from integrating with the country's economy.

Geographical Location: inter-enterprise and cross-border activities have certain costs, and therefore the geographical location of the investment region constitutes a major significance. However, the advancement in the transportation and telecommunication technologies limits the importance of the geographical location.[91]

Geographical closeness is a positive factor for making investment during the decision taking for a direct foreign capital investment. The geographical closeness is a siGNPficant condition for the Western Europe direct foreign capital investors. For instance, in the central and eastern Europe countries (Poland, Hungary, Czech Republic), the prevailing enterprises making investments are German, Italian, and Austrian. This is due to the fact that these three countries are close to them in the geographical sense. Taking into account the transportation costs once more for instance, the American enterprises in Mexico make more investments than the Japanese enterprises.[92]

Transparency Level and Corruption: The multinational enterprises expect utmost assurance from the places they consider for making investments whereas, the investment that is planned to be made abroad always bear uncertainty.[93]

The countries, where there is the least transparency in their administration and most prevailing confidentiality and corruption in the general

[90] Candemir A., op.cit., p.75
[91] Dunning J.H., "Reevaluating the Benefits of FDI". Transnational Corporations. Vol.3. No:1. 1994, pp. 29-34.
[92] Candemir A., **op.cit.,p**.75.
[93] Dunning J.H., **op.cit.,** p.29

governing, shall remain insufficient in the predetermination of the risks and advantages. Such an environment of risk and uncertainty becomes a preventing factor for the country to be regarded as a business and investment environment. Therefore the more the instability, the confidentiality and corruption in the government of the host country increases; the more the level of uncertainty increases. Such an uncertainty has a negative effect on the investments. The uncertainties taking place could only be solved with the market familiarity. The investors may prefer making investments in the countries where there is less risk due to the uncertainty. In that case, the uncertainty in the countries having similar characteristics from the perspective of market technologies and humane sources decrease and the investments are encouraged. [94]

Corporate Structure: One of the reliable foundations from the perspective of direct foreign capital investments' future is a sound corporate structure. The fact that there are very different decision focuses in the operation of the decision mechanism of Foreign Direct Investments and that they have lack of coordination causes bureaucratic slowness and creates a deterrent effect for direct foreign capital investments.

The laws and rules that the enterprise will be subject to after taking the decision for an investment and their continuity and compliance with the international operations are determinant factors so long as it exists in the host country. The countries, whose foreign fund flows are not based on a sound corporate foundation, which has a weak, non-diversified capital market or having none of such markets, and which has rather weak enterprises in the international markets are disadvantaged countries from the perspective of direct foreign capital investments. Making the laws that regulate the administrative and financial possibilities and corporate environment attractive for the foreign investors is one of the basic points of attracting the direct foreign capital investments.[95]

Additionally, since the weakness of corporate structure makes it harder for the monitoring of the enterprises that are operating; the possibilities of avoiding taxes and possibilities for monopolization despite the prohibition in the laws for

[94] Duran M., **op.cit.,** p.63.
[95] Zengin. A., op.cit., p.59.

cooperating with the local monopolies could increase. This becomes the cost of underdeveloped corporate structure in the country's economy. Changing the regulations often and making changes in the laws and decisions concerning the economy at unexpected instances becomes a factor of mistrust. Acceptance of the right of ownership and its protection is among the most siGNPficant determining factors of direct foreign capital investments. As a sound corporate structure is required for protecting the direct foreign capital investments, they may not always be sufficient. The fact that concluding the disputes aroused from the agreements made with the foreigners by an international commission of arbitrators rather than the international justice is more trust giving.

1.3.3. Foreign Direct Investments Oriented International Foundations

Encouraging the Foreign Direct Investments throughout the world and encouraging the Foreign Direct Investments in the developing countries especially is a concept, which is an accentuated subject for years and tried to be improved either by various international organizations or national organizations or commercial unions. The point of origin for such organizations that organize various programs for providing this relies on two assumptions.[96]

- The Foreign Direct Investments originating from the developed countries shall contribute in the economic development of the developing countries.

- Unless the providing of Foreign Direct Investments to the developing countries is supported, the flow would be very limited. The importance of such foundations increased especially in the years of debt crises, and such institutions began place more enthusiasm for this subject within their activities.

The primary international organizations and programs that gives place for the encouragement of the Foreign Direct Investments in the developing countries within their programs are as in the following:

[96] Devlet Planlama teskilatı. Dogrudan Yabancı Sermaye Yatırımları Ozel İhtisas Komisyonu Raporu,

-OECD (Organization for the Economic Cooperation and Development)

-UNCTAD (United Nations Conference on Trade and Development)

-UNIDO (United Nations Industrial Development Organization)

-IFC (International Finance Corporation)

-WTO (World Trade Organization)

-ITC (International Trade Center)

-World Bank

-TRIMS (Trade-Related Investment Measures)

-MIGA (Multilateral Investment Guarantee Agency)

-FIAS (Foreign Investment Advisory Service)

-KEI (Blacksea Economic Cooperation)

-EFTA (European Free Trade Association)

-WAIPA (World Association of Investment Promotion Agencies)

The OECD organization is among the significant organizations that encourages the direct foreign investments to the developing countries. The Committee on Investment and Multinational Enterprises (CIME), which undertook the task of improving the cooperation between the member countries concerning international investments within the body of the organization and the multinational companies was founded in 1975.[97]

The committee gives special importance for the encouragement of

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Ankara. 2000. p.13.

making investments in the developing countries and the concerning works are being carried out. Three of the work groups affiliated with the committee are closely interested with this mater. Advisory Working Group, International Investment Policies Working Group and Committee on Capital Movements and Invisible Transactions (CMIT) are the partner work groups. The committee is working especially for the coordination of member countries in the subject of the Foreign Direct Investments and the solution of problems. [98]

UNCTAD provides services in any subject concerning the Foreign Direct Investments and the cross-national companies within the body of United Nations Secretariat. The program concerning the cross-national companies was executed by United Nations Center for Cross-national Companies up to 1992 and United Nations Department of Economic and Social Advancement Office of Cross-national Companies up to 1993. The program was transferred to UNCTAD in 1993. UNCTAD is working in the field of preparing environments, which encourage the international investments by analyzing the structures of the cross-national companies. The working method involves organizing seminars and conferences and organizing the international negotiations and assisting in technical subjects.[99]

The TRIMS (Trade Related Investment Measures) Committee regulates the applications that shall provide the removal of certain measures taken by the countries, where the foreign investments are made, in connection with the investments (the obligation of using and exporting domestic inputs and limitation of imports, etc) due to the reason that they are considered to be preventative for the free commerce.[100]

The foundation purpose of IFC clearly shows the significance of the institution as it is encouraging the private investments to the developing countries. Besides the financing operations in the form of credit or capital participation, IFC encourages the Foreign Direct Investments along with the technical support such as pre-investment planning, improving the capital markets and investment advisory for the

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[97] Ibid., p.13
[98] Ibid., p.15
[99] Ibid., p.14
[100] Ibid., p.15

foreign investment.

The works of IFC, which is trying to encourage any type of direct foreign investments, is focused on the sector promotion programs, matching and combinations of project development.[101]

MIGA was founded as a subsidiary foundation of World Bank for the purpose of increasing the direct foreign investment flows oriented at the developing countries as well as coordinating them in 1998. The foundation of the agency is focused on alternative financing possibilities due to the fact that the direct foreign investments in the developing countries did not reach the desired levels because of political and commercial risks and the flow of traditional foreign financing resources to the developing countries is gradually becoming limited. The mission of MIGA is to encourage private investments for development and ensuring the direct foreign investments against non-commercial risks as well as encouraging the member countries by providing advisory services so that an appealing climate for investment in the developing countries shall be provided.[102]

[101] Ibid., p.16
[102] Ibid., p.15

PART II

2. THE ECONOMIC SITUATION IN AZERBAIJAN

2.1. General Information Regarding the Republic of Azerbaijan

The Caucasus region which includes Azerbaijan is an aisle between the East and the West, the North and the South. This region is an intersection point of energy and transportation passways established in Eurasia after the Soviet Union collapsed. This location has made the region strategically more important and significant in the sense of prosperity and stability in Eurasia.

The surface area of the Republic of Azerbaijan is 86.600 square kilometers. Its population is 8.99 million (January 2010). Azerbaijan has borders with Iranian Mountains in south, Armenia and Georgia in west, Russia in north and Turkey in southwest. Country topography is determined with Caucasus Mountains and Iranian Mountains, Caspian Sea Basin, Valleys of Araz and Kura rivers. Climatic properties of Azerbaijan have nine branches. These branches vary from cold mountain climate to tropical climate on the coastal region.

Azerbaijan has a very big diverse flora and fauna with over 4.500 plant species and over 20000 animal species. Azerbaijan has the largest surface area in North Caucasus. Moreover, Azerbaijan has a very enormous ecologic diversity. There wide areas below sea level, mountains higher than 4000 meters, deserts and rain forests. 9 out of the 11 belts can be found in Azerbaijan and it also harbors 15% of all the water sources in Caucasus. All of the water sources in the country fall into the Caspian Sea. The fish stock of the Caspian Sea is 6 times bigger than that of Black Sea.

Azerbaijan is an agricultural and industrial country that has very rich gorund and underground resources. It has oil, natural gas, mineral resources and such agricultural areas as cotton and etc. The existence of these resources makes agriculture,

mining and manufacture the main locomotives of the country's economy. Azerbaijan also has very rich iron, copper and rock salt reserves.

Together with the mineral water there are also very big hydroelectric resources. Oil and natural gas, oil products, oil drilling rigs, steel, iron, ore mineral, cement, chemical substances and petrochemical products and textiles are the main industrial products. Agricultural manufacturing is based on garden stuff, cotton, tobacco, tropical cultivation and the animal husbandry is mostly based on silkworm breeding, poultry husbandry, bovine and ovine breeding.

2.1.1. Azerbaijan as a part of the Soviet Union

While in Soviet Union, Azerbaijan's economic organization form and operating mechanism was based on the economic strategies of the Union. All of the industrial facilities were established according to the needs of the Soviet Union. There was a division of labor among the member countries towards the centralized planning. In this context oil industry was the main branch of industry in Azerbaijan. A considerable part of the exportation of refined oil products, machinery,textiles and wine was made to Russia and Ukraine and most of the importation of food products and crude oil products that were refined and exported back was made from these countries.[103] Before the Soviet Union collapsed Azerbaijan was considered as one of the two countries that were ready for an autonomy in the sense of economic power. Of course this evaluation was not only based on rich natural resources, but also on the economic progress perspectives of the country. That is because usually the budget income of Azerbaijan was greater than the expenses. The produced national income was higher than the consumed national income.[104]

Considering the economic data it can be said that Azerbaijan had achieved a certain progress in the Soviet Union. On the other hand, Azerbaijan had lost

[103] Azerbaijan, IMF Economic Review, Washington DC, May, 1992, p.32

[104] Azer Emiraslanov, "Dövlet Musteqilliyi ve Milli Iqtisadiyyatin Formala şması Problemleri", *MeşveretBülleteni,* No:7(43), Oktyabr 2001, pp.50-52.

more that it achieved during that period, because at that time the economic planning was centralized which resulted in taking no notice of the ecomonic conditions in the country. Most of the products or raw material or intermediate products were sold at a small price to other member countries and bought at a greater price as an end product. Moreover, despite the fact that Azerbaijan was the exporter of such income-generating products as oil and oil products, cotton, tobacco and wine, it never really was the owner of its own resources as the income was gathering in the bugdet of the Union.

In last 20 years before the autonomy came Azerbaijan did not make a considerable economic progress. For example, during 1960-70s Azerbaijan's average economic growth rate was 5.2% while in 1970-80s this number increased to 7.4%. During 1980-90s there was an intense decrease in economic growth rate. The economy of the country had decreased 4.9 % in 1981-85s and 5-6% in 1986-1990.

Especially concentrating sectors like the energy sector which is based on using natual resources and cheap labour force established an environment convenient for economic crysis. Considering tha facts mentioned above, it is obvious that collapsing of the Soviet Union was caused not only by political circumstances, but also by economic conditions. The control of a union which consisted of different republics made socio-economic development very difficult. Current situation of economy of the Soviet Union which was secluded from world economy was behind even that of developing countries.[105]

2.1.1.1. First Period After the Independence (1991-1994)

To be able to properly evaluate the process of economic progress after achieving the autonomy it is very important to take into account conditions under which the independence was gained and teh events that took place during first years of autonomy.

1989-1991 was the period of fighting for the independence. 1991-94 can be considered as the first stage after it was gained. Over 20 years passed since the

[105] Konsepsiyasmın Seç.mi", *MeşveretBülleteni,* No:7(43), Baki, Oktyabr-2001, pp. 6-8.

provision “About the Autonomy of the Republic of Azerbaijan” of the constitution was adopted in October 18th 1991. Considering the struggle to gain the independence it becomes clear how important the date October 18th 1991 is in the process of economic progress of Azerbaijan. After the collapse of the Soviet Union the economic settlement based on the division of labor in Azerbaijan came to an end and Azerbaijan lost its general markets. Organization based on old centralized planning regarding raw material, semi-manufactured products, equipmentn marketing, financing and business management resulted in halt of production or in unproductive manufacturing in many facilities. The economic unlinking from other republics of the SU, losing the marketshare in these republics and the subsidies from the SU resulted in shocking declines in production. The war with Armenia and the Chechnya conflict resulted in blocking the roads through which the intermediate products were imported.

The beginning of 1990s was a period of economic crysis in Azerbaijan. Political instability and transition to market economy resulted in a major economic crysis. Production volume and inflation was the main reason of the economic crysis and socio-economic tension in society. Azerbaijan was assaulted at arms by Armenia since 1988 and lost 20% of its lands until an armistice was signed in May 12th 1994.

During that period necessary reforms for economic progress, spending most of the government budget for war, 1 million people becoming migrants as a result of the loss of 20% lands, lack of foreign investment and impossibility of actual privatization in industrial sectors, not having a proper strategy for transition to market economy, inconsistence of economic decisions made in that period, war with Armenia, Russia applying an embargo on transportation to Azerbaijan and impossibility of using the two of the most important petroleum pipelines because of the war in Chechnya; these were the political and military problems that affected economic performance negatively. Shortly, 1991-1994 was a period when the country had to face all these political, socio-economic and military problems that led to a decline in economic progress.

The worst period regarding the economic progress was 1992. In 1992-94 the gross national income had decreased more than 2 times and was 48% that of 1991 [20].

During 1992-94 GNP decreased 13-20% each year and was 1629.3 million dollars in 1994. In comparison with 1990 GNP decreased 53%, industry 62%, agriculture 44%, consuming 75% and tax revenue 45% [106]. As a result, living standard of the population decreased 3.6 times and the real average wage decreased 80%. Improper economic policies followed during that period had caused serious problems in fiscal system and foreign trade.

2.1.1.2. Reforms Made During the First Period

The Private Ownership Law was enacted in June 1991. In the beginning of 1992 price liberalizaton was made and in January of the same year Value Added Taxes were applied. In April the Foreign Investment Law and in August Central Bank Law were put into action. Manat began being used in the market as a unit of currency.

The war that was still going no during 1993-94 had also caused a slowing in reforming process. In January 1993 the privatization of small scale enterprises became legal and in January 1994 Manat was put into use as a single legal nit of currency. After the armistice was signed with Armenia in May 1994 the economic reform progress started gaining speed and in June the Law of Bankruptcy was enacted and the process of consolidation of banks started being conducted[5].

2.1.2. Second Period After Gaining the Autonomy (1995-2000)

After the elections in summer of 1993 Haydar Aliev who had 30-year statesmanship experience was elected as the president which led to serious changes in Azerbaijan administration and juridical reforms. During this period reform programs to stop the decline in economic progress and models determining ways of strategic economic development were designed. Also important laws were enacted for establishing necessary juridical infrastructure for forming a free market, improvement of private sector, new economic structure, rearranging of customs, taxes and financial system, liberalization of trading, reforms in agriculture, increasing the social standards

[106] Asef Nadirov, "Iqtisadiyyatın Yeni inkişaf Merhelesi", *Azerbaycan Qezeti,* 15 Sent-yabr2001,p.2

and improvement of education and healthcare conditions.[107]

With establishing free market conditions and the steps followed in order to liberalize the prices, foreign trade and exchange rates the inflation level had decreased in a considerable rate and budget deficit had come to a minimum.

As a result of the precautions taken the privatization of small scale enterprises was completed, the privatization of the middle and big scale enterprises was started, macroeconomic stability achieved, economic crysis ended, land reform conducted and assigned to private ownerrship, agricultural sector was freed of all the taxes except of the land taxes for 5 years and all the tax debts were cancelled. [108] These corporations were provided with a discount on fuel and energy. 93.2 % of the agricultural properties that were planned to be privatized were assigned to private ownership. As a result, agricultural and husbandry products had shown a 7% increase.[109] As the national resources in Azerbaijan were insufficient for an economic progress the government tried to attract foreign investors to the country.

Considering the fact that it was impossible to achieve an economic progress with the national resources Azerbajani government decided to attract more foreign invesment to the country. Reforms conducted since the second half of 1993 helped to achieve a social, politic and economic stability in Azerbaijan. Important steps wee taken in order to rearrange banking and fiscal systems in the country. Steps taken regarding the free market economy strengthened the correlation of Azerbaijan with international finance facilities.

Durign this period an important oil contracts later referred to as “the contract of the century” was signed with major oil companies. After signing “the contract of the century” in 1994 and adopting the new constitution in November 12th

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[107] Ayhan Kraca "Azerbaycanda Ekonomik Dönü şüm Süreci ve Reformlar ın 10 y ılı", http://www.foreigntrade.gov.tr/ead/DTDERGI/ocakozel2002/ayhan.htm (13.03.2003).

[108] İmn Ceferzade "Esaslı İnkişaf İlleri" İgtisadiyyat Gazeti, 18Oktyabr, 1 Noyabr 2001, p3

[109] Ş. E. Yaqubov - A. M. Mahmudzade, "Azerbaycan Respublikasında Apanlan Aqrar İslahatların Çiymetlendirilmesi,*Azerbaycanda İaûsadi Islahatlann Heyata Keçirihne-si Hususiyetleri ve Problemler*, İqtisadi İnkişaf Nazirliği İqtisadi İslahatlar Merkezi, Baki, 2001, pp.60-63; Ceferzade, p.3.

1995 the juridical normative basis of the market economy was set which led to a big foreign investments.

The adoption of the first Constitution was the beginnig of the new age in social, political and economic structure of Azerbaijan. The new Constitution was not only defining the rights and responsibilities of the government and the society, but also accepted the need for establishing a liberal market economy based on democratic values. With this new Constitution the juridical bases of private enterprise, private ownership and the integration to world economy were determined. From this perspective, 1995 can be considered as the year of major economic reforms in Azerbaijan. Shortly, the armisticce on the front line and the stability within the country led to important economic reforms. With the help of a strong partnership with the IMF and by uncompromisingly applying the programs of IMF a proper monetary policy was conducted. This led to a decline in inflation and the increase in GNP was prevented. As a result, regress in Azerbaijani economy started to slow down since 1996. In last 5 years the GNP increased 26.3 %, level of living standards of the population increased 2 times, share of the private sector in economy increased from 29% to 68 %. Companies that signed contracts about common usage of oil fields made 3.4 billion dollar investment in Azerbaijan. As the economic progress policies conducted in 1996-1997 were not supported by the governmental policies and tax immunity provided before 19997 for attraction of foreign investors was later cancelled, there were no invesments made regarding production.

There was a 59 billion dollar foreign investment made in 1994-2000. 22.8% of it was financial loan, 56.3% was made to oil sector and 20.9% was made to other sectors.[110] Investments made to oil sector made Azerbaijani economy one of the most progressive economies among the countries of the former SU. The grpwth rate of GNP was 10% in 1998 and 7.2% in 1999. This economic progress came as a result of construction activities in oil sector, communication sector and a small part of it came from agricultural sector.

[110] İatisadi İnkişaf Stratejiyası ve Vergi Si-yaseti". İgtisadiyyat ve Audit Jurnali, No: 10, October-2001, p.12. » Senan Eyyubov,

FDI played a key role in economic progress n Azerbaijan. Most of the FDI was made to oil drilling and production fields. During 1995-98 the investments in creased 59.1 %. Constant investments had a 40.6% share in GDP in 1998 which is 2 times more than it was in 1995. The contribution of foreign investments to agricultural sector which is the major employement source in Azerbaijan and second most important sector in general was less than 0.5%. Foreign investors avoid investments to manufacturing industry which has led to a decline in production in this sector.

In 2000 economic partnerships with 122 countries were established and total volume of these trade relations was more than 2.9 billion dollars. This is 2.2 times more than it was in 1993.[111] An important point that should be considered in evaluating the process of economic progress in Azerbaijan is that this progress was achieved under conditions where 20% of the lands of the country were occupied by Armenia (which means that a very big part of the production potential was lost), 300 000 people were unemployed and approximately 12% of the population were forced to migrate as a result of Armenian invasion. The total surface area of 27 provinces and counties occupied by Armenia is 22700 km ^{2}. Nahcivan's frontier regions were also affected as well as Nagorno Karabagh's. 17100 km^2 area of Azerbaijan (20%) is still occupied by Armenia. Goldenmines present in that area is used by Armenia and the income from these goldenmines constitute 51% of the governmental budget of Armenia.[112]

The occupied territories are in ecologic danger. Nuclear wastes are being stocked in the region. Moreover, the occupied areas contain 25-26% of the forests of the country which leads to other dangers regarding the flora and the fauna of the region. Calculations show that 8-10% of the forests are damaged in occupied regions. Economic loss in damaged areas is 22 billilon dollars.[113]

500 m^3 of 520-530 m^3 of the polluted water coming to the Caspian sea

[111] "Bazar İgtisadiyatına Keçid ve Senaye Kompleksi»*Melere, Bülleteni*, No:7(43), October-2001, pp.66-67.

[112] Tebriz Vefalı, "Qarabağın İqtisadıyyatımıda İzi", *HerbiAnd Qezeti*, 1-15 April 2003, p.3.

[113] 'Azerbaijan Economic Damages and Heavy Tolls Caused By Armenian Aggression', vww.economy.gov.az/HTML/aggression.html(09.04.2005).

by the rivers come from Armenia and Georgia. The war with Armenia affected Azerbaijani economy not only directly, but also through the inetrnational relations that were formed in the light of this war.

2.1.2.1.Reforms Conducted During the Second Period

In January 1995 a law regarding unfair competition was enacted and in April 1995 the first IMF program was adopted. In 1995 financial stability policies began to be applied with the support of IMF and other international organizations which led to an economic progress. In September 1995 a law concerning the privatization of small scale facilities was enacted. In 1996 small scale facilities began to be privatized. In June 1996 the law of Central Bank was amended and securities market was activated in September. The Land Reform Law was enacted in August. In February 1997 a law concerning saving the competition in public realms and a parliamentary bill concerning an amend in Law of Bankruptcy in June were enacted. Also in June the Law of Customs was enacted and a new simplified customs tariff began to be applied. The Law of Telecom was enacted in Jule. In 1998 the Law of Electricity was enacted in order to rearrange the energy sector. In August the Pawn Law and in September the Blue Sky Law was enacted. In February 1999 the Labour Law was enacted. The verdict proposing establishing an Oil Fund for gathering all the oil income in one single account and for more transparent spending rules was announced in January 1999. Also a new Privatization Law and a new Tax Law were enacted in May and June, respectively.

There were three major goals during this progress period:

1. To provide the use of natural resources of the country.

2. To establish an economic structure based on liberal-democratic market priciples.

3. To achieve a global and regional ecconomic intagration to the world economy.

2.1.3. The Third Period After Achieving the Autonomy (since 2001)

The period after 2001 can be considered as the third period after achieving the

autonomy. In this period the main goals were :

1. To continue the economic progress and strengthening the economic policies,

2. Adopting the Second Governmental Privatization Program and reforming and increasing the volume of energy sector,

3. Improving the social perspectives of economic policies considering achieveddevelompment level, increasing the level of social prosperity and aiming the resources acquired by the progress of the energy sector.

It is aimed to increase the prosperity level with the new activity program which came as a result of discussion taken place between the Azerbaijani government and international organizations. The main goal is to improve the sectors other than the oil sector with the help of the economic policies that are going to be applied. Oil refinery, chemistry, petrochemical industry and electrical energy fields make oil even more important in economy. With attaching necessary importance to it, there can be established a worldwide market of oil products in Azerbaijan. Major investments have been made to this sttrategically important sector inlast few years. All the necessary workings for modernization and reconstruction of industrial fields are being conducted. The electric sector is increasing the efficiency of use of the oil and gas products. Most of the foreign investments are made to this sector. The main goal of the economic progress strategy in the closest perspective will be to achieve a bigger progress of the economic system of the country based on the progressive tendency of the world production system and modern market relations. This strategy aims to provide an active use of economic resources of the ccountry, making use of Caspian oil and natural gas resources in order to achieve an economic progress, to increase the transportational potential of the country and the yield and to increase the yield concerning human resources in the country.

2.1.3.1. Reforms Conducted During the Third Period

In May 2001 Haydar Aliyev signed the “Governmental Program For

Economic Progress and Poverty Reduction" which aimed to provide an economic progress, beginning new businesses, increasing the income level of the population and raising the living standards in the country. This program was planned to be performed during 2003-2005. IMF board of management approved the program in July 2nd 2001. There was a necessity for a poverty reduction program in Azerbaijan. Nearly 40-50% of the Azerbaijan population was living in poverty. In 2002 Haydar Aliyev had a meeting with foreign businessman which led to signing enactments supporting enterpreneurship in August and September. By these enactments some of the tax, customs, licence and facility inspection problems of businessmen were solved. These reforms strengthened the belief that the new age in economy for businessmen began. This attracted foreign businessman. After having discussions with the businessmen tax rates were decreased and a program concerning the improvement of big and small scale managership wasa acccepted. Economic progress strategies that started to be applied in 1994 were continued in 2004. This led to an increase in per capita income to 5.1 million manats. Average monthly income was increased 26.2% which was 483.4 thousand manats. This meant a 19.6 % increase in per capita income. By the end of 2004 total foreign investment involved in national economy was 22 billion dollars and the share of private sector in national economy was 74%. In 11th of February 2004 president Ilham Aliyev signed a "Governmental Program" concerning socio-economic progress of Azerbaijan's regions during 2004-2014. This was an important step to providing an efficient use of economic potential and natural resources of Azerbaijan's regions, to improve agricultural and other non-oil sectors, to increase the income and linig standard level of the population.

The Governmental Program aimed to increase the per capita income to 5,878 dollars and the share of the private sector in national economy to 85% until 2011.

Importants steps have been taken to improve non-oil sectors, reduce poverty and especially to achieve an economic progress in regions in Azerbaijan. There is an important progress in regions concerning oil sector

2.2. General Economic Situation

After achieving a political stability and declaring cease fire with Armenia the economy became the main concern of the government. As a result "The Contract of the Century" on "Common Usage and Share of Oil Fields Azeri, Cirag, Gunesli located in the Azerbaijani Part of the Caspian Sea" was signed in 1994 between Azerbaijan State Oil Company and major oil companies of the world.

After these steps were taken the real value of the gross domestic product increased in 1996, for the first time since 1988 (1.3%). During 1996-2003 the GDP increased 67.6% (annual average 8.5%) and during 2003-2009 the GDP increased 470.4% (annual average 59.8%). In 2009 GDP increased 21.9 % and was 34.578,7 million manats (43.223,4 million dollars) campare to 2007. Share of industrial sector in GDP was 50%, share of agricultural sector was 6.4 % and share of other sectors was 43.6%. Per capita income increased 4.093,6 dollars and became 4.858.7 dollars. Share of private sector in GDP increased to 73.3% (share in industrial sector was 53.4% and 99.7% in agriculture). Also in this period average monthly income of an employee increased 27.2% to 274,4 dollars and annual inflation rate was 10.6%. Inflation stood out especially in food stuff in 2009. There was a 3.3% increase in foodstuff prices and 1.0% increase in other products. The national income of the governmental budget was 10.325,9 billion manats (12.907,4 million dollars) and the outgo was 10.567,9 million manats (13.209,8 million dollars). In 2009 8.407,1 million manat (10.509,4 million dollar) credit in national economy. 28.1% were temporary credits and 71.9% were long term credits. 17.8% of it were delinquent credits. 43.6 % of the credits belonged to the government, 45.6 % belonged to private sector and 10.8% belonged to non-bank credit organizations. 10.282,7 million manats (12.8 billion dollars) was invested into economic and social progress in 2009. 42.7% of it were foreign investments. By the end of 2009 the amount of foreign loans is 3.421 million dollars. This is 22.2% of GDP. In 2009 savings of the population in banks was 2.334.900 thousand dollars which is 22.6% more than in 2008. 965.600 thousand dollars were deposited in manats and 1.369.300 thousand dollars were deposited in terms of foreign currencies. All of the oil sector is controlled by SOCAR which is a public corporation. In 2009 21 oil contracts were

signed between 33 oil companies from 15 countries and running all of these projects will cost approximately 63 billion dollars.

2.2.1. Gross National Product

After achieving the autonomy no modern tax policies were applied, there were restrictions in foreign trade, national income was low and there was a war with Armenia. All of these factor resulted in a decline in national income [114]. The process of switching from socialist economic structure to the liberal structure during 1991-95 resulted in a 60% decline. Despite the regress in GNP during 1991-1995, reforms and privatization programs conducted as a result of partnership with IMF and World Bank am economic progress was achieved since 1996.

During the process of changing the economic structure Azerbaijan's economy was the fastest progressing among the membres of the former SU. The main role in the progress was played by foreign investments and the hydrocarbon sector which is the main source of exportation income.

Table II.1. Change in GNP

Years	Change in GNP	Industry	Agriculture
1991	-7.8	-8.9	0.3
1992	-22.6	-30.4	-23.8
1993	-23.1	-19.7	-15.5
1994	-19.7	-24.7	-12.8
1995	-11.8	-21,4	-7.0
1996	1.3	-6.7	3.0

[114] Saleh Memmedov; "Inflasya ve Malliye Bazarı", Baku , (**1998)** p:48

1997	5.8	0.3	-6.1
1998	10	2.2	6.2
1999	7.4	3.6	7.1
2000	11.1	6.9	12.1
2001	9.9	5.1	11.1
2002	10.6	3.6	6.4
2003	11.2	6.1	5.6
2004	10.2	5.7	4.6
2005	9.8	6.9	12.1
2006	26.4	17.6	13.2
2007	34.5	23.5	15.1
2008	23.4	16.7	11.8
2009	10.8	8.9	6.7

Source: The State Statistical Committee of the Republic of Azerbaijan(SSCRA) Publication

In 1995 the GNP was %-11.8 and started increasing after 1996. Although Azerbaijan was affected by the Russian crysis in 1998, there was a 10% increase in the economy as a result of the worldwide increase of oil prices and foreign investments made according to the oil contracts, high performance in construction sector in the last quarter of the year and the progress in foreign trade.

Despite the regress in Azerbaijan economy in the beginning of 1999 there was an increase in oil and natural gas investments. Other sectors showed minimum progress.

In 2000 the 11.1% progress in GNP was the maximum since 1990[115]. During 2003-2009 the highest economic progress among CIS countries was in Azerbaijan.

There were some changes in the structure of the factors affecting the real increase in GNP. In 2001-2009 there was also a 20% increase. During 2005-2008 there was an increase in production in all fields of the economy. This increase was mainly observed in construction and manufacturing industry.

The Per Capita Income was increasing year by year since 1995 and in 2009 there was a 39.6% increase compared to previous years which was 5.603,3 USD[116]. The increase in per capita income led to an increase in purchasing power and this resulted in progress of the real sector.

According to the evaluation of the World Bank in 1996 the poverty rate in the country was 61%. According to the domestic sources the rate of population under the poverty limit was approximately 60%. According to the data of 2000 average monthly income per capita could only afford 45% of the minimum consuming budget. The poverty rate in Azerbaijan decreased to 39% in 2007, to 26.7% in 2008 and to 24.7% in 2009. The governmental program concerning the poverty reduction was based on strengthening the macroeconomic stability, providing more opportunities for generating an income, increasing the enterprises and services in educational and healthcare fields, improving the infrastructure, increasing the social security of low paid citizens and improving the life standarts of the immigrants.

This program was aiming to achieve these goals in four ways: economic progress and stability, social policy and human improvement, regional policy and structural progress and improving the existing potential.

Azerbaijan government will put into practice a new program for 2010-2015 after the Poverty Reduction and Economic Progress Governmental Program for 2003-

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[115] "Azerbaycan Respublikasının Sosyal Iqtisadi Veziyeti",*Milli Bank illik Hesabat 2000,* Azerbaycan Respublikası Milli Bankı, Baku **2001,** p.6.

[116] E.S. Imanov, E.M.Baasaov, R.H.Dayyev; "Iqtisadi Islahatlar Seraitinde Ehalinin sosial Mudafiesinin Teskili Meseleleri", Azerbaycanda Iqtisadi Islahatların Heyata Kecirilmesi Hususiyyetleri ve Problemleri,*Iqtisadi Inkisaf Nazirligi Islahatlar Merkezi*,Baku **(2009),** p.102.

2009. In 2003 when the first program was approved the poverty rate was 44.7%. In 2009 it decreased to 24.7%. It is predicted that after 2010 this rate will be decreasing year by year. The new program called “Long Term Constant Human Improvement Strategy” is supposed to result in a decrease in poverty rate up to 20-25%.

In 2004 an enactment concerning an increase in minimum wage was signed. According to the enactment the minimum wage that was 60 thousand(150 USD) manats was increased to 200 manats(250 USD) in July 2009. The goal was to improve the socio-economic conditions for the citizens, to reduce the poverty and increase the living standards of the low paid citizens. During 2001-2009 the minimum wage was increased up to 18%. In 2010 the minimum wage is supposed to increase 25%.

The income provided by private ownership and private enterprises plays an important role in monetary income of the population. The opportunities provided for the progress of private owneship and enterprise led to an increase in income generated from these fields. Wages are the second important factor in monetary income. According to the official data the average monthly wage in 14 dollars in 1995 and 50 dollars in 2000. In 2009 the average monthly wage was 296,9 manats (372,1 dollars). This amount is 10.7% more than it was in 2008. Although Azerbaijan is ahead of the Armenia and Georgia in terms of the average monthly wage, it is still far behind such energy carriers as Russia and Kazakhstan.

The industry, transportation, construction and finance sector employees and merchants have a relatively higher income than other sector employees.

From 1995 to 2009 the average monthly wages has increased 16 times. In 2009 the average monthly wage was 10.7% higher than it was in 2008. It is predicted that in 2010 it will be 328 manats, in 2011 356,2 manats and in 2012 420 manats.

On the other hand, economic reforms made in Azerbaijan according to advices of IMF were monetaristic and balanced budget policies were folowed by decreasing public expenditures and all of this had negative effects on the population that still had a very low welfare level. Also subsidies applied to gas, fuel and bread were cancelled, discounts on electrical energy, water, public transportation were cancelled for

those who were not immigrants, disabled or coming from martyr families and this also caused problems for the population during the process of switching to a new economic structure.

The per capita income in Baku is two times higher than in other regions. As a result of the reforms the sectoral distribution of the GNP and the importance the private sector in economy had been subjects to various changes.

On the other hand, improvement of the income distribution is a prerequisite for a progress, because no economic progress can be achieved by a capitalistic idea that "makes the rich even richer and the poor even poorer" and with ignoring fairness in distribution of wealth while accumulating the wealth.

First of all, information exchange is easier nowadays and this could make public protests against wealth accumulation easier and affect the general stability in the country. Secondly, economic progress needs an increase in domestic demand. For this reason, improving the income distribution will widen the domestic market and encourage the industry by increasing the total demand.

The income from the oil sector after 2010, foreign investments, applying socio-economic progress program in 2004-2014 will help to produce high real national income.

2.2.2. The Privatization

Azerbaijani government decided to switch to free market economy after achieving the autonomy and started acting in this direction. Firstly, "The Privatization Law" was enacted in 1993, but it started being applied only in 1995.

Privatization activities that are very important in switching to free market economy and are very important factors in reformign the national economy and where also western wealth can participate were started with the enactment of a law that was approved by the Azerbaijani Parliament in January 7th 1993. Unlike the preceding

period Azerbaijani economy now consisted of state ownership, private ownership and municipal ownership.[117]

2.2.2.1. First Privatization Program

With enactment of the "Law of Privatization of the State Ownership" that consisted of 27 articles, a juridical basis for switching to free market economy formed and in 1993 first draft workings were done on this matter, but the program was not approved by the parliament. After long discussions and revisions in 1993 and 1994 " The State Privatization Program" was approved by the national assembly in 1995 and started being applied. With the advices of IMF and the World Bank privatization became one of the main goals for the Azerbaijani government. Systematic privatization and liberalization of the market were the main factors in speeding up the process of switching from planned economy to the free market economy.

Two thirds of the state ownership in production field was subject to privatization in the first stage. Within the privatization program such small scaled facilities as restaurants, cafes, barbershops, markets were subject to obligatory privatization. Oil, natural gas and telecommunication facilities, artistic buildings and mines were not subject to privatization, but by the decision of the President or the Prime Minister they could be privatized. Privatization was conducted by the State Real Estate Committee established in 1992. In 2000 the Real Estate Committee was annulled and Ministry of Real Estate responsible of the privatization was established. During 1993-1993 only houses and taxis were privatized.

In accordance with the enactment signed by the President in February 8th 1997 8 million State Privatization Share cheques each consisting of 4 bills were printed and 7.183.803 of them were distributed among the Azerbaijan citizens without charging. Country citizens could participate in privatization with these cheques and foreign citizens could participate with privatization cheques called "options". The first privatization program for 1995-1998 was completed only in 2000. Most of the small and middle scale facilities included in this program were privatized by the end of the

[117] Azerbaycan Respublikasının Konstitutyası, *Azerbaycan Publication*, Baku, **(1996)**

program. In 1996 6200 small scale facilities and in 1997 15,000 small scale facilities were privatized.

2.2.2.2. Second Privatization Program

Due to the delay in completing the first program the second one could only be signed by the President in 10.08.2000.

Second privatization program aimed to privatize middle and large scale corporations. As a result the governments role in the economy was decreasing. In 2001 President Aliyev announced that 100 large public economic enterprises operating in manufacturing, energy and chemistry sectors will be privatized.[118]

Approximately 450 large facilities involved in various fields are included in the privatization program. These facilities are divided into three groups: small, middle and large scale corporations. 15% of the small scale corporations are handed to the employees without charging and 85% are sold in auctions. Middle and large scale corporations are first incorporated and then privatized. These corporations are privatized as follows: 50% of their shares are privatized by cheque auctions, 15% are given to the corporation employees in exchange for cheques, 10% are sold in auctions and the rremaining 25% are given to closed-end mutual funds by the government.[119]

In the second privatization program the process of privitizing of communication, transportation, chemistry, energy and other sector corporations continued.

Since the beginning of the privatization program to the beginning of 2005 40.7 small scale corporations with the total value of 651.1 billion manats were privatized. Also by the beginning of 2005 1537 state companies (356 middle and large scale companies) were incorporated.

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[118] Ayhan Kraca; "Azerbaycanda Ekonomik Dönüşüm Süreci ve Reformların 10 yılı", http://www.foreigntrade.gov.tr/ead/DTDERGI/ocakozel2002/ayhan.htm **(13.03.2003)**

[119] "Process of Privatization",www.msp.gov.az/html/eng/xod.html **(18.04.2005).**

As a result over 150 thousand Azerbaijan citizens became private property owners.[120] After the privatization program was completed %56.9 (4.913.639 hectares) of the Azerbaijan lands belong to the government, %23.5 (2.032.744 hectares) belong to municipalities and %19.6 (1.695.123 hectares) are private properties.

2.2.2.3.Privatization Of The Middle And Large Scale Corporations

One of the goals set in the "Governmental Program on the Socio-Economic Progress in Azerbaijan Republic Regions" approved February 11th 2004 by the President of Azerbaijan Republic is to speed up the privatization process of state facilities and equipments.

By the reforms almost all of the small scale corporations were privitized. Considerable privatization activities were conducted in agricultural sector too. Total asset value of the privitized small scale corporations is approximately 6.5% of the GNP. Sadly, no similar success could be achieved in the privatization process of the large scael corporations. Since the beginning of the privatization process 1.065 middle and large scale corporations were incorporated and privitized by auctions.

The rate of foreign investments involved in the privatization process increases day by day. Despite the success achieved in privatization, it is still progressing very slowly.

Sadly, privatization reforms since 1995 did not give expected results in agricultural sector. Reforms done made the economic situation in some fields ever worse. Another problem was that the employees of tha provitized corporation became unemployed after privatization. On the other hand, privatization conducted through cheques did not give the expected results. No strong class of joint stock companies could be formed in the country and the citizens were not active in participating in the privatization process. Joint stock companies faced various problems because the governmental inspection was not sufficient and there was no juridical base for necessary

[120] N.O.Haciyev; "Sahibkarlıq Sektorunun Inkisafının Suretlendirilmesi ile Bagl problemler", Azerbaycanda Iqtisadi Islahatların Heyata Kecirilmesi Hususiyyetleri ve Problemleri, *Iqtisadi Inkisaf Nazirligi Islahatlar Merkezi*, Baku **(2001),** p.117.

social inspection. As a result, people started selling their shares. The number of joint stock companies is around 50 thousand now while it was around 100 thousand. This kind of privatization also had negative effects on the soruces in governmental budget.

2.2.2.4.Private Sector

The private sector produces 73% of the GNP and it is very important in solving social and economic problems. The taxes collected from the private sector is the main source of the budget income. The share of the private sector in the budget was 10% in 1995, 26.5% in 1997 and 50% in 2009. 70% of the current employees are in private sector and only 30% are in state sector. 81% of the companies in the country are middle scale companies and most of them are operating in trading or agricultural sector.

An important progress was achieved in the privatization progress in Azerbaijan. By the beginning of 2000 during the first stage of privatization 21.544 middle scale companies were privitized and 996 companies were opened to stock market. In March 2001 these numbers were 23. 539 and 1. 230 respectively. In 2002 number of privitized companies was 33. 700.

In order to solve the problems concerning the progress of private sector “The governmental program for supporting small and middle scale enterprises in Azerbaijan Republic (2002-2005)” was approved.

The enactment “On extra measures to be taken on governmental support for the progress of the private sector in Azerbaijan Republic” signed September 10th 2002 was aiming to provide necessary macroeconomic conditions for the progress of enterprises. On September 28th 2002 an enactment “On Prohibiting the Interventions Preventing the Progress of Enterprises” was signed by the President.

According to this enactment various governmetn bodies were restricted to inspect companies. By another enactment the number of products subject to licencing was decreased from 250 to 30. Moreover, an Enterpreneurs’ Council was established and its structural chart is ready. The Enterpreneurs’ Council is a tie between the government and the businessmen.

2.2.2.5.The Comparison of State and Private Sectors

The private sector became the most important part of the economy as a result of the privatization of state ownership and people's private enterprises. Some sectors, especially agricultural sector is a part of the private sector.

Economic data show that as a result of the reforms made, private sector's importance in the economy increases year by year. The private sector produced 46% of the GNP in 1997, 55% in 1998, 62% in 1999, 68% in 2000 and 74% in 2009. This means that government's importance in the economy decreases day by day.

The observations show that private sector plays an important role in forming the governmental budget due to the tax income. Of course, the first factor for private sector becoming such an important element of the economy is the privatization of state ownership.

By the end of 2009 57% of industrial priducts, 99% of agricultural products, 57.8% of transportational services and 71.3% of communication services is provided by the private sector. On the other hand, government's monopoly in basic and strategic sectors continues. One way to get rid of the government's monopoly is to privitize large scale facilities. It is obvious that this process is very slow in Azerbaijan.

Although the data show that private sector is very important in the economy of the country, this is mostly caused by governmental facilities' and especially industrial facilities' passiveness. It is actually wrong to consider some facilities as a part of the private sector. For example, most of the joint stock companies operate as governmental facilities. Considering the fact that the private sector is involved in the energy sector only formally and only foreign enterpreneurs operate in the private sector of oil and gas production, it can be said that the private sector does not actually exist in such an important sector as the energy sector.

2.2.3. Inflation

The fact that before 1994 no considerable indicator was in money supply and monetary emission was performed in order to reduce the budget deficit led to a

hiperinflation as a result of currency depreciation. The inflation was also caused by the unavailability of the northern railway due to war between Russia and Chechnya which led to a decline in importation. Another factor were some of the applications of financial organizations related to the foreign trade. [121] Manat's losing value before U.S. dollar despite the interventions made by the Central Bank and foreign products being admired more by the population also were the factors in inflation. Shortly, economic problems left from the former SU and war economy increased the inflation rates up to 4-digit numbers. The inflation was increasing during 1992-94 and reached its maximum %1763.5 in 1994.

After signing the armistice in May 1994 and measures taken the inflation rates started decreasing since 1995, but were still high as 511.8%.

After applying the progress programs designed together with the IMF the inflation rates started decreasing after 1996 to a non-dangerous level. The progress programs apllied by the government after the armistice with Armenia put end to the high inflation rates. As a result, the inflation rate in 1997 cpuld be expressed by 1-digit number. IN 1998 and 1999 serious decline in prices was observed. In 1999 there was an average 8.5% decline in prices. In 1998-99 there was a deflation in the country as a result of the moetary policies pursued and since 2000 the prices again started increasing. In 2009 the inflation rate was 10.6%.

In Azerbaijan which is in state of structural changing inflation is also structural. It is not easy to provide a aupply demand equilibrum during the dynamic process of progressing. The main reasons for the inflation rate being expressed by 2-digit numbers in 2009 are the lack of modernization in agricultural sector, unsufficiency of amount and variety in industrial production and marketing problems between producers and consumers.

The main point to be focused on for a stability in general wage level is: there are contradictions in wage stability goals and high increase in production goals. In the short term increase in wages with no changes in other conditions will increase the rate

[121] Nesimi Kamalov , "1990-2000 yılları arasında Azerbaycan'da Enflasyon"

of profit of the producers and encourage them to produce more, so there will be a high increase rate and an increase in employement. In this sense, with a control provided, 10-15% inflation in Azerbaijan can be considered as acceptable.

2.2.4. Employement

As a result of the economic changes and recessions most of the employable citizens are left unemployed. As a result of Armenia's occupation of the 20% lands of Azerbaijan and forcing over 1 million people to migrate also increased the unemployment rate.

The international mobility of the labor potential was a problem in Azerbaijan. There is a high rate of labor mobility in Azerbaijan. This situation will seriously affect the future demographic situation in the country. On the other hand, qualified labor force in the country is not appreciated which results in people leaving the country. Most of the unemployed citizens go to neighbour countries like Russia, Turkey or Iran. Most of the citizens leaving the country are the young ones. This kind of a "brain drain" increased in the last 5-6 years [21]. Azerbaijani government made social reforms since 2005 in order to make the citizens come back.

60% of the citizens that migrated from the occupied territories are considered economically active, but still most of them are unemployed and are trying to live with the state support.

The government tries to make reforms in order to solve the unemployment problems. New places of employment are established, convenient market system is being established (bread market, change of occupation courses and etc.) and social security of the unemployed citizens is provided. The progress in the private sector in last few years also creates suitable conditions for this.

The observations show that there is a very little increase in the level of employment of the total population: the rate of the employed population was53.4 % in 1998, 56.7% in 1999, 56.8% in 2000, 56.9 % in 2001 and 57% in 2004.

Table II.2. Sectoral distribution of the Employment

Years	Industry	Agriculture and husbandry	Other
1990	12.7	30.9	56
1995	9.8	30.8	59
1996	7.7	31.8	60
1997	6.6	29.0	64
1998	6.8	30.7	62
1999	7.0	42.3	50
2000	6.8	41.0	52
2001	6.5	39.9	53
2002	6.7	41.1	45
2003	6.7	40.0	43
2004	6.5	41.0	47
2005	4.8	392	56
2006	4.9	38.9	51
2007	4.9	38.6	47
2008	4.8	38.2	44
2009	4.8	38.4	45

Source: The Stat Statistical Committee of the Republic of Azerbaijan(SSCRA) Publication

The sectoral distribution of the employement also changes with time. The labor force employed in industrial and constructional sectors decreases and the labor force employed in the services sector increases day by day. The rate of employment in agriculture was nearly constant before 1998, but it started increasing since. From 1995 to 2009 the employment rate mostly increased in transportation, communication, agriculture, tourism and construction sectors. The sectoral distribution of the labor force is shown in the chart above.

The highest income of the employees is observed in oil and gas production fields and the lowest income have the healthcare system employees.

The rate of the employees in governmental sector (state facilities and administration bodies) constantly decreases since 1990. As a result of switching to the free market economy the rate of employment in the governmental sector decreased from 70.7% to 28.2% from 1990 to 2009.

In 2009 number of the economically active citizens was 4,331 million. According to the official data 4 million 71 thousand of the were employed. 46.7% of the population is economically active. At the beginning of 2010 41,100 economically active citizens were registered as unemployed. Most of the unemployed citizens are middle-aged. According to the official data 12,063 citizens aged 25-35 and 29,037 citizens aged over 35 are willing to work, but can not find a job.

In 1995 59.7% of the unemployed were women while in 2009 the number was decreased to 44%.

If the official data can be considered to reflect the real unemployment rates, the unemployment rates are lower even thhan that of developed countries. Actually the unemployment rate in the country are much higher than it is shown in the official data. Moreover, even according to the official data the unemployment rate increases year by year. Although the official data state that the unemployment rate in the country is 0.9%

the information given by the international organizations and various calculations show that this number is around 10-16%.

There are different reasons of the high unemployment rates. The active laobor force is unemployed because of the socio-economic conditions, switching from one socio-economic structure to another and the country still remaining under the war condition. Also wrong or insufficient economic policies led to the closign of many facilities and left many citizens unemployed. On the other hand, technological progress results in middle-aged people becoming unemployed. In fact, these problems are typical for the countries under market economy conditions. Unemployment is one of the most important and topical problems in Azerbaijan that needs to be solved. At the beginning of 2009 44% of the population was under the poverty limit. The evaluations of the World Bank show that the average daily income of these people is 16.20 dollars. The fact that the unemployment problem in Azerbaijan is rather structural than caused by the insufficiency of exportation and investments claims that this problem can be solved by long term and continuous policies.

The fact of 600 thousand working places being opened in the regions shows that it is a very important problem to solve for the government.

2.2.5. The Governmental Budget

Azerbaijan had expenditures for defence as a result of the Karabag war and this led to problems with keeping the income-expense balance since 1993 and this resulted in a budget deficit.[122] The reforms made in the tax system, increase in the governmental budget's income caused the high budget deficit in the beginning of 1990-91 start to decline since 1995.

The budget deficit in 1994 was equal to 9.4% of the GNP, in 1999 to 2.4%, in 2000 to 1% and in 2001 and 2002 less than 1%. The reason of the budget deficit is the fear of inflation. [123] Another reason for the budget deficit are the impasses in the tax

[122] Ercan Sancak, "Azerbaycan Iqtisadiyyatı" , *Qafqaz Univesiteti Publication,*Bata**, (1999),** p.32.
[123] F.Y. Bayramov- S.E. Necefov; " Dovlet Butcesinin Kesiri ve Inflasyası", Azerbaycanda Iqtisadi Islahatların Heyata Kecirilmesi Hususiyyetleri ve Problemleri,*Iqtisadi Inkisaf Nazirligi IslahatlarMerkezi*, Baku **(2001),** p.118.

system. The bidget expenditures increase yerar by year as well as the bidget income. The observations show that public expenditures have an important role in GNP.

Azerbaijan is one of the top countries with poverty level and unrecorded economy among the CIS countries.[124] This have negative effects on budget income. The share of social defense and security expenditures in budget expenses increases year by year.

Table II.3 Budget Income and Expenses (Million Manat)

Years	**Revenue**	**Expenditure**
2000	714,6	764,0
2001	924.0	1037.5
2002	1551.2	1658.6
2003	2104.5	2172.7
2004	2405.8	2.505,0
2005	2.055,2	2.140,7
2006	3.868,8	3.790,1
2007	6.006,6	6.086,2
2008	10.762,7	10.774,2
2009	10.325,9	10.567,9

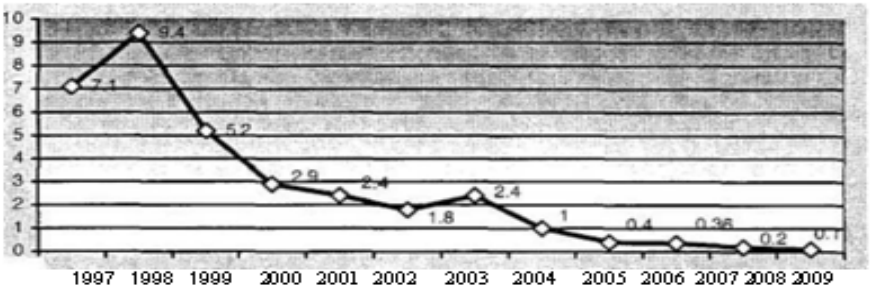
[124] Javid Ahmadli, " Development Perspectives of Azerbaijan Agriculture", *Expert Iqtisad Journal*, No:7-8, **(2001),** pp.8-9, Stansilav Zhukov, " The Macroeconomic Situation in Azerbaijan: At the End of the First Post- Soviet Decade", Expert Iqtisad Journal, No:7-8, **(2001),** pp.6-7

Source: The Stat Statistical Committee of the Republic of Azerbaijan(SSCRA) Publication

The share of the income from oil sector in the budget income is as follows: The oil share in the governmental budget that came through Azerbaijan State Oil Company (SOCAR) was 36.5% in 2002 and 41% in 2008. Considerin the transfers made from State Oil Fund (ARDNF) the share of the oil sector in the governmental budget is 52.1%. In 2009 this rate was 44% (38.6% SOCAR share and 5.4% ARDNF transfers).

Oil became a very imporant factor in budget income in the last few years. The share of the oil and gas sector in the governmental budget is supposed to change after 2010. Compared to the 2009 data in 2010 the non-oil budget deficit is planned to be 2.4% of the GNP which corresponds with the governmental targets of the middle term strategy for increasing the oil income expenditures and 2010 macroeconomic goals. In 2010 the expenditures are mostly related to the social activities like wages, education and defense. In this context the average wages were increased 22%. This increase is an indicator of an effort to reduce the poverty. The defence expenditures increased 30%.

Figure II.1. Budget Deficit (GNP percentage)



Source: The Stat Statistical Committee of the Republic of Azerbaijan(SSCRA) Publication

2.2.6. Foreign Trade

The oil production will increase as the exportation of oil products increases. This may lead to a problem of dependence on this sector. As a solution the oil income

could be used in other sectors. The structure of the importation is completely different from the structure of the exportation. Since 1996 the domestic demand had increased due to the economic progress and this led to an increase in importation rate. In 2009 the share of the private sector was 72.93% in importation and 49.15% in exportation.

Due to the increase in production of the products that substitute imported products there is a decline in the importation of general consumption products and agricultural products.

The government tries to import machinery and equipment in order to increase the production volume and the technological level of the production. As a result of the lack of production due to structural problems such as the deadlock in privatization of the industrial facilities, importation being concentrated on raw materials with a low added value and intermediate products and the increase of the monetary value of manat with respect to US dollar in 1997-2000 the importation became a very admirable option.

Azerbaijan is in a state of monetary dualism like other developing countries which makes it necessary for the country to have and increase a foreing money reserve to import stuff and services.

Although the country still has not completed the structural change and industrialization process and the exportation in fields other than oil sector is very poor it balances the payments using the income from oil sector. This situation is not good for the national economy. It can even be interpreted as an economic disease.

In order to get rid of this disease and considering the fact that in 15-20 years the oil exportatin will decrease it is important to perform a fast industrialization, to substitue the importation with production and increase the exportation by applying long term economic progress programs.

2.2.6.1.The Primary Countries in Foreign Trade

In 2009 Azerbaijan established trade relations with 123 countries in the world. 67% of the importation is made from Russia,Turkey, Germany, Ukraine, China, USA, Japan, France, Belarus, Italy. 87.70% of the exportation was made to Italy, USA,

France, Israel, Russia, Taiwan, Indonezia, Canada, Malasia, Spain, India, Ukraine, Uk, Croatia, Greece and Georgia.

Table: II.4. Azerbaijan's main trading partners in 2009(in mln USD)

Countries	**Foreign Trade**	**%**
Italy	3.916	18,8
USA	2.011	9,7
Russia	1.815	8,7
France	1.468	7,1
Israel	1.317	6,3
Turkey	1.013	4,9
Ukraine	695	3,3
Taiwan (the province of China)	690	3,3
Indonezia	664	3,2
Germany	638	3,1
China	614	3
Canada	596	2,9
United Kingdom	471	2,3
Georgia	454	2,2
Other	4.456	21,4
Total	**20.818**	**100**

Source: The Stat Statistical Committee of the Republic of Azerbaijan(SSCRA) Publication

In 2009 the rates of the foreign trade with other countries is as follows: 18.8% with Italy, 9.7% with USA, 9% with Canada, 8.7% with Russia, 7.1% with France, 6.3% with Israel, 4.9% with Turkey, 3% with Germany, 3.3% with Taiwan, 3.3% with Ukraine, 3.2% with Indonezia, 3% with China, and 2.2% with Georgia.

Italy is the main oil exportation country for Azerbaijan due to the Trieste terminal where the oil loadings are performed. As a result of the devaluation after the economic crysis in Russia in 1998 russian products lost their value with respect to Azerbaijani currency which led to a price advantage for Russia in Azerbaijan market and a increase in demand for russian products. After this point Russia became one of the most important countries in Azerbaijan foreign trade.

Evaluating the foreign trade data shows that the foreign trade underwent a structural change and trading is done more with the Western markets rather than former SU countries.

Low quality of the products imported from Iran makes it less admirable in foreign trade of Azerbaijan.

In Azerbaijan's foreign trade changes also happen in the country portfolios. The data show that Azerbaijan tends to cooperate with developed or developing countries.

2.2.6.2. Foreign Trade Relations With The Cis Countries

After declaring the independence Azerbaijan started foreign trade realtions with the countries other than former SU members, but during the first years of the independence Azerbaijan was still dependent on the former economic region.

Azerbaijan's dependence on Russia made it difficult to establish an independent economy and to form a national economy.[125]

CIS's share in the total trade of the country was 27.7% in 1998 and 22.6% in 1999 and 17.3% in 2009.

Azerbaijan's foreign trade relations with the CIS countries that had a 80-85% share in 1991-93 started weakening as a result of the changeover in foreign trade relations after 1994.

In 2009 the foreign trade volume with the CIS countries was 2,961.9 million dollars. 1,888.7 million dollars of it was a share of importation and 1,727.4 million dollars was a share of the exportation. This means that in 2009 Azerbaijan had a 690 million dollar deficit in foreign trade relations.[126]

The share of the CIS countries in Azerbaijan's importation was 80% in 1991, 31.4% in 1999, 32% in 2000 and 29.8% in 2009.

The share of the CIS countries in Azerbaijan's exportation was 94% in 1991, 22.7% in 1999, 13.5% in 2000 and 11% in 2002. In 2009 the exportation volume to the CIS countries decreased 2 times and the share of the CIS countries in total exportation of the country decreased to 7.7%.

Evaluating the foreign trade with CIS countries and Russia shows that the increase rate in importation is smaller than that of exportation. The importation rate from other CIS countries like Ukraine has decreased even more.

As mentioned before, Azerbaijan became less dependent on CIS countries in terms of foreign trade and was more interested in EU countries.

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[125] Ekber Eldaro ğlu, "Dünya Ticaret Te şkilatı ve Azerbaycan", *Azerbaycan Milli Demokratiya Fondu "Azerbaycan"Bülleteni, No:22 (142),* **31 May 2001**

[126] A.V.Veliyev "Azerbaycanın istihlak bazarının formalaşmasında MDB Ülkeleri ile igtisadi elagelerin Rolü Azerbaycanda" , National Bank of Azerbaijan, **March, 2010**

2.2.7. Foreign Debts

The foreign debt stock and the share of the foreign debts in GNP increases year by year. The current deficits that appeared in the beginning of the transformation proecess and increased more and more year by year were financed by direct investments and financial foreign investments. For example, use of foreign funds in financing the public deficits can be detected by the increase of the shares of foreign debts in GNP.

The fact that in 1999 foreign debts increased despite the decrease in foreign invesments shows that current deficit was financed by the foreing debts.

Similarly, increase rate of the exportation income is smaller than the increase rate of the foreign debts which leads to an increase in debt/exportation ratio. The debt/exportation ratio increased from 7.3% to 77.1% during 1993-1999. This ratio was 66% in 2000, 54% in 2001 and 63% in 2009. In this case a decrease in exportation rate will cause a vicious cycle in which the debts will be payed by debts.

2.2.7.1.Loans Borrowed For Economic Reforms

Total 455.8 million dollars were borrowed for economic reforms. 208,9 million dollars of it was borrowed from IMF and 246,9 million dollars from The World Bank. The total loan given for the investments in 1132.2 million dollars. 531.3 million dollar of it was spent to energy sector, 92,9 million dollars to agriculture, 57,6 million dollars to chemical industry, 139,2 million dollars to transportation sector, 52,8 million dollars to recinstruction of the territories that were freed after occupation and 120,3 million dollars to social fields. There are some doubts on the loans being spent to the fields they were borrowed for.

Azerbaijan and Turkey had come to terms on the polemical debt of Azerbaijan to Turkey. There are still problems about the subject of Azerbaijan having debts to Turkmenistan.

Azerbaijan only owes 16 million dollars to Georgia. 3% of the governmental budget is dedicated to paying the foreign debts. This rate is very low compared to other CIS countries. By the end of 2009 Azerbaijan’s foreign debts were

equal to 18.6% of GNP correspond to foreign currency reserves of the country which expresses the country's financial security considering Oil Fund resources.

According to the international standards the foreign debt rates are considered critical if they exceed 40% of the GNP or 200-250% of the annual exportation. On the other hand, most of Azerbaijan's debts have due dates over 10 years.

Azerbaijan also gets foreign aid from different countries. Main countries that provide humanitarian foreign aid are USA, Japan, Germany, Switzerland, Turkey, Italy and Finland.

The economic partnership between Azerbaijan and Japan is at a very high level. Japan especially helped Azerbaijan regarding immigrants from the territories occupied by Armenia. Japan has provided an 11 million 470 thousand US dollar financial aid to the immigrants thorugh International Organizations since 1993.

After declaring the independence Azerbaijan started an economic and technical partnership with Germany. Germany is the third country after USA and Japan that provided aid for Azerbaijan. The partnership between Azerbaijan and Germany is not only in economic, but also concerns ecological and medical fields [27].

2.2.8. Environment and Ecology

Azerbaijan has a surface area of 86.600 km^2 50% of which is agricultural and 2.5% is urban areas. Azerbaijan also has a very rich flora. There are over 1400 plant species known.

12% of Azerbaijan's surface is covered by forests. 950000 hectares of the country surface is considered to be covered by forests. There is a 127 million m^3 wood reserve in the country. The government forbid woodchopping for industrial and other reasons. Forest areas are tried to be wodened by preserving, maintenance and planting works. Most of the forests in the country consist of non-evergreen and pine trees.

The vegetation cover of the southern region is in serious danger. The problems caused by the lack of natural gas in the regions is also topical for the forest security officials.

Illegal woodchopping occurs mainly in two ways: some uje the trees for wormup, others use it for commercial reasons. The maing regions that are being damaged are Lerik, Guba, Zagatala, Balaken and Hanlar.

In 2009 new plants were planted on 100.700 hectares of lands for reconstruction purposes. This was mainly done in Kobustan, Gilezi and Karadag regions. Moreover, workings have been done in 500 hectares were for the replanting purposes. The Ministry of Ecology and Natural Resources announced that the lack of the natural fuel is a very serious danger for the forests. This means that if the natural gas will not be provided soon, problems with destroying the forests will add up to the problems of unemployement, diseases, child deaths, lack of infrastructures for foreign investments and legal and illegal immigration in regions.

Oil and natural gas are the most important natural resources. Azerbaijan also has rich mineral resources of iron, aluminium, zinc, copper, arsenic, molybdenum, marble and fire clay.

Azerbaijan is Transcaucasia's most polluted region. As a result of the industrial activities during last 10-15 years the ecological situation in Azerbaijan became even worse. There are lots of various ecological problems in Azerbaijan. Air, water and soil are polluted.

The surface water is polluted despite the sufficient amount of water reserves. Drinking water reservs get polluted more and more as the time passes. The rate of heavy metals in drinking water is 10-15 times higher than normal. Despite the serious water insufficiency problem in the country 29% of the water is lost while carrying.

Although there is a decline in industrial production, air pollution is still very high. Cars are the most important cause of the air pollutioin in the country. 41% of the total volume of harmful substances that are released to the atmosphere come from the

cars. Most of the cars are low-standard russian cars. Most of the cars that are imported from other countries are old.

Also the toxic wastes that were left from previous years are also affecting the ecologic condition in the country. In 2003 3 million tons of poisonous wastes were produced in Sumgayit facilities. This number is 130000 tons in Baku and 18000 tons in other regions. These poisonous sunstances that are considered very dangerous for the organisms are produced during production processes. Soil fertility decreased due to poor watering conditions. The ecologic problems that exist in the Caspian Sea are also very important. The sea water has been polluted even more during last years. The Caspian Sea is mostly polluted by the rivers that fall into it. 70-75% of the pollution is caused by the Volga river. Another reason for the pollution of teh Caspian Sea is that newly built building are not connected to the central sewage system. The wastes that come from oil production and other industrial facilities are also polluting the sea.

The eustacy of the Caspian Sea is another ecological problem. The fertileness of the Caspian Sea which is an important region for the fishing industry is in danger. As a result of an eustacy in the Caspian Sea in 1977-1995 over 50 thousand hectares of lands submerged. If the eustacy continues over 250 thousand hectares of lands will submerge until 2015.

Compared to other countries that share the same sea borders Azerbaijan is influenced the most by the pollution of the Caspian Sea, because 70-75% of the industrial potential of the country is spotted on the seaside [28].

Soil pollution problem started appearing since 70s. There are serious pollution problems in Absheron lands. Over 30 thousand hectares of the Absheron lands are polluted. The polluted areas can be cleaned and used for agricultural purposes, making public gardens and other profitable purposes. The main workings on this issue were planned to be done in an the end of 2005-beginning of 2006.

2.2.9. Population

At the beginning of 2010 the population of Azerbaijan was 8.997.400. 152 thousand of them were born in 2009. In 2009 the birthrate in the country was 17.2% and deathrate was 5.9%. 98 persons in one square kilometers.[127]

In 2009 the population increase rate was the highest in last 9 years. 49% of the population are male and 51% are female.

40% of the well educated and qualified population live in Baku. 54.1% of the population live in urban areas and 45.9% live in rural areas. Average life is 72.4 years. This rate is 75.2 for women and 69.2 for women.[128]

In 1992 the Nagorno-Karabagh war started between Azerbaijan and Armenia. With the domestic political debates effecting the stability in the country 20% of the lands of Azerbaijan including Nagorno-Karabagh were occupied by Armenia in 1993. Approximately one million citizens (12% of the population) had to immigrate from the occupied territories.

After declaring the independence the Azeris who lived in the former SU were coming bach to Azerbaijan while most of the Russians and Armenians left the country. The largest minorities in the country nowadays are Russians and Daghestanis. 3.2% of the population are Daghestanis and 2.5% are russians. The predictions state that 2% of the population are Armenians. 2.3% of the population consists of such etthnic groups as Lezgis and Talishs. Azerbaijan population is Muslim while minorities like Russians are Russian Orthodox Christians and Armenians are Armenian Orthodox Christians.

2.3. SECTORAL ANALYSIS

2.3.1. Industry

Before declaring independence the main sector of Azerbaijan economy was industry. In 1988 42.1% of the national economy was provided from industry. [129] In the

[127] The Stat Statistical Committee of the Republic of Azerbaijan(SSCRA) Publication, **March, 2010**

same year 1005 facilities were active in industrial sector: 529 of them were involved in heavy industry, 206 in light industry and 263 were food production facilities related to agricultural industry complex.

First year of independece can be considered as the years of concordance of industrial facilities to free market economy. In 1995 there was a 70% decrease in physical volume of the industrial products in comparison to the year 1990. Considering other sectors over 3800 facilities that were active in 1990 stopped their activities in 1995. Some of them partially continued operating. On the other hand there was a decline in industrial products in all sectors during 1990-95. Even the fact that the total number of industrial facilities increased from 1005 to 2984 including the newly established private facilities, production volume still continued declining.

The main reason for the decline in industrial prodcuction during the first years of independence was the weakening of state control in industry, lack of compatible progress program and facilities not being inspected. It also should be noticed that these negative economic processes were not only the results of events happening in Azerbaijan, but also the results of the political and economic processes in former socialist block.

2.3.1.1. Oil Sector

The industrial sector mostly consists of chemistry, petrochemistry, machinery and manufacturing sector, because the whole Azerbaijani economy is based on the oil sector.

20% of the industrial potential of Azerbaijan consists of oil processing machinery production sector and related machinery production sectors. Production of oil processing machines is the oldest and the most important industrial branch in Azerbaijan. During the SU period Azerbaijan was providing 70% of the products in this sector. The fact that the technology for producing was very old and lack of raw material

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[128] *Investors' Handbook,* International Conference Investing in Azerbaijan- Gateway to the Newly Insdependent States, Baku, **May 7-9 2010**, p. 16.
[129] E. Ehmedov - M. Haqyev, *Azerbaycan Iqtisadiyyati,* Seda Yayınları, Bakı, **2004,** p.31

and replacement parts resulted in factories producing insufficient amounts of products for satisfying the demands of the country or stopping operating.

All of the industrial facilities were related to other countries during the SU period and this caused serious problems after declaring the independence. On the other hand, production became useless, because the equipments were of a low quality.

The government considered the industrial sectors related to oil as strategic industrial branches and included in the privatization program. Also in 1995 a new program was prepared aiming to find foreign investors for common production.

The industrial production started declining in 1990, but after 1995 when in Azerbaijan and other former SU countries political and economic stability started forming, the industry also started progressing. In 1994 the rate was 20.8% and in 1995 it was 29.6%. The share of industrial products in GNP was 22.9% in 1998 and 28.2% in 1999. The industrial products that had a 36% share in GNP in 2000 included oil, natural gas, oil products, technical equipment for oil production, steel, iron ore, cement, chemicals, petrochemicals and textiles. In 2000 the production had considerably increased compared to 1999. 1996-2000 were the years of economic progressing and the increase in GNP during these years was mostly formed by an increase in oil productioin industry and related construction activities.

In 2001 the share of industrial products in GNP was 37.6% and in 2002 it had decreased and was 34.9%. In 2008 15.378.200 tons of oil, 5.127,8 millions m3 of natural gas was produced. This rate increased in 2009 and was 50.1% .

Shortly, since 1996 the macroeconomic stability was achieved and new industrial facilities were established. Although the number of facilities increased, labor force employes considerably decreased in comparison wtih 1995.

Approximately 7% of the population is employed in industrial sector. Considering the process of change after 1996 there was a political stability, but it was not sufficient for solving the problems of employement in industrial sector. 90% of the newly established industrial facilities are small and middle scale private facilities.

Existing large scale industrial facilities had old technology and low yieldance. This is the reason why oil and most of the mines in Azerbaijan are sold as raw material or intermediate products. 1/5 of the Azerbaijani industry consists of oil processing equipment production sector and related machinery-construction sector. Other major industrial branches are energy manufacturing industry, electronic or metal workings, machine and ship construction and textile industries. There are many already established facilities in manufacturing industry, but as in most of the other sectors, dependence on the foreign countries (former SU countries) forces the facilities to be idle.

2.3.1.2. Manufacturing Industry

After declaring the independence the manufacturing industry was regressing in terms of production volume until 1999.

Other manufacturing sectors like iron and steel production, paper and forestry production, construction material production and textile manufacturing sectors also regressed until 1999. Since 2000 there was a considerable progress in manufacturing industry.

2.3.1.3. Food Industry

The main branch of the food industry is winemaking. Textile, carpets, leather products and domestic furniture are the main production branches. In 2003 the production volume in food industry increased to 5.2%. In last few years new meat producing, milk producing, confectionery producing facilities were established.

2.3.1.4. Energy

Although Azerbaijan is one of the richest countries in the world in terms of energy it still has problems with energy supply and can not meet the demands regarding this problem because of lack of increase in production. In 2008 18.991 billion kw/hr of electrical energy was produced. In 2009 this number increased to 21.040 billion kw/hr. Regions other than Baku have a problem with electrical energy and natural gas supply and this negatively affects on the possibility of investments in these regions.

2.3.2. Agriculture

2.3.2.1. Climate and Soil Structure

Azerbaijan is a very convenient country for agriculture in terms of climate and soil structure. It is possible to get products 2 or 3 times in one season. There are problems with breeding, seeds, sapling, seedling, manure and medicaments, lack of machinery and equipment and credits that make it impossible to reach the market. Still there is a very good potential of agricultural production in case of solving these problems.

49% of the Azerbaijan population live in villages. There are 4243 villages in the country. 18% of 86.600 km2 lands of Azerbaijan is tilth.

Agriculture and husbandry are the second most important sectors to help socio-economic progress in Azerbaijan. Rich agricultural areas and regions with different climates make it possible to grow a diverse types of products of high quality. 9 out of 11 existing climate zones from subtropical to tundra climates exist in Azerbaijan. This diversity of climate zones makes it possible to produce different products.

The main agricultural products in Azerbaijan are wheat, cotton, tobacco, tea, olive, vegetables and fruits. The cereal production potential of the country can afford to meet the domestic demands.

2.3.2.2. Lands

After Azerbaijan was occupied by the Soviet Union in 1920 all of the private ownerships were cancelled and the agricultural areas were now controlled by kolhoz (general facilities) and sovhoz (state facilities) that were based on governmental ownership. During this period central administration decided which products to produce, where to produce and where to send the products.

Table: II.5. Agriculture Areas

Areas	Soil reserves (thousand hectares)	%
Arable areas	4.588	53.1
Irrigable areas	3.200	37
Cereal field	1.622	38.8
Forests	1.037	12
Eroded areas	3.610	41.8
Total Area	8.641	100

Source: The Stat Statistical Committee of the Republic of Azerbaijan(SSCRA) Publication

Lenkeran region where mostly cabbage, tomato and pepper is produced is located on the southern border of the country near Iran and years ago it was called “The Garden of the Whole Union”. Also Guba, Hachmaz and Masalli regions were the most important regions of vegetable production. Azerbaijan was sending total 500.000-600.000 tons of vegetables to the Union Fund.

Cotton industry was also very important in Azerbaijan. Over 1 million tons of cotton was produced annually in 70s and 80s, but due to the problems during the transitional period and due to the decrease in cotton prices in world market the production of cotton had declined.

Cereal production in 70s and 80s increased at a very high rate and became around 1 million tons annually. Also the amount of product gained form unit area had increased 3 times during 1913-1970. The Soviet government decided to concentrate on winemaking industry rather than on cereal production.

Another product that had a decline in production is rice. Rice was produced traditionally in Azerbaijan and in some southern regions and in mountain foot of

Gagavuz mountains located in north. During the Soviet period the production of rice was stopped in Azerbaijan, because too much rice was produces in other member countries.

In 1970s the government started to improve the winemaking industry in Azerbaijan. Around 70.000-80.000 hectares of lands were destinated for the production of wine grapes. The goal was to start producing over 3 million tons of grapes after 1990.

During the Soviet period three branches of agriculture were developed: cotton, wine grape and vegetable production. Very little of these products were left in Azerbaijan. For example, produced cotton was sent to Russia.

After the collapse of the SU the privatization of lands has been almost completely conducted. According to the data provided by the Ministry of Agriculture over 1 million citizens became private land owners and the number of farms reached 40.000.

2.3.2.3. Grapes

Once grape production was one of the main agricultural fields in Azerbaijan. Until 1990 there were around 275 thousand hectares of vineyards in the country. Approximately 2 million tons of grapes were produced in the country annually. During the presidency of Gorbachov there was an alcoholism reduction program which led to a damaging of 150 thousand hectares of vineyards.

After the collapse of SU Azerbaijan started concentrating mostly on cereal production. During this process vineyards were destroyed to increase the cereal production. During the SU period Azerbaijan was an agricultural country but after losing 20% of its lands in 1993 it lost most of the arable areas which led to a decrease in agricultural production. No desired income was achieved from winemaking and sold grapes and it led to a loss of interest to grapery. As a result only 7700 hectares of vineyards were left in the country. After Armenia occupied the agricultural areas of Azerbaijan the vegetable production decreased two times. 117 of the winemaking factories stopped operating. Most of the lands occupied by armenians are arable areas.

For example, 100.000 tons of grapes were produced in Fuzuli region. Zengilan region had three grape processing factories and 3000 hectares of vineyards. Agdam was famous for its cotton and Gubadli for its husbandry. While immigrating due to the occupation, over 145.000 bovine animals were left there. Winemaking and grapery still have a high production potential provided that the necessary investments will be made. In last few years new vineyards started being established in Celilabad, Tovuz, Shemkir, Agstafa, Kazak, Shamahi and Samuh regions. The development of the grapery is a part of the state regional progress program.

2.3.2.4. Hazelnuts

Another potentially profitable agricultural field is hazelnut production. It is being produced in Zagatala, Baku, Guba and Hachmaz. 65% of the shelled hazelnuts are exported to EU.

2.3.2.5. Sugar Beet

Sugar beet is another product that is supposed to be produced again in Azerbaijan. Before the Soviet period Azerbaijan was producing a considerable amount of sugar beet.

After Ukraine started producing this product and supplying it for the whole SU its production in Azerbaijan had stopped.

Aftre declaring the independence it had started being produced in Nahcivan, Beylagan, Sabirabad, Imishli and Salyan regions. Unfortunately, there is no factory in the country to process the sugar beet. As a result the produced sugar beet is being sent to Erdebil city of Iran from Bilesuvar that is located near the Iran border to be processed. Iran processes the sugar beet and sends it back to Azerbaijan. This process is not profitable for Azerbaijan, so some programs for developing this field are being applied.

The sugar demand in Azerbaijan is 360.000 tons, so there is a need for sugar beet production and sugar processing factories. Azersun Holding is building a factory in Imishli region for sugar processing. As a parto of the socio-economic progress program

sugar factories are planned to be built in Nahchivan, Sheki, Masalli and Bilesuvar regions.

In Guba and Saatli regions small packs of jam and marmelade are being produced. Another factory in Lenkeran is producing tomato paste. These three new factories export their products to Japan, Russia, Belgiun and Switzerland.

2.3.2.6. Tea

First tea production in Azerbaijan started in 1930s in Lenkeran-Astara region. By the end of 1960s and in the beginning of 1970s tea production reached its maximum[130]. Azerbaijan was producing around 34.000 tons of tea in 1970s, but as the time passed this amount decreased to 1.900 tons. This situation is a result of lack of available tea processing factories in the country. Tea processing factories also need to be privatized. Tea processing factories located in Baku were bought by Turkish companies and the farmers started producing tea. Tea produced in these factories is mixed with the Indian and Turkish tea and sold [131].

Socio-economic progress governmental program regarding the regions includes a development program for tea production in southern regions including Lenkeran and Astara. Tea production area that have not been used and were damaged are being restored to start tea production again. Over 1000 hectares of tea fields will be restored in Lenkeran. According to the state program it is prodicted that tea production in Lenkeran will result in 19 billion manat income in 2007. Enough investments have been made in Lenkeran and Astara to start tea production. The activities of “Azersun Holgind” for the improvement of tea sector in southern regions is considerable.

2.3.2.7. Cotton

The production rate of cotton in Azerbaijan has decreased due to the lack of fertilizers formerly imported from Russia and Uzbekistan, lack of reaping machines and increase in the replacement part prices for these machines. The cotton production

[130] E. Ahmedov - M. Hacıyev ,op.cit. p.86

[131] Azerbaycan-Türkiye Tohum Üretim ve Ara ştırma İşletmesi Projesi ile İlgili Görüntüler", http://www.tika.gov.tr/tur/projeler/tarim/main.htm. (12.12.2009).

potential of the country is 830 thousand tons annually. 70% of the cotton products are exported as a raw material. Although large amounts of cotton is produced in the country, there are a few cotton processing factories. 35% of the cotton is gained by handpicking and the control over parasytes is not sufficient. These problems also exist in tea and tobacco production sector.

2.3.2.8. Tobacco

Tobacco production is mostly developed in Sheki-Zagatala region. During the SU period tobacco production volume was 62 thousand metric tons annually, but after declaring the independence this amount considerably decreased [132]. Azerbaijan can not export tobacco to foreign countries. In order to export tobacco 20-25 tons of tobacco must be produced in the country. Azerbaijan produces total 4 thousand tons of tobacco annually. Cigarette producers in the country import the raw material from foreign countries. The reason why the quality of the produced tobacco is low is that some regions are new in the tobacco production.

2.3.2.9. Potatos

In 2009 cultivation areas increased in Azerbaijan and the rate of increase in production was over 21% compared to the previous year. Azerbaijan also exports potatos to Russia and other neighbour countries.

2.3.2.10. Olive

Olive production and treatement processes are not on the desired level in Azerbaijan. Provided that the needed procedures will be applied in order to solve the existing problems, domestic olive oil need can be met. Of course the damaging of the olive groves should be prevented.

Some regions like Kobustan, Shirvan, Mughan and Absheron are suitable for olive production. If the necessary measures will be taken, Azerbaijan have a great potential in olive production in 10-15 years.

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[132] E. Ahmedov - M. Hacıyev, op.cit. p87

The main problem of the producers in the country is the insufficiency of cash flow. The Ministry of Agriculture is aiming to establish credit unions in every region. Regional Progress Program (2004-2014) is the main step taken to actual provision of credit to farmers.

The contribution of the agricultural sector that 40% of population is employed in to GNP runs lower day by day. On the other hand the average monthly income of the population is 441 thousand manats (90 dollars). For the employees of production industry this number is 667 thousand manats, for construction sector employees 453 thousand manats and for agriculture sector employees 67 thousand manats.

This amount is only 30% of the average monthly income in the country. While in developed countries an agricultural sector employee can maintain 50-60 persons, Azerbaijani agricultural sector employee can barely afford to maintain his own family.

Table: II.6 Agricultural Products (in thsnd tons)

Years	Sugar Beat	Potatos	Vegetables	Fruits
1996	40.1	214.6	570.0	321.2
1997	33.7	223.4	495.4	330.9
1998	41.4	312.5	502.3	390.6
1999	42.2	394.1	670.8	436.5
2000	46.7	469.0	780.8	477.0
2001	41.3	605.8	916.4	497.5
2002	115.8	94.9	974.6	516.8
2003	84.6	69.0	1046.3	572.1

2004	156.8	30.0	1076.2	420.4
2005	127.5	68.5	670.8	436.5
2006	145.4	154.2	880.8	577.2
2007	41.3	605.8	916.4	645.2
2008	115.8	94.9	974.6	478.2
2009	84.6	69.0	1045.4	572.1
2010	148.4	134.2	1078	420.4

Source: The Stat Statistical Committee of the Republic of Azerbaijan(SSCRA) Publication

2.3.3. Husbandry

All of the animals (99.8% bovine, small cattle 98%) that belonged to the government until 1996 were distributed among the population. Rest of the animals are used by the government for breeding.

After declaring the autonomy bovine animal husbandry became a very profitable business. Husbandry has developed enough to meet the demands of the country. Until 1998 seriouos decline in husbandry sector occured.

The production of meet and milk products has increased compared to the previous years. Almost all of the production is done by the private farmers. As a result of the privatization program applied since 1998 bovine husbandry has developed.

Also the quality of the milk products increases. Azerbaijani companies produce more than 15 different types of milk products (yoghurt, yellow cheese, white cheese, milk and etc.)

As mentioned above, country has all the needed natural resources for providing the food products for the population. Although the climate and natural environment is

sufficient, there no needed machiery-equipment or they too old, no quality seeds, fertilizers and medicaments (for example, only 4-5 % of the fertilizer need can be met) to use the potential[133].

The solution for the problem is to supply the necessary financial opportunities for the agriculturist, help them with the production, manufacturing and selling. Of course the world practice also should be used for the solution of the problems in agriculture and husbandry.

2.3.4. Services

Share of the services sector in the GDP was 42.4% in 1998, 38.0% in 1999, 35.1% in 2000, 22.8% in 2008, and approximately 28.3% in 2009. Important subsectors of the services sector are described below.

2.3.4.1. Health

Azerbaijan had the legacy of a developed health system according to the conditions of those times, described as the success of the Soviet Union. However, due to not allocating the necessary funds for the budget on one side and decreasing of the income level on the other, health services are not satisfactory nowadays. Health institutions acting in Azerbaijan do not meet the up-to-date requirements and many buildings and equipment are old and useless. Health expenses receive 1% share from the public income. This shows that the share allocated for health expenses is insufficient.

In Azerbaijan, the amount of physicians per 10 thousand people is 37.5, amount of medical officers is 72.6, the amount of hospital beds is 82. When these numbers are calculated for Baku only, they will be higher than regular average. In Baku the amout of physicians per 10 thousand people is 85, the amount of health officers is 110, the amount of hospital beds is 115. This situtation demonstrates that health services

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Azerbaycanın İqtisadi İcmali, Rüblük Bülleten, TASIS Avropa Ekspertiza Xidmeti, Bakı, Iyul-Dekabr 1999, s.41; Sinan Oğan, "Bağımsızlığının Onuncu Yılında Azerbaycan Ekonomisi ve Türkiye Ile Ekonomik ilişkileri", www.ceterisparibus.net/arsiv/s_ogan.pdf. (12.03.2003).

in Baku are even more insufficient. The lacking of health services causes the increase of some diseases year by year. Registered diseases starts with the upper respiratory diseases, respiratory infections, digestive system infections, nervous system diseases sistemi, otorhinolaringology system diseases[134]

Table :II.7. Health Data

Years	Hospitals	Polyclinics	Physicians	Health Officers
1995	768	1,779	29,217	67,000
1997	759	1,694	28,873	63,200
1998	746	1,630	28,477	60,700
1999	739	1,611	28,485	60,600
2000	735	1,614	29,033	60,000
2001	735	1,618	29,084	59,900
2002	738	1,603	29,090	59,100
2003	734	1,591	29,700	59,500
2004	740	1,652	31,300	59,890
2005	741	1,618	30,078	60,098
2006	745	1,617	30,199	60,102

[134] "Azerbaycan Respublikası insan inkişafı haggında hesabat"

2007	750	1,591	30,297	60,356
2008	750	1,652	30,686	60,723
2009	755	1,653	31,078	60,963

Source: The State Statistical Committee of the Republic of Azerbaijan(SSCRA) Publication

Transfer of the hospitals to official and unofficial paid systems resulted in the deficit of medicaments, technical gear and financial resources, increased the price for services and medicaments which decreased the usage of health services

The establishment of new private health centers should take an important role in increasing the quality of health services.

Despite many problems in the health sector, economic progress together with the increase of the income level are seen to participate in the decreasing of this problem.

The State Program for Social-Economic Progress of the Regions has 21 new consturcion projects for new health institutions.

2.3.4.2. Finance

The country where actions are taken on independent maket system including both free and financial markets, the establishment of new financial system is made upon institutions, facilities and legal arragements.

2.3.4.3. Banks

The country has Central Bank (Milli Bank), banks with public capital, local banks with private capital and banks with foreign capital.

The development stage of the bank system in Azerbaijan can be separated in three stages. The first stage was in 1990-92 when the Central Bank system was established. In 1992-94 in unstable condition of hyperinflation the banking system was

established. In 1994 and later years, in the conditions of macroeconomic stability the banking system was re-established and developed[135].

The legal basis of Azerbaijani banking system was reflected in chapter 14.1 “Bank systems and money circulation” of the Constitutional Law on “The Basis of Economic Independence of Azerbaijan Republic” dated 25 May 1991 [136]. This chapter established an independent banking system as well as the legal foundations of national money unit in Azerbaijan, the status and authorizations of the Central Bank. Central Bank was established on 11 February 1992.[137]

Concerning the Banking and Central Bank configurations, on 7 August 1992 "The Law on Central Bank " as well as "The Law on Banks and Bank Activities " were in power. In December 1992 the Regulations of the Central Bank of Azerbaijan Republic were passed. According to the passed laws, a system consisting of Central (Milli) Bank and other Banks should be established.

The new Law on "National Bank of Azerbaijan Republic" was passed on 10 June 1996. The concerning law was changed and improved in 1997, 1998, 2001, 2002 and 2004. Finally, the Law on “National Bank of Azerbaijan Republic” was passed and approved by the President Ilham Aliyev in its final state on 10 December 2004.

The determination of policies in money and banking sector, control and supervision authorities belong to the Central Bank. The capital of the National Bank belongs solely to the State and it has a very strong control over financial markets.

During the tranfer to an independent economic market, Azerbaijan did not possess a baking system, hence there was no strong control and supervision over it. There was a rapid growth of banks established from legal gaps. Established banks were mainly enaged in speculative action.

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135 Azerbaycan Respublikası Bank Sistemi Haqqında Melumat Toplusu, Azerbaycan [A] Banklar Assosiyası Neşriyyatı, Bakı, 2000, s.5-6.

136 Azerbaycan Respublikasmm Milli Bankı, http://www.nba.az. (08.04.2010)

137 Azerbaycan Respublikasmm Milli Bankı, http://www.nba.az. (08.04.2010).

“The Law on Banks in Azerbaijan Republic” was approved in its final state on January 16th 2004.

Banking Law covered all of the banking operations in the modern view, however the goals were not reached because the economy was not completely transferred to an independent market systems and the banking system was not organized and placed in a modern way.

Since 1991 all of the banks started using international accounting operations. Azerbaijan does not have financial market facilities and banking services developed. In order to compete with foreign bank branches, the local banks tried to improve their services variety as well as their quality.

158 banks and all other credit unions in 2001 dropped to 116 in 2002. In the beginning of 2010 there were 114 licensed credit organizations. In 2009 there were 42 saving licensed credit organizations, 43 licensed credit organizations acting on foreign capital, 2 licensed credit organizations allowed to operate on precious metals, 41 licensed credit organizations giving guarantees, 30 licensed credit organizations servicing in plastic cards

The increasing trend in the amount of banks in Azerbaijan lasted until 1995. However, since 1996 the amount of banks started decreasing. Especially in the first years of independence, because the bank establishment capital was kept low, there was an increase in the amounts of banks. After the banker distaster happening later, the Central Bank increased the establishment capital which lead to the decrease of the amount of banks. According to the improvements made on 1 October 1997 the limit of the capital for new established banks and regulations was increased to 1.250.000 USD, and for acting banks it was increased to 800.000 USD. Following this change, small banks started closing down.

On 01.01.2000 as a part of strengthening the banking system, the minimum bank capital was raised to 2 million USD, and for new establishing banks it was raised to 5 million USD. In July 2002 the establishment capital was increased to 2.5 million

USD[138]. Due to increasing the establishment capital to 2.5 million USD, some trade banks joined together and some ended their operation, hence the high amount of banks was lowered. In 2002 those banks that did not raise their capital to 2.5 million USD were cancelled their regulations.

In 2003 the bank establishment capital was continued to raise. Cetnral Bank increased the regulation capital from 2.5 to 3 million USD in 2003. As in previous years, this led to the close down of banks that did not have enough regulation capital. Central Bank planned to increase regulation capital of private banks semi-annualy for on 0.5 million USD until it reached 5 million USD.

As a result of the increase in the establishment capital of the banking sector, in 2001 the operation of about 50 banks was stopped. Lastly, 240 banks operating in 1990's were decreased to 59 in the beginning of 2007, 53 in the beginning of 2008 and 42 in the beginning of 2009. Two of them are state owned, the rest are private. 15 of them operate on foreign capital or partially on foreign capital.

Of course, it should be noted that the applied strong money policy also had an important effect on decreasing the amount of banks.

In the end of 1995 4 state banks Agrobank, Industrial Bank, Savigs Bank and International Bank owned 80% of bank assets, 85% of unpaid credit, 75% of depists, 65% of branches and 70% of employees of the sector.

Since the beginning of 2009 there were 2 state banks in country. They were Azerbaijan Beynelhalg (International) Bank and Capital Bank. Specialized banks established in 1988 during the Soviets such as Agrobank, Industrial Bankas ı and Savings Bank joined together in 2000 into Joined Universal Bank (BUS Bank) anonimous company. In 2004 the name of the bank changed to Capital bank. Azerbaijan International Bank is another state bank that was established in 1992 as a part of the Soviet Vnesheconombank.

[138] National Bank of Azerbaijan (www.nba.az)

The banking sector which is mainly controlled by the State, is especially effected by the Azerbaijan International Bank. The amount of capital of Azerbaijan International Bank is 4.4 billion Manat. The assets of the Azerbaijan International Bank in 2009 were 54% of all of the assets in the sector. It is also useful to note that this rate increased by 7 points compared to a previous year.

Before the arrangements were finished, the state budged did not consider privatization of BUS Bank (Capital Bank) and the Azerbaijan International Bank in 2005. The branch amounts of operating banks in 2007 were 291, increased to 326 in 2008 and 385 in 2009. There is only 1 branch of unsettled banks. The operation of credit organizations abroad in branhes, representative and other activities is weak. These organization have 1 branch, 1 representative and 1 closed bank abroad. [139]

When analizing the branch amounts of the banks operating in country, there are 223 branches of private banks and 162 branches of state banks, hence it is demonstrated that the private branches are more than public ones. There are Turkish as well as other foreign banks represented in Azerbaijan. Foreign capital banks can establish as a 100% foreign capital bank, as well as as a share in country. The total share of the foreign investment in the banking sector was 25%, 30% and 50%, finally, according to last change the limit was removed. At the end of 2008 the regulation capital volume was increased on 53% compared to previous year and became 7,163 million Manat. In January 2010 4 billion Manat of the total regulation capital belonged to state banks, and 4.4 billion to private banks. Regulation funds of foreign capital banks are 1.8 billion Manat'tır, which equals 33.6% of the total regulation funds.

Credit and Credit Interest Rates: The economic weight of the banking sector is increasing and with the increase of trust in banks, the total assets and credit amounts are also increasing.

In the credits given it is observed that every previous year the private secrot share is increasing. In 2008 the credits given by the private banks made 35%, while in 2009 this rate increased to 46%. The weight of the state banks in 2002-2004 is 45%.

[139] National Bank of Azerbaijan (www.nba.az)

The credit organizations excluding banks in 2007 was 15%, while in 2009 decreased to 9%.

Tablo: II.8. Credit (Billion Manat)

Years	Short term	Short term (%)	Long term	Long term (%)
1995	252.96	87.3	36.84	12.7
1997	380.22	93.1	28.18	6.9
1998	417.54	97.8	9.18	2.2
1999	432.1	97.5	11	2.5
2000	334.4	72	129.96	28
2001	353.98	72.8	132.28	27.2
2002	374.24	71.9	145.92	28.1
2003	487.08	72.7	183.22	27.3
2004	700.78	70.82	288.68	29.1

2005	913.2	63.4	527.7	36.6
2006	1142	48.3	1220.7	51.7
2007	1649.5	35.2	3032.3	64.8
2008	2295.9	32.1	4867.4	67.9
2009	2360	28.1	6047.5	71.9

Source: The State Statistical Committee of the Republic of Azerbaijan(SSCRA) Publication

In the credits given, no continuous weight of currency is observed. In 2009 41.3% of credits were in Manat, and 58.6% of them were in currency. The are also important increases in credit amounts directed to private sector.

The total credit amount of short term credits were placed 32.1% in 2008 and 28.1% in 2009. The credit amount directed to state sector in 2008 was 30% and 20.4% in 2009. Moreover, the credits given were mainly divided sectorely to trade-service and communications-media. The interest rates were defined by the market, taraf ından belirlenmekte olup, the market operated by treasury bonds was trying to provide a development for the financial sector. The interest rates were %19.53 in 2007, 19.74% in 2008 and 18.17% in 2009. Thre interest rate for long term credits was 21.60% in 2007, 20.70% in 2008 and 18.86% in 2009. In the in between bank market the 3-month credit interest rates were 20.3% in 2007, 19.75% in 2008 and 19.67% in 2009 [140]. In 2009 the average nominal interest rate was increased. In the end of 2008 the Manat credit interest rate was 14.91%, while in 2009 it increased to 15.55%. However, while considering the

[140] National Bank of Azerbaijan (www.nba.az)

inflation rate of 10.6% in the last 12 months, the real interest rate was decreased to 9.76%.

2.3.4.4. Pipeline Transportation

Azerbaijan was the first country after the USA to have a pipeline constructed and the transportation via pipelines is very important. Petrol and natural gas use the pipelines the most as the means of transportation. While the share of the pipelines in load carriage was 9.5% in 1990, it increased to 31.5 in 1995. However, within the next couple of years there were decreases in this rate. Its role in the transportation sector, the pipelnes that received great importance after the increase of petrol explorations, and the establishment of the main export pipeline of Baku-Tbilisi-Ceyhan as well as the gasline Baku-Tbilisi-Erzrum will all grant them an important role. The information about the pipeline is given more detailedly in the chapter Importance of the Caspian Energy Resources.

2.3.5. Communication

In December 1996 Azerbaijan joined GSM cellular phone system. Wireless communication is the most active sector in the telecom industry in Azerbaijan.

Wireless communication has received many foreign investments after the first wireless network creation in 1994. In 2004 the volume of mobile phone services increased to 47.9% compared to 2003. While in 1994 there were total of 2 thousand mobile phone users, in 2005 this number increased to 2,2 million. Hence, approximately 26% of the populations were using mobile communication services. While the estimates for this number increased to 7,7 million in 2009, the area demonstrated an investment potential. In Azerbaijan the use of mobile phones changes from region to region. While Baku has the rate of 90%, some small cities have a rate of 70-75%. In many cases the mobile phone communication is an alternative to an old and uneffective cable phone communication. There are two operators in Azerbaijan: Azercell and Bakcell. Azercell share in the market is 76%, Bakcell share is 18%, while Azerfon share is 8%. 71% of Azerbaijan is under the coverage area. The investment made by Azercell only was over 770 million USD. After the investments into communication networks, some

international manufacturers determined that they were ready to commit to the sector for a long period of time. The Ministry of Communications and Information Technologies started holding meetings on establishing a third operator.

The postal system will receive a total investment of 15 million USD and in 2005-2006 all of the post offices was automated. Considering that approximately half of the country population moved to Baku due to migrations, the economic strength and telecom infrastructure as well as the Internet are developed in Baku and 90% of subscribers are concentrated in Baku. Due to rapid development and established internet market in Azerbaijan, the Communications and Information Technologies Ministry providing all of the telecom services is seen to be ineffective concerning techology and personell.

2.3.6. Construction

In 1990-2009 there was a strong relationship between improvements in the construction sector during the economic and social progress in Azerbaijan. Within these years, many buildings and complexes directed to production or not were constructed.

Moreover, operating buildings were enlarged and restored. While the progress of the construction sector into GDP in 1991 was 8.1%, in 1999 it was 9.9%. The effect stated remained low in 2006-2007 increased back in 2008 and reached 7.4% in 2004.

According to the analysis made by the IMF the contribution of the sector to the economy is more than as per official statistics. Very important part of the construction operations remains unregistered. Since the petrol sector started receiving foreign investment in 1995, the construction operations have increased greatly.

While the investments in the construction sector were unstable in 1990-2009, except for 1990, the share that the construction sector received from the total investment was under 10%. More investments were made each year into production locations.

In 2009 the investments directed to the construction sector were increased on 20.2% compared to last year and were 1.07 billion Manat. 3.318 billion Manat of this

amount (4.128 billion USD) which is 75.5% of the total investment was made out of the foreign investment[141].

In 2009 the investments directed to non-petrol construction sector was decreased on 12.6% compared to 2008 and made 3,055 million dollars. 73.7% of the investments directed to the construction sector were under the foreign investment share. This rate is increases the effect of foreign businessmen in the development of Azerbaijani construction sector.

The increase rate of the construction sector caused new production and establishment of new workplaces in the first stage. In 2009, the establishment of thousands of new workplaces owed to the newly constructed organizations. Parallel to the development of the sector, the employment volume increased daily and reached 200 thousand.

Specialized companies like Azersanayetikinti, Azersutikinti, Azerenerjitikinti and organizations like SOCAR (The State Oil Company of the Azerbaijan Republic), Caspian Shipyard Company, Azerbaijan Railway Department are the largest construction enterprises. Turkish companies are also observed to have a large share in the sector.

Approximately 20.1% of the Turkish companies operating in Azerbaijan are construction companies that have the most important share on the market. Projects that occupy Azerbaijan agenda as petrol pipelines, residence restoration and construction, re-construction of venues destroyed after the war and re-construction of approximately 1/5 of Azerbaijan, infrastructure restoration, industrial facilities restoration and contruction, entertainment and accommodation facilities contruction have let the Turkish companies enter the market.

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[141] "2002-ci İ lin Yekunlar. Üzre Pul-Kredit Siyasetinin Yerine Yetirilmesi Veziyyetı Haqq,nda", http://www.nba.az/az/analitic/2002yekunu.shtmi, (01.04.2003).

Turkish companies constructing residences and business centers are very active on the Azerbaijani market.

Together with this, Turkish entrepreneurs need to compete with American and Western European powerful companies.

Baku's overveiw modernizes daily by destroying old buildings and erecting new ones instead. However, modern architectural constructions and construction materials as well as geological and geodesical explorations do no allow for more than a 20-storied building. On the other side, new constructed skyscrapers are a concern as per the green areas and urbanism. Considering these concerns in 2008, the erection of more than 18-story building was prohibited downtown capital and within the city zone.

Construction of the pipelines, establishment of modern industrial facilities, new re-construction and restoration projects and especially, hotels, restaurants and different facilities for tourism-entertainment sector are all important investment opportunities in Azerbaijan construction sector.

New construction projects have increased quality construction materials. Home production is unable to meet the needs for both quantity and quality. Because there is a large variety and cheap price for the materials and raw materials and supply deficit, the construction sector is a very encouraging sector for external investment.

Petrol sector as well as the construction sector parallel to it are developing rapidly in Azerbaijan. Parallel to the increase of the income level, and considering new venues and trade centers establishment increase, the construction sector is one of the most developing sectors. The development in the construction sector is several levels higher than the population increase. Parallel to this the price of the construction materials also increases. Lacking of homes is one of the facrtors causing a divorce. Moreover, it causes people to engage in late marriages. From this point of view, it is suitable for the petrol income to be spent on residence construction.

2.3.7. Mining

Azerbaijan has rich banks of iron, aluminum, copper, tin and marble. Iron and aluminum are the most important ones out of them. The development of existing mining investments and their spread need foreign capital.

2.3.8. Transportation Infrastructure

There is a 2,089 long railway netrowk basing the transportation and shipping in Azerbaijan. The land network provides regional transportation as well as connects the country to international land. Water transportation is the most important area that connects Azerbaijan to Central Asia, Iran and Russia. Baku is the largest port city on the Caspian Sea. Baku has regular flights to CIS countries, Germany, Israel, Turkey, Iran, Austria, Pakistan, the Netherlands, Greece, Poland, China, Italy, Great Britain and UAE.

2.4. SUSTAINABILITY OF AZERBAIJAN IN THE ECONOMIC GROWTH

In 1990-1995 GDP annualy decreased on 15%. The first half of the 90's the inflation was greatly high and production was low. The economic recession started in 1991 lasted for 6 years and got prevented in 1996. The rate of economic growth is continuously increasing. In the past eight years, GDP production was provided with a growth dynamics. In 1996-2009 the average annual increase in GDP was 42,9%. Only in 2008 the increase was 9,3%. In this period, there was an increase of 6,1% in production of industrial materials. There is a big role of the private sector in the economic growth.

Currently the private sector share in the GDP is 73%, and the share of the private sector in the production of industrial materials is 54%. The rate of economic growth is larger in the private sector rather than in state sector. In 2009, the growth rate of industrial materials was increased 4,4% in state sector and 7,6% in private sector. 50% of GDP is industry, 6,4% is agriculture, 7,4% is construction, 8% is trade and services sector, 8,6% is transportation, 11,7% is communications, other areas are 8,6%. As a result of higher rate of economic growth GDP per person in 1992 was 180 USD, in 2003 it reached 880 USD and in 2009 it reached 4,874.1 USD. As per the criteria set by the World Bank, if the per person income of GDP is less than 755 USD, this country is

considered as a low-income country. This way, Azerbaijan will no longer have the stateus of a poorly developed country and tranfer into medium developed or a country with medium income.

PART III

3. THE LOCATION OF FOREIGN INVESTMENT IN AZERBAIJANI ECONOMY

3.1. FOREIGN INVESTMENT

The Law passed and applied in 1995 on “Investment Operations” was finally appoved by the National Assembly with minor changes on 19 April 2005. The stated law covered the establishment of foreign capital in country, development of international economic relations and partnerships and trustworthyness of the investments.

The foreign investment flow in Azerbaijan started in 1994. In 1994-97 to the laws and regulations made to provide a healthy flow of foreign investment. Especially foreign capital compnanies directed to petrol and natural gas expolorations started increasing in first years in other sectors as well. Economic stability witnessed in Azerbaijan in 1996-1997 and policies providing economic stability, support from the state policies that motivates real economy, cancellation of tax exemption before 1997 to attract foreign capital to country and because the state institutions did not show enough sensibility there were not investments directed to production in 1997.

3.1.1. Investment Amount in Azerbaijan

Since 1994 the flow of foreign capital to Azerbaijan reached its maximum level in 1998 with 1472 million USD. However, as a result of strong money policies applied, recession of the economy, late privatization and lack of expected economic reforms the economy was under the deflationist pressure on one side and after 1998 a recession was

witnessed in Azerbaijani economy, especially in the foreign capital on the other side. Russian crisis of 1998, together with bureaucracy present in country, officionalism and problems like that have caused the decrease of foreign companies in country and drop in foreign capital fromt that date.

The cancellation of tax incentives on foreign capital in Azerbaijan has raised this negation in other non-petrol sectors[142]. Foreign companies have invested around 5.9 billion USD capital in 1994-2000 into Azerbaijan economy. 77.2% of these investments were direct investments, 22.8% of them were financial credits. 73% of the direct investments were directed to petrol industry. In Azerbaijan economy the weight of foreign capital in GDP is at a high level. Between 1996-2000 the rate of foreign investment to GDP increased from 30% to 35-40%.

Foreign companies, whose entrance to the market after 1998 and between 1999 and 2000 was low, increased since the last months of 2000. Some changes made in legislation, relative decrease of customs and tax rates and and remaining this period, protection of foreign capital and steps taken by the state in this direction have increased the foreign capital in country. The join of the macroeconomic system with stability, improvements made to strengthen the private sector and development of the petrol sector have all provided opportunities for high capital flow from world financial centers to Azerbaijan[143].

Investments made into Azerbaijani economy in 2006 were spread as 60.9% foreign investment and 39.1% internal investment.

Investments of 2007 were spread as 55.3% foreign and 44.7$ internal. Sectoral spread of investments was as follows: 77% were industrial, in this frame 68.5% were oil and natual gas, 11.3% were construction, 9.4% residence construction, 38% transportation, 2.4% telecommunications, 1.8% trade and services, 0.8% agriculture and 2.9% to other areas.

142
"Sinan Oğan, "bağımsızlığının 10.yılında Azerbaycan Ekonomisi ve Türkiye ile ekonomik ilişkileri," www.ceterisparibus.net/arsiv/s_ogan/pdf(13.03.2003)
143"Azerbaycan Respublikasının Sosyal İgtisadi Veziyyeti.", p22

Total investment made in 2008 was (16.2 billion USD). When comparing this to previous year it is 34.4% more. 89% of the investments were from the private sector and 11% were from the state sector.

Financial resources used in investment spread were as follows: 85.3% were from companies and organizations, 3.2% were from public savings, 2.7% were from the budget, 1.6% were from bank credits, 0.8% were from budged funds and 6.4% were from other financial resources.

In 2008 79.7% of the used capital from financial resources was used on industry development (76,2% were invested into oil and gas production, 1,9% into production industry, 1,6% into electric energy and water facilities), 1% into agriculture, 0,2% into construction, 0,8% into trade and services, 8,7% into trasportation, 1,4% to communications, 5,5% to residence construstion, 2,7% to other areas.

The share of foreign investment in Azerbaijan in 2008 was 42.2% foreign and 57.8% was the local share of the investment. As per the sectoral share of the invested capital, the industrial sector had the 79.7% share. 76.2% of the investment was directed to oil and gas exploration, 1.6% to electrical enetry and water distribution, 1.9% to production sites. Agriculture sector share was 1.0%, construction sector share was 0.2%, trade and services share was 0.8%, transportation share was 8.7%, communication share was 1.4%, residence construction share was 5.5% and other areas share was 2.7%.

In 2009 Azerbaijan received a total investment of 10.28 billion Manat (12.79 billion USD). When this rate is compared to 2008 it is 21.1% less. 42.7% of the invested capital, which is 4.4 billion Manat (5.4 billion USD) was foreign capital, 5.87 billion Manat (7.32 billion USD) which is 57.3% was local capital.

While the investments made by foreign and local operators and organizations equaled 86.4% and decreased on 21.1%, the investments made by the state budget decreased on 1.9% and became 10.56 billion Manat.

Table :III.1. Investments in Azerbaijan (Million $)

Years	**1995**	**1996**	**1998**	**1999**	**2000**	**2001**	**2002**
Total investments 544		932	1932.2 1571		1441,4 1561,8 2796,6		
Internal investments	168,9	311,5	460,2	479,9	514,4	470	561,7
Foreign investments	375,1	620,5	1472	1091,1 927		1091,8 2234,9	
Years	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
Total investments 4326		5922	7118.5 8300.4 12066.1			16222 12794.2	
Internal investments	955	1347	2225.3 3247.6 5391.8 9374.6 7325.6				
Foreign investments	3371	4575	4893.2 5052.8 6674.3 6847.4 5468.6				

Source: The State Statistical Committee of the Republic of Azerbaijan(SSCRA) Publication

Foreign investment in 2009 decreased on 21.1% compared to 2008. 90.2% of the foreign investment in 2009 was made into petrol sector. Investments made with the local capital in 2009 decreased on 21.8% compared to the previous year.

Until 2009 the total foreign investment was 54.8% of total investments in Azerbaijan or 39.2 billion USD.

Direct foreign investments played the key role in the economy strength in Azerbaijan. Economic improvement was supported by foreign investment made mostly into petrol sector.

Since the beginning of 2010, the foreign investment made into Azerbaijan consisting of 12 billion USD was the largest in Eastern Europe and CIS. As per the volume of foreign capital per person, Azerbaijan is the first among the CIS countries. Azerbaijan’s social-economic progress has provided for decrease of unemployment, the increase of prosperity of people and widening the international relations of Azerbaijan.

When analyzing the country spread of investment in 1998-2008 29.7% share belong to Turkey. United Kingdom has 18.9% , USA has 17.5% share and they are sharing second and third places. Iranian investors have invested 23 million USD into Azerbaijani economy. 26 million USD of these investments were made into petroleum sector. Main foreign capital comes to Azerbaijan from credits of international financial organizations, direct capital investment, petroleum profits, other credits and capital.

The majority of foreign capital incoming to the country if in credits, hence it will be given back with added interest in future. Apart from the credits received from international financial organizations, capital directed to petroleum sector is also a credit and they have to paid back with very high interested rates from the Azerbaijani petroleum income.

The flow of capital from the country outside within the last three years is seen due to that. Azerbaijan has to pay back the credits it received from international financial organizations on one side, and membership fees to international organizations on the other side. Moreover, the withdrawal of shareholding investors of the "contract of the century" has started.

3.1.2. Country spread of foreign investment

In the end of 2008 there were 329 Turkish-Azeri partner companies, 302 Turkish companies and 27 representatives. The trade relations between Turkey and Azerbaijan are continuously being developed by 150 million USD trade volume and 500 million USD investment. As seen in Table III.2., there are 329 Turkish companies operating in Azerbaijan, investment amount if 60.8 million USD. Turkish companies are followed by 65 Russian and 38 USA companies.

Table: III.2 Country Spread of Foreign Investment

Country	Number of companies	Investment (million $)	%
Turkey	329	60.8	12.3
USA	38	108.8	22.0
United Kingdom	10	146.4	29.6
Germany	21	48.2	9.8
UAE	15	38.5	7.8
Russia	65	5.8	1.2
China	11	8.1	1.6
Other	120	77.5	15.7
Total	**609**	**494.1**	**100**

Source: The State Statistical Committee of the Republic of Azerbaijan(SSCRA) Publications

Table: III.3. Sectoral Spread of Foreign

Sector	Number of Companies	Investment (million $)	%
Petro-chemical	42	317.7	64.3

Communications	22	115	23.3
Construction	67	15	3.0
Health	18	11.1	2.2
Agriculture	69	6.8	1.4
Consumer goods	200	15.5	3.1
Other services	22	3.8	0.8
Electric	21	2.6	0.5
Carpetry	17	1.7	0.3
Machines	11	1.6	0.3
Automobile	4	1.4	0.3
Other	116	1.9	0.4
Total	**609**	**494.1**	**100**

Source: The State Statistical Committee of the Republic of Azerbaijan (SSCRA) Publications

3.1.3. Investment

It is witnessed that foreign companies are mostly operating in consumer goods, agriculture, construction and petro-chemical sectors. In 2009, United Kingdom was on the first place in foreign investment of 146.4 million USD, USA was on the second place with investment of 108.8 million USD (Table: III.4.).

Table: III.4. Country spread of foreing investment in 2009 (Million $)

Country	Turkey	USA	United Kingdom	Germany	UAE	Russia	China
Investment (million $)	60.8	108.8	146.4	48.2	38.5	5.8	8.1

Source: The State Statistical Committee of the Republic of Azerbaijan(SSCRA) Publication

Turkey, Great Britain, USA, Germany, France, Norway, Japan, South Korea, Malaysia and India are all trying to increase their business and investment opportunities in Azerbaijan. Before June 1992 half of textile and trade sector was occupied by Turkish foreign investors with 110 investors, which raised greatly within the next terms.

3.2. Petroleumeum and Natural Gas Potential

The Caspian Region (Azerbaijan, Turkmenistan, Kazakhstan, Russia and Iran) have 10 billion barrels of petroleumeum reserves. The approximate petroleumeum reserves makes 233 billon barrels in total. Confirmed natural gas reserve of the Caspian Region is approximately 170 Tef (trillion cubicfeet)[144]. It is important to note that many different assessments are made upon the hydrocarbon reserves of the Caspian Region as well as the petroleumeum and natural gas potential of Azerbaijan[145].

According to the data of Azerbaijan Ministry of Energy, the region covering the agreements made in Azerbaijan possesses 6-8 billion barrel ton (1 billon ton) of petroleumeum reserves. Just Azeri-Chirag-Guneshli oil platforms have petroleumeum

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144 *"Bkz:I. T.Akbarov, "the role and economic Importance of Caspian Sea Region " Materials of the International Conference on aTlıeıne Caucasus and Central Asia During Globalization,* Baku, 2003, ss.66-67.
Note: 1 ton = 7,33 barrel; 1 trilllion cubic meter = 35,33 trillion cubic feet.

145 Bkz: Gubad Ibadoğlu, "Azerbaycan'ın Kalkınma Stratejisinde Petroleumün Rolü:Ortodoks Bakış Açısıyla", *2023 Dergisi,* S.18, 15 Ekim-2002, s.73.

reserve of 730 million ton. As per the data above, Azerbaijan has 0.7% of the petroleumeum reserves of the world[146].

The operating platforms in Azerbaijan have 200 billion m3 natural gas reserves. With the exploration of the “Shahdeniz” platform which is the world’s important condensate platform and according to 2 different calculations the natural gas reserve of the platform is thought to be 1 trillion m3. Azerbaijan’s confirmed total natural gas reserves are 1,37 trillion m3. According to the confirmed natural gas reserves, Azerbaijan has the world’s 0,8% natural gas reserves. As per the calculations and considering the risk factor, total geological gas reserves are between 8-10.7 trillion m3[147]. With these reserves Azerbaijan will be among the world’s natrual gas exporting countries within the next 10-15 years. In 5 years after the complete operation of "Azeri-Chirag-Guneshli (ACG)" and "Shahdeniz" platforms Azerbaijan will have a great progress in petroleum and natural gas production. With the start of the 3rd stage of "ACG" in 2010 the daily production of these platforms will increase from 240 thousand barrels to 1 million barrels. With the start of the 1st stage of "Shahdeniz" platform over 400 m3 of natural gas will be produced. With this production Azerbaijan will be one of the natural gas producing countries and Baku-Tbilisi-Erzurum natural pipeline will provide Turkish market with “blue energy”.

According to some calculations, Azerbaijan’s petroleum reserves will be exhausted in 60-67 years. According to Russian specialists this period is 25-35 years[148].

3.3. Petroleum Agreements

In order for Azerbaijan to operate the rich petroleum reserves, in September of 1992 Azerneft and Azemeftkimya state companies joined together into State Oil Company of Azerbaijan Republic (SOCAR). SOCAR is the only state

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BP Statistical Review ofWortdEnergy 2004, http://www.bp.com/centres/energy (07.04.2005); Sevil Yıldırım, *Dünyada ve Türkiye'de Petroleum*, T.C. Başbakanlık Dış Ticaret Müsteşarlığı Ekonomik Araştırmalar ve Değerlendirme Genel Müdürlüğü, Ankara, Ağustos-2003, ss.4-5.

147Rkret Sucayev, "Azerbaycanda Qaz Hasılatı ve Ona Olan Telebatın Odenilmesinin Başlıca Istiqametleri", *Azerbaycan Müsteqillikden Sonra Beynelhalq Konfrasın Materialları* 168 Bakı, 3-4 Mart 2003, pp.36-37.

company authorized to operate petroleum reserves and make agreements with international petroleum companies.

There are approximately 3,5 billion ton of petroleum reserves in the Caspian Sea and 5 agreements were made upon them for the period of 30-35 years. The largest one in these agreements was made on 20 September 1994 named "Mega Project or Contract of the Century" the total investment of which was 7,5-8 billion USD with total produced petroleum reserve of 540 million ton and 90 billion m^3 of natural gas. The presense of raw petroleum platforms in the Caucasus has been since the 13th century.

Towards the end of the 19th century there was a great competition between regional strengths, worlds strength and petroleum companies. Russia that was afraid to lose the control over the petroleum market sabotaged an agreement between Amerikan Standart Oil, the Rothschilds and Nobels companies in 1895. The competition in the region, ethnical conflicts, official putrification and poorly developed legal and trade applications were raising even more.

Technological progress in the 19th century made possible the strong operation of petroleum reserves and the struggles given to control the region were even stronger. The competition was concentrated in the Caucasus and Capsian regions. The raw petroleum coming out of the region played a strategic role in during the two world wars of the century. Protection of Caucasus petroleum locations was the most important priority of confederations.

During the Second World War, the Caucasus petroleum was Hitler's most important goal in his expansionist policies. After the 1939 German-Russian Pact, the Soviet petroleum explored from the Caucasus made the third of the German petroleum export. In 1942 in order to gain control of the region's natural resourses, Germany organized military attacks.

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[148] Ersan Bocutoğlu, *Orta Asya ve Kafkasya 'daki Durum ve Avrupa Güvenliği,* Karadeniz Teknik Üniversitesi Matbaası, Trabzon, 1998,p.47.

During the Soviet Union Azerbaijan covered the Union's petroleum needs without using it itself. Inspite of the unbalanced raise in the investments made to increase petroleum production and export, the investments made into other industries decreased. After the collapse of the USSR the whole world's attention was on independent Turkish Republics. Unfortunately, Turkish Republics possessing rich petroleum and natural gas resourses did not have enough financial and technical potential to operate the existing reserves on their own.

Azerbaijan's work on petroleum production and development in the Caspian Sea concentrated on Guneshli, Chirag, Azeri and Kepez. However, due to using easy technology, two problems of production and productable resources faced each other. While petroleum production was 14,7 million ton in 1980, it decreased with time to 12,5 millon ton in 1990, 9,2 millon ton in 1995 and 9,1 million ton in 1996. This decrease in the petroleum production was due to old technology use and poor care of the petroleum locations. In order to operate rich petroleum reserves of Azerbaijan, in September 1992 two state companies of Azerineft and Azneftkimya joined into the State Oil Company of Azerbijan Republic (SOCAR). The increase in the petroleum production and improvement of the existing reserves was only possible with using modern technology and new development projects. The economic potential of Azerbaijan as well as the technology it owned was not enough to operate and develop the existing reserves. The deficit stated directed Azerbaijan to partnership with major oil companies[149].

Petroleum is explored both on and offshore in country. Petroleum explored onshore is mainly explored on the Absheron penninsula. Azerbaijan's petroleum agreements are mainly made upon the sea platforms. Moreover, agreements are also made upon explorations onshore. Azerbaijan aims to gain petroleum reserves to country's economy with the agreements made with major oil companies. In order to achieve this goal, including platforms related to the ones onshore, since 20 September 1994 international 23 petroleum agreements were signed with 33 companies from 19 countries in Azerbaijan. These agreements that were Production Sharing Agreement

[149] Natig Aliyev, The Azerbaijan Oil and Gas Industry in 1949-1999 Period' http://www.caspenergy.com/no3rus21.html, (04.04.2005); Çelik Kenan - Kalaycı Cemalettin, "Azeri Petroleumünün Dünü ve Bugünü", *Journal of Qafqaz University,* V.II, No.II, 1999, p 63.

(PSA) type all cover a period of 25-30 years. The total amount of determined investment is over 60 billion USD.

A total of 400 companies, 72 of which are local, are occupied in developing of Petroleum projects. The operation of the companies spread until ecological services. Local and foreign companies partnerships create opportunities for modern technology, software, materials and management techniques.

3.3.1. Contract of the Century: "Azeri" - "Chirag" - "Guneshli" Platforms Agreements

"Contract of the Century" that brought new breath to the sector that was continuously pulled back during the Soviet era and which is one of the most important agreement has a very great economic importance to Azerbaijan[150].

The agreement covering ACG is the most important historical event as per Azerbaijan's independence and throughout changes in the area. The meetings that were held very difficultly started between Azerbaijani govermnent and Western Companies during the Soviet period.

Lıberazation period that weekened the Soviet economy attrackted more Western companies to rich mineral sources explorations in Azeri, Chirag and Guneshli and Azerbaijan's well developed petroleum industry.

In order to develop and explore the resources Azerbaijani government decided to attract Western investment to the country due to not having necessary funds. In January 1991 the government opened the projects for bidding. BP, Statoil, Amoco, Unocal and other companies joined this bidding process.

In 1991 a group consisting of companies such as Amoco, BP, McDermott, Pennzoil, Ramco, Unocal, Tukish Petroleum Anonimous Partnership (TPAO) and Statoil started meeting that lasted for 3 years with Azerbaijan in order to improve Chirag and Guneshli platforms in the Caspian Sea of Azerbaijan.

[150] Azerbaijan International Magazine, Summer-1995, pp-40-44

In 1992 companies wishing to operate in the Caspian petroleum platforms joined into concortium and held meetings. State Oil Company of Azerbaijan Republic (SOCAR) made a petroleum agreement in order to develop the platforms with Azerbaijan International Operating Company (AIOC) under Abulfaz Elchibey's supervision with SOCAR having 30% share of the project[151].

As required by the agreements, in June 1993 the meetings had to continue in London. However, due to changed government in Azerbaijan, the meetings were unsuccessful. Without being able to finish the meeting Abulfaz Elchibey was removed by the military and Suret Huseynov on 18 June 1993. Haydar Aliyev who became the President in the same year in Azerbaijan cancelled the stated petroleum agreement. Meanwhile, Elchibey's momentarily removal brought the companies to meet with President Aliyev. On 4 February 1994 the meetings started again. In April 1994 SOCAR stated that Russian company Lukoil will receive 10% share from Azerbaijan to the consortium. Companies taking place at the Consortium considered the pressures Russia could apply in future. Because Russia could block the load ships entrance in the inner waters of the Caspian with control over Volga river. Meetings continued in Baku, Istanbul and Houston and as the result, the agreement with Consortium including Russia was made again and SOCAR handed over its 10% share to Russia. Meetings lasting approximately 3 years resulted in signing of an agreement called the "Contract of the Century" on 20 September 1994 between SOCAR and the Consortium in Baku's Gulistan palace officially called "An Agreement on Partner Operations of Petroleum in Azeri, Chirag and Guneshli platforms and Share Division" that gave exploration and lifting authority in related areas to AIOC [152]. Inspite of many pressures and issues the agreement was signed and was a life changing step for Azerbaijan. As per the agreement Azerbaijan has the ownership rights on these 3 petroleum platforms. Related agreement was approved by the Parliament of Azerbaijan on 2 December 1994 and was in power on 12 December 1994 [153]. The project also named as "Mega Project" the total investment amount of which was 11 billion USD and total produceable petroeum

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[151] S. Bölükbaşı, "Ankara's Bakü-Netred Transcaucassa Policy",*The Middle East Journal* Winter-1999, p.87.
[152] Nasser Sagheb-Masoud Cavadi, "Azerbijan's 'Contract of the Century' Finnally Signed With Western Oil Consortium"*Azerbaijan International Magazine*,Winter-1994, p.27.
[153] *Azerbaijan International Magazine*,Summer-1998, p.77.

reserves 5.4 billon barrels (730 million ton) and natural gas reserves 96 billon m3. The platforms also have 6 million ton condensate reserve. The approximate values above have changes from time to time. The agreement covers a 30 year period. Guneshli platform covered by the agreement is 82 km, Chirag is 94 km and Azeri is 113 km away from the shore.

In December 1994 the Consortium established the Azerbaijan International Operating Company (AIOC). The main responsbility of AIOC is to review the project on a daily basis as well as establishing Azerbaijani petroleum industry infrastructure based on Western standards [154]. As per the negotiations of the agreement it covered issues on extinguishing the contract by the companies. They were as follows: spread of the Nagorno Kharabagh war, ruining of economic and political relations of Azerbaijan and Russia, unstable issues in Azerbaijan will let to not finding a stable export line and also any disagreements on the Caspian Sea status regime.

Japanese "Itochu" company at first did not join the agreement and then bought 2.45% shares from “McDermott International” and joined “ACG” consortium. Japanese company also bought 1.5% share from Amoco that sold 5% share and raised its total share to 3.9%. Shares sold by Amoco were purchased 3% by Exxon and 0.5% by Unocal. Before SOCAR’s share was agreed to be 30%, but after the signing of the agreement it handed over 10% of the share to Russian Lukoil company, in April 1995 5% to Exxon company and on the same date 5% to TPAO. Even though 5% were planning to be handed over to Iran, it did not happen under Western pressures. After the signing of “Agreement on Joined Operating” between Consortium memebers Azerbaijan International Operating Company was established. This organization consisting of SOCAR together with 11 companies from different countries services the operation of platforms stated in the agreement. The final state of the share division in the Contract of the Century is as follows:

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N. Aliyev, E. Şahbazov, ***Heydar Eliyev ve Azerbaycan Neft Sanayisinin inkişafı,*** Azerbaycan International Matbaası, Bakı, 1998, pp.9-10.

BP (operator) %34.13

Unocal %10.3

SOCAR %10

INPEX %10

Statoil %8.56

ExxonMobil %8

TPAO %6.75

Devon %5.62

Itochu %3.92

Amerada Hess %2.72

The “Contract of the Century” being a “Production Sharing Agreement” type gave the most share to USA. The total share of American companies is 40%. USA produces around 340 millon ton of petroleum annually and imports around 600 million ton. Hence, the USA needs new energy resources it can import. This way, the Caspian is located in the interest area of USA economically. The total share of British companies is 19%. The next large share after the American and British companies is Russian and Azerbaijani companies that own 10% shares.

The role of the “Contract of the Century” is that 90% of the investments to operate the platforms is made by the Consortiu. Azerbaijan keeps the right to control and mamage the petroleum and gas platforms. Undoubtedly it is very important to attrackt and partner the most experienced foreign companies to purchase new technology and make large investments into rapid operation of the sea’s petroleum

reserves. Because in order to operate these platforms a great investment is needed to explore, dig, build the pipelines and procurement systems on the shore.

The “Contract of the Century” was a strong element in national economy development as well as an important way in the external policies that actively helped take a first step in integrating Azerbaijan to world economy.

The first project of Azeri-Chirag-Guneshli platforms had all of the planned activities completed, latest technologies applied in petroleum production and the infrastructure of petroleum industry was modernized. The construction of "Chirag-1" sea platform is completed and the first petroleum producing well is drilled, underwater pipes to onshore Sangachal terminal and Oil Rocks have been constructed. An onshore terminal was established at Sangachal, Baku-Novorossiyk pipeline is being repaired and on 12 November 1997 this pipeline started operating.

The operations related to petroleum production after Chirag-1 production covered by the Contract of the Century consist of 3 stages. First stage started in August 2001 with necessary works at the Central Azeri field. The second stage started in September 2002 with works on West and East Azeri fields. The agreement on the third stage was singned on 20 October 2004. The agreement aimed to start production in Guneshli field. Petroleum production was aimed to start in 2010 according to the third stage. In 200 the daily production of petroleum would be 300 thousand barrels. One year later, as per the Contract of the Century, the daily petroleum production would be 1 million barrels.

3.3.2. "Shahdeniz" Field Agreement

The agreement on Shahdeniz Field was signed on 4 July 1996, approved on 4 October 1997 and acted on 17 October 1997. The agreement signed upon the “Production Sharing Agrement” covered a 30 year period. This agreement gave authority to Shah Deniz Consortium. BP Exploration Ltd. is responsible for the field operations. Shah Deniz field located in the Southeast of the Caspian Sector of

Azerbaijan is 70 km away from Baku. The field is 800 km2. BP Exploration started operating in October 1996. Investment amount of the project is 4.1 billion USD[155].

Shahdeniz field has approximately one trillion m3 natural gas reserves. 400 m3 of the natural gas was confirmed. An annual exploration of 60 billon m3 of natural gas is estimated. Hence, Shah Deniz field has raised Azerbaijan's natural gas potential on 1 trillion m3 approximately.

The information on basic indicators of the given project turned the contract into a political struggle. After an agreement on Karabakh field, the "Libration" paper stated information on new petroleum agreement to be signed in 6 months and French petroleum company "Elf Acquitaine" to join it. President Aliyev's visit of France in December 1993 has its effects on France joining the new petroleum agreement[156].

On the other side, Lukoil's other Russian company Yukos was also joining the consortium. However, there were problems with Iran joining. In may 1996 at the meeting of Economic Partnership Agency in Ashkabad an agreement between Aliyev and Rafsancani was signed on handing over 10% share of the 20% Azerbaijani share on Shah Deniz to Iran. This way it was aimed to remove unsuccessful outcomes of Caspian Petroleum and Iran. Although, American companies joined the consortium earlier, Washington refused to participate in the agreement if Iran joined. In the end, while Iran joined the OIEC consortium, no American companies were present. The share of companies at Shah Deniz is as follows:

British BP % 25.5

Norwegian Statoil Alliance % 25.5

Azerbaijan SOCAR % 10

Russian Lukoil % 10

[155] "Caspian Staging a Comeback", offshore engineerjune 2000, s 38; Doing business in Azerbaijan. Baker&McKenzie, May-2000, p.57.

[156] "Caspian Staging a Comeback", s.38; *Consulting & Business*, S.9, 1999, p.30.

French Total FinaElf % 10

Iranian OIEC % 10

Turkish TPAO %9

Shah Deniz field will provide for Azerbaijan to take place in the world's natural gas producer and exporter. Due to this, without approving of the Baku-Tbilisi-Ceyhan pipeline the plans on natural gas export pipeline started to be made.

Four agreements were signed in 2004 on Shah Deniz gas production. The first agreement was signed with "Botas" on selling 6.3 m3 of gas. One agreement was signed with the Azebaijani government and two with the Georgian government. According to the agreement, 1.5 billion m3 gas will be sold to Azerbaijan and 800 million m3 gas will be sold to Georgia.

During Ilham Aliyev's visit to Great Britain in December 2004 and agreement was signed with the European Bank for Reconstruction and Development (EBRD) on financing the 10% share of Azerbaijan in the Shah Deniz Project. According to the agreement, EBRD will loan SOCAR a credit of 170 millon USD to finance Azerbaijan's Shah Deniz share.

Hence, that was an important step in bringing Shah Deniz gas to the world market and financing it from foreign organizations.

Every month approximately 100 million USD are spent on Shah Deniz project. Shah Deniz will be one of the world's 10 largest projects. The field will start producing natural gas in the end of 2006.

3.4. Agreements made on Sea Fields.

3.4.1. 'Lenkeran-Deniz' - 'Talish-Deniz' Field Agreements

Agreement Date: 13 January1997. Approval Date: 13 June 1997.

Participating Companies:

TotalFinaElf (35%, operator),

Winter shall (30%),

SOCAR (25%),

OIEC (Iran) (10%).

Estimated Reserves one million barrel petroleum.

Investment amount: 2 billon USD. Status: first well tested in 2001.

3.4.2. Yalama-D222 Field Agreements

Agreement Date: 4 July 1997 Approval date: 4 November1997.

Participating companies: Lukoil (80%, operator),

SOCAR (20%). Estimated Reserves: 750 million barrel petroleum.

Investment amount: 4 billion USD.

Status: 2-D and 3-D seismik works were done.

3.4.3. Absheron Field Agreement

Agreement Date: 1 August 1997

Approval Date: 11 November 1997 Participating companies:

SOCAR (50%); Chevron (30%, operator), TotalFinaElf (20%).

Estimated Reserves: 13 billon barrel petroleum, 100 tef natural gas.

Investment amount: 3.5 billion USD.

Status: First well drill in 2001 was not satisfactory.

Second well drilling was in 2004.

3.4.4.Oguz Field Agreement

Agreement date: 1 August 1997.

Approval Date: 5 Kasım 1997. Participating companies

ExxonMobil (50%, operator), SOCAR (50%).

Estimated Reserves: 290 million barrel petroleum and 685 bcf (billion cubic feet) natural gas.

Investment amount: 2 billion USD.

Status: In April 2001 a well was drilled. Exxonmobil stated it was leaving the project in April 2002.

3.4.5.Nakhchivan Field Agreement

Agreement Date: 1 August 1997.

Approval Date: 14 November 1997.

Participating Companies:

ExxonMobil (50%, operator), SOCAR (50%).

Estimated Reserves: 750 million barrel petroleum.

Investment Amount: 2 billion dolar.

Status: ExxonMobil drilled a successful well. The works will continue.

3.4.6. Kurdashi-Arazdashi-Kirgan Sea Field Agreements

Agreement date: 2 June 1998.

Operation Date: 7 July 1998. Participating Companies:

SOCAR (50%), Agip (25%, operator),

Mitsui (15%), TPAO (5%), Repsol (5%).

Estimated Reserves: 730 million barrel petroleum.

Investment Amount: 2.5 billion USD.

Status: First well drillings were unsuccessful.

3.4.7.Inam Field Agreement

Agreement date: 21 July 1998.

Approval date: 1 Aralık 1998.

Participating Companies:

SOCAR (50%),

BP (25%, operator),

Royal Dutch/Shell (25%).

Estimated Reserves: 2.2 billion barrel petroleum.

Investment Amount: 2 billion USD.

Status: In August 2001 BP suspended its first assessment drilling works. New drilling works are planned until the 2005.

3.4.8.Araz-Alov-Shark Fields Agreements

Agreement Date: 21 July 1998.

Approval Date: 18 December 1998.

Participating Companies:

SOCAR (40%), BP (15%, operator), Statoil (15%), ExxonMobil

(15%), TPAO (10%), Alberta Energy (5%). Estimated Reserves: 4

billion barrel petroleum. Investment Amount: 10 billion USD.

Status: In December 2001 due to undeterminedness between Iran and Azerbaijan on the Caspian borders the explorations stopped.

3.4.9. Yanan Tava - Ateshgah - Mugan Deniz Fields Agreements

Agreement Date: 25 December 1998. Approval Date: 11 June 1999. Participating countries:

SOCAR (50%),

JAOC consortium (50%).

Shares of companies inside JAOC is as follows: Japex (22.5%, operator), Inpex (12.5%), Teikoku (7.5%), Itochu (7.5%). Estimated Reserves: 600 million barrel petroleum. Investment Amount: 2.3 billion USD. Status: Seismic works are made.

3.4.10. Lerik-Cenab-Savalan-Dalga Field Agreements

Agreement Date: 27 April 1999.

Participating Countries: SOCAR (50%),

ExxonMobil (30%, operator), unallocatable (20%).

Estimated Reserves: 1 billion barrel petroleum.

Investment Amount: 3 billion USD.

Status: explorations at D-43, D-44 and D-73 block are continued.

3.4.11. Zafer-Meshel Field Agreements

Agreement date: 27 April 1999.

Approval Date: 21 April 2000.

Participating Companies: SOCAR (50%),

ExxonMobil (30%, operator), Conoco (20%).

Estimated Reserves: 1-2 billion barrel petroleum, 1.8 Tef natural gas.

Investment Amount: 3 billion USD.

Status: Explorations at D-9, D-38 blocks are continued.

Final drilling operations made in September 2004.

3.5. Onshore field agreements

3.5.1.Kelameddin-Mishovdağ Field Agreements

Agreement Date: Was signed in 1992 as a Joint Venture.

In 2000 turned into a PSA.

Participating Companies: National Energy (85%), SOCAR (15%).

Estimated Reserves: 200 million barrels petroleum.

Investment Amount: 50 million USD.

Status: Average production volume in 2004 was 2700 bpd.

Planned to increase to 3200 bpd.

3.5.2. Anshad Petroleum Agreement

Agreement date: Was signed as a Joint venture in 1993.

In 2000 it turned into PSA.

Participating Countries: SOCAR (51%), Attila Do ğan (31.5%), Land and General Berhard (17.5%).

Estimated Reserves: 219 million barrel petroleum (Neftchala, Killi, Babazanan Fields).

Status: In 1998-1999 4 wells were drilled. In 2004 the average petroleum production volume was 77000 bpd'dir. In 2004 average natural gas procution volume was 1.1 mef/day.

3.5.3. AzGeroil Agreement

Agreement Date: Was signed as Joint Venture in 1995.

In 2000 it turned into PSA.

Participating Countries: SOCAR (51%), Grunewald (49%).

Estimated Reserves: 140 million barrel petroleum (Ramani, Balahani Sabunchu Fields).

Status: In 1999 average production volume was 1000 tbl/d

3.5.4. Southwest Gobustan Field Agreement

Agreement date: 2 June 1998.

Approval date: November 1998.

Participating Countries:

SOCAR (20%),

CNPC of China (62.83%),

Aravvak Energy of Canada (37.17%).

Estimated Reserve: 180-200 million barrel petroleum.

Investment Amount: 900 million USD.

Status: 2-D seismic explorations are continued.

3.5.5. Zig-Hovsan Field Agreements

Agreement Date: 5 June 2000.

Approval Date: June 2001.

Participating Countries: SOCAR (50%), Lukoil (50%).

Estimated Reserves: 66-150 million barrel petroleum.

Investment Amount: 250 million USD.

Status: Fields were rehabilitated. Due to environment issues the start date of the agreement was postponed.

3.5.6. Kuisengi-Karabaghli Field Agreements

Agreement Date: 15 Date 1998. Approval Date: 16 April 1999.

Participating Countries: SOCAR (50%), CNPC (30%),

Amerada Delta-Hess JV (20%).

Estimated Reserves: 730 million barrel petroleum.

Investment amount: 1 billion USD.

Status: In order to increase the production, 10 new wells were drilled in 2003. Since June 2004 petroleum production was 6600 tbl/d.

3.5.7.Muradhanli-Jaferli-Zerdab Field Agreements

Agreement Date: 21 July 1998.

Approval Date: 20 November 1998.

Participating Companies:

SOCAR (50%),

Ramco (50%, operator).

Estimated Reserves: 730 million barrel petroleum.

Investment Amount: 1 billion USD.

Status: First well to close in Muradhanli was in April 2001.

3.5.7. Padar-Harami Field Agreements

Agreement Date: 27 April 1999. Approval Date: 9 June 2000.

Participating Companies:

Nations Energy (85%, operator),

SOCAR (15%).

Estimated Reserves: 580-750 million barrel petroleum.

Investment Amount: 140 million USD.

Status: Seismic explorations are continued.

3.5.8. Shirvan-Kurovdag Field Agreement

Agreement Date: Signed as JV in 1997. In 2000 turned into PSA.

Participating Companies: SOCAR (49%),

Caspian Energy Group (UK) (51%).

Estimated Reserves: 650 million barrels petroleum (Kurovdag Field).

Status: Since 1997 well rehabilitation is continued.

In 2004 average petroleum production was 57000 bpd, natural gas production volume was 1.5 mcf/d.

3.5.10. Western Absheron (Karadagh-Kepez-Umbaki) Field Agreements

Agreement Date: 10 August 1994.

Participating Companies: BMB (100%).

Estimated Reserves: 200 million barrel petroleum.

Investment Amount: 700 million USD.

Status: After BMB's request to stop its operation SOCAR took over the fields operations in December 1999.

3.5.11. Pirsaat Field Agreement

Agreement Date: 5 Haziran 2003. Participating Companies:

SOCAR (25%), Sheng Lee Oil (50%) Middle East (25%).

Estimated Reserves: 7 million ton. Investment Amount: 147 million USD.

Status: 7 new wells were drilled in the field, 27 were planned to rebuild and start reproduction.

3.5.12. Karachukur Field Agreement

Agreement Date: 18 Haziran 2004. Participating Companies: SOCAR (25%),

Nobel Sky (Sheng Lee Oil ve Middle East) (75%).

Status: It was aimed to construct and start petroleum production in the field that has not been active since 1954. Karachukur field consists of 121 wells. Daily production volume is 45 ton.

3.6. NON-PETROLEUM SECTORS

Azerbaijani government is aware of the danger of the country's economy being dependent on one industry or sector. Due to this it is active in developing other sectors. The goal of the economic politics of Azerbaijan is to increase the balance. International Monetary Fund, World Bank and multinational credit organizations have supported many programs in Azerbaijan.

During the reconstruction period trade, services, communication, transportation and construction sectors have been developing in Azerbaijani economy.

3.6.1. Foreign Capital in non Petroleum Sector

As known, USA and Great Britain have the most share in investments into petroleum industry, however Russia, France, Norway, Turkey, Iran and other countries are following these countries. Turkey which is the country with most investments into non petroleum sectors is followed by Iran, Great Britain and other countries.

There are 611 joint ventures, 81 representatives and a total of 1175 100% Turkish Capital companies. Moreover, around 7.0% of 3000 employees are Azerbaijani and 30% are Turkish.

Table:III.5. Foreign Capital in non Petroleum Sectors in Azerbaijan per country

Country	**2005**	**2006**	**2007**	**2008**	**2009**
Turkey	**4**	**8**	**15**	**28**	**37**
USA	**2**	**0**	**5**	**8**	**13**
United Kingdom	**0**	**0**	**0**	**12**	**5**
Germany	**3**	**5**	**8**	**9**	**11**
UAE	**0**	**0**	**4**	**9**	**14**
Russia	**8**	**10**	**12**	**14**	**19**
Other Countries	**9**	**4**	**14**	**8**	**71**
TOTAL	**26**	**27**	**58**	**88**	**170**

Source: The State Statistical Committee of the Republic of Azerbaijan(SSCRA) Publication.

Table :III.6. Number of foreign capital companies operating in different areas

	2003	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
Agriculture, hunting and forestry	-	-	-	-	2	4	11
Industry	65	265	179	149	109	141	171
Construction	12	79	115	79	48	58	62
Wholesale and retail trade	166	514	531	177	176	228	250
Hotels and restaurants service		14	17	14	11	19	23
Transport and communications	8	83	100	78	49	66	73
Real Estate services		135	259	247	129	69	112
Education		10	14	9	10	12	21
Health and Social Services		11	11	7	4	3	10
Other areas	42	13	21	15	13	9	15
TOTAL	**293**	**1124**	**1247**	**775**	**551**	**609**	**748**

Source: The State Statistical Committee of the Republic of Azerbaijan(SSCRA) Publication

3.6.2. Manufacture Industry

Petroleum equipment and related machine manufacture sectors are one of the most rapidly developing sectors. After gaining independence, chemicals, completed metal products, pipes, machine parts and other products related to petroleum based industries have shown increase, and Sumgayit being country's third largest city was assessed as a free area and attracted many foreign investors and exporters.

3.7. Some Legal Changes to Attract Foreign Investors to Azerbaijan.

The economic crisis lasting from 1992-95 in Azerbaijan was gone in 1995 in a short period of time with the help of applied economic programs and and budget gaps in 1991-94 of 13-17% lowered to 3-4%; the inflation rate of %1800 in 1994 was decreased to 20% in 1996 and 13% in 1997.

With the 3 year progress program of 1997-99 the foreign capital investments in 1995-96 were over 150 million USD. “Privatization Program” passed in August 1995 privatized 1 million 900 thousand workers and 56.147 businesses. With over 100 legal changes and widespread privatization of 1995-97 as well as protection of foreign investment the trust of foreign investers to the country has raised greatly. Within the privatization program 10.000 small businesses got privatized in a short period of time. Medium and large 450 business were turned into anomimous companies.

The removal of Azerbaijan from the risky countries to invest into was an important step in the international world for the country. To encourage foreign investment into Azerbaijan the IMF recommended the following in 1996-98:

- Lowest possible bureacracy;
- Liberalization of banking system and getting it to international standards;

Attracting foreign investors to Azerbaijani economy will play a great role in it. Necessary investments to modernize Azerbaijani economy into different areas, especially modernizing the infrastructure will play have reached an important number.

Table:III.7. Areas Needing Investment, (Billion $)

Energy	1.2-1.5
Chemical-PetroChemical	0.8-0.9
Metallurgy	1.55-1.72
Machines	0.5-0.55
Construction Materials	0.4-0.5
Food sector	0.19-0.22

Infrastructure	05.Haz

Source: The State Statistical Committee of the Republic of Azerbaijan(SSCRA) Publication.

The factors encouraging foreign investors and accepted on international levels in Azerbaijan are as follows:

1.Being able to used tax and other encouragements and/or experience same titude as local investors;

2.Easyness and independence in production and raw materials provision;

3.Independence in transferring investment profits and other sources of profit;

4.International trust;

It is easy to find specialist workforce in country. In order to see how deep these basic factors operate in Azerbaijan, it is necessary to analyze the legal changes made to attract foreign capital and their application.

Azerbaijani government demonstrates the increased amount of foreign investors as well as being decicive in the independent market economy with the decisions shown below since the transfer period until today.

1. January 1992 A Law on Protection of Foreign Capital;

2. July 1992, Membership to IMF and World Bank;

3. August 1995 The start of the “Privatization Program”;

4. The establishment of Foreign Investment Department under the Ministry of Economy in order to determine general policies, meet with potential investors and make changes to related legislation to coordinate and support foreign capital with the help of the World Bank in 1993;

5. January 1997, Exception from export certificate of all of the productc exported from Azerbaijan;

6. Transfer to free area application and establishment of free areas.

3.8. Questions faced by foreign investors.

1. Obliged taxpayers have to present a tax decalaration every three months;

2. Present application of Soviet accounting system and lacking of transfer to a single balanced accounting system;

3. Frequent change of import unit prices in the customs lists;

4. No presence of invoicing system;

5. No complete liberalization of a tax system, lacking of works on preventing double taxation;

6. Deficit of communiction infrastructure facilities;

7. Deficit of international baking system services;

8. Application of customs tax on import of every raw material and auxiliary materials used in company production;

9. Provision of 2 year tax exemption for 100% foreign companies or companies 30% or more of capital of which is foreign.

Table:III.8. Foreign investments (Million $)

Years	**Financial Credit**	**Petroleum Sector**	**Foreign companies and joint ventures**	**Other investments**	**Total**
1998	120	891,8	460,2		**120**
1999	336,2	544,5	210,4		**0**

2000	262,9	546,1	118		**118**
2001	192	820,5	79,3		**192**
2002	223	1693	318,9		**1916**
2003	238.3	2972.4	45.4	56.3	**3312.4**
2004	293	4088.1	104.2	49.6	**4534.9**
2005	698.4	3799.9	230.5	85.4	**4814.2**
2006	983.5	3422.3	368.4	203.8	**4978**
2007	1576.6	4003.3	439.1	587.1	**6606.1**
2008	2357.9	3350.7	494.1	641.2	**6843.9**
2009	1,438.30	2,412.70	624.4	992.2	**5467.6**

Source: The State Statistical Committee of the Republic of Azerbaijan(SSCRA) Publication

3.9. Foreign Investment and Investment Potential in Azerbaijan

According to calculations made by the World Bank and British "Oxford Analytical" company, Azerbaijan is in the 5th row on foreign investment between Central and Eastern Europe, Central Asia's 26 old socialist states in the transit period of 10 years. The total foreign investment into Azerbaijan was more than Poland's, Russia's, Hungary's and Chech Republic's[157].

The investments increase especially in energy and petro-chemical sectors. However, in other areas, especially in food and textile the investment climate is not where it is desired to be. While this factor is seen as a disadvantage to some investors, it can be assessed as an advantage in states as market share and first market entrance. Foreign investors are being invited to the country and and they are promised easyness of operation. İn general, foreign capital in Azerbaijan is positively met[158].

Due to important amounts of foreign investment into Azerbaijan's petroleum sector, it is now one of the most rapidly growing economies among the old Soviet Union countries. The growth in Azerbaijani economy comes from the petroleum sector and related to it construction sector, transportation sector and agriculture sector in small

[157] Nizami Suleymanov, Economic History of Azerbaijan, Baku, 2001, p. 232;Sinan Oğan

158
- Y. Hesenli, Profit Problems on Oil Profits of Azerbaijani Economy – Currency Crisis: "Destroing Increase ", "Holland Disease", and Asian Financial Virus "*Materials from the International Conference on Globalization Process in the Caucasus and Central Asia*

amounts. The rest of the economy is still. In order to attract foreign investors to non-petroleum sectors a socie-economic program of 2004-2008 was established. The Ministry of Azerbaijani Economic Development also prepared the Azerbaijani Investment Map that demonstrated to the foreign investors the investment possibilities of Azebraijan.

In 2008 a capital of 16.2 billion USD investment is expected into Azerbaijani economy. 6.8 billion USD of this amount will belong to the foreign investors. According to the state budget calculations of 2009, a capital of 650 billion Manat was planned for 80 projects. The internal investments are expected to be 10 billion USD in 2010. It is also calculated that a total investment of over 40 billion USD will be made into Caspian energy resources until 2011. According to the calculations of "MAI Consulting" British company operating in Baku, the total investment until 2030 will reach 135 billion USD [159]. It is necessary to develop existing reserves in Azerbaijan, renew the economy's technologic makes, vary the production makes, create new communication networks to atract foreign capital to country. It is a little worrying that most of the investments into Azerbaijan are made into petroleum sector and this way the important part of GDP comes from petroleum profits. One sided development of the petroleum sector causes the world market price fluctuations to effect GDP. This was clearly observed in 1998 Russian crisis.

In short, Azerbaijan is faced with a danger known as "Holland Disease", which very generally means a rapid development of one sector causes undevelopment of other sectors. It is also observed that Azerbaijan is not just depended on one sector but it is dependent on one region. Other problems resulting from foreing investment apart from the Holland Disease are as follows [160]: the increase of country debt, the direction of foreign investment and joint ventures to early profit bringing raw materials and services,

[159] D.A.Mamedov, O.A. Aliyev, "Contract of the Century and its effect on Economic Development of Azerbaijan" (Contract of the Century and Azerbaijan's economical development effect), Azerbaijan is in the 21st centruy Astana, (Ziyad Semedzade), Azerbaijan Academy of Sciences Publications, Baku 1998, p. 87

[160] "V.E.Rustemov, The Role of the Foreign Capital in the Establishment of Azerbaijani Economical Structure", Characteristics and Problems of Azerbaijani Economic Policy, Center of Economic Research of the Ministry of Economic Development of Azerbaijan Republic. Baku, 2001, pp. 27-28; R.X. Shaulov, "Regional Development Strategy in the Independence Conditions", Azerbaycan İktisadi İslahatlarının Heyata Keçrilmesi Xüsusiyetleri ve Problemleri, Azerbaycan Respublikası İgtisadi İnkişaf Nazirliyi İktisadi İslahatlar Merkezi, Bakı, 2001,

a very low amount of foreign investment into country's production industry, concentration of all of the investments in the Absheron region, an almost complete absense of foreign capital in other regions, although the credits received from international financial organizations and the advices given by them play a major role in country's macroeconomic stability, changes to improve production level and productivity level in the real sector as well as changes to solve social economic problems as nation's social security increase are not taken.

3.10. LEGAL CHANGES MADE

Considering the wellness of the investment climate of the countries in the transition period, lacking of necessary legal improvements is one of the most discussed issues by the entrepreneurs.

Azerbaijan, taking this issue in mind, has taken an important space in necessary legal improvements especially since 1995. Laws on customs, taxes, labor, state service and anti-monopoly helped perform many reforms.

Between 1995-2004 approximately all of the areas of Azerbaijani economy were considered together with specific country conditions while passing the laws. With these laws, it was tried to etablished a new legal infrastructure to shape of the economic make according to an independent market, in other words, a competitor environment as per local and international markets was tried to be created.

As per the research of the European Bank on Reconstruction and Development, Azerbaijani trade laws were considered satisfactory.

Of course, there are changes to be made and steps to be taken still. The decrees established by the President of Azerbaijan have a special importance for reforms to be applied. According to the decree made by the President in July 2002, it is observed that Azerbaijan has applies an open-door policy towards foreign investors and tries to provide necessary profitable environment.

Characteristics and Problems of Azerbaijani Economic Policy, Center of Economic Research of the Ministry of Economic Development of Azerbaijan Republic. Baku, 2001, pp. 84-86

Except for national defense, as per the new changes, foreign investors have the same rights as local investors. The businesses established by foreign investors have to be accepted as Azerbaijani businesses by law. Hence, local and foreign investors have same legal principles applied towards them. However, branches and representatives do not fall under this law's authorization. The changes in the Tax Law and procedures consolidated the desires of taxpayers on tax regime clearness.

According to additional changes applied to the Tax Laws, the financial penalty system has been simplified since 2004. As per the changes made to the Tax Law, the financial penatly will be removed for repeating legal violations. The reason in application of this mechanism is to remove conditions preventing small and medium businesses to develop.

Foreign physical and juridical persons do not legally have the right to privatize land, however they may rent it with an agreement. By giving the foreigners right to rent, they were giving many other rights.

Together with regional socio-economic progress program, the government planned to start projects within the State Investment Program since 2005. Again, to accelerate the economic progress of the country a Law on "Investment Operations" was passed. The passed law was replacing laws accepted in 1992 and 1995. This law aimed to establish an even more clear investment climate for foreign investors to raise invesments in country. It aims to direct foreign investors that invested 24 billion USD into Azerbaijan in 2005 into suck nw areas as tourism and food industry. The new law does not limit the pofit of the foreign investors.

On of the other advantages of the Law on "Investment Operations" is that vehicles entereting the country to produce or service and businessmen bringing egricutlture technology to the country are exepmt from taxes. This is a serious factor in creating complex manufacturing and servicing areas that will show its importance in establishment of independent economic regions. Moreover, it is still an issue whether foreign businessmen will receive different privileges in establishing independent

economic regions in the industrial cities. Hence, the law going into power, has provided for legal environment into flow of foreign investment to Azerbaijani regions.

In order to create an environment with independent competition the application of Anti-Monopoly Code was of great assistance. The analysis of countries macroeconomic indicators before 2009 and preparation of socio-economic progress consept was planned to increase economic importance productivity. With the works stated the export volume was planned to increase in Azerbaijan's non-petroleum sector.

3.10.1. Legal registration period of the businesses

Azerbaijani or foreign capital businesses have to register with the Ministry of Justice before establishing business. During the registration is it obligatory to present all the documents requested. The legal period of the registration process is 10 days, however on practice it lasts 2-3 times more. After the registration at the Ministry of Justice, another registrations are needed at the Social Security Organization and State Statistics Committee. With the decree announced in September 2002 by the President, the registration process of the businesses was simplified.

According to the nature of business, the documents requred to receive lisence are minimized, the state fee needed to be paid for the license was lowered greatly, the lisence validity was expanded and the lisence given was the only state procedure to fo through. The amount of operations to go through have been lowered from 240 to 30 in order to receive a running lisence and the validiy period has been raised from 2 years to 5 years.

Foreign investor can start doing business on the Azerbaijani market as 100% foreign investor of a joint venture. The specific required share rate or limit is not an issue for foreign investoment or company. The receiving of the lisence takes up to 40 days approximately.

Legally businesses are divided into 5 categories: General Patrnership, Limited Partnership, Limited Liability Company-LLC and Joint-Stock Company-JSC. The last two business types are specifically preferred legal organizations.

The establishers of the foreign investment business have to receive health expert and environmental safety reports as per the legislation of Azerbaijan Repblic. During an operation of foreign invested facilities and closing down of the same facilities these reports also need to be received. While opening natural resources to operation, establishment of large facilities or their reconstruction also requires a special feasibility expert report.

3.10.2. Protection Of Property Rights And Respect To Agreements

Investors in the transition period countries are worried about property rights and agreements. However, according to the analysis made by the EBRD Azerbaijan is one of the best countries of the transition period. Protection of property rights is in the Constitution of Azerbaijan. The Civil Law acting in 2001 covers agreements, trade relations, property rights and valuables. The Law of Civil Procedure accepted lately has simplified the law suit periods. On the other side, the decree accepted by President Haydar Aliyev in September 2002 aims to prevent illegal limitation and pressures to property owners from the government.

3.10.3.Protection of Intellectual Rights

Copyright, trademark and patent are determined by the acting legislation. Since the mid-1990's Azerbaijan created its own national system in protecting and registering intellectual rights. An updated law on copyright (Law on Copyright and Related Rights -1996), (Patentle İle İlgili Kanun-1997) and law on trademark protection (Law on Trademark and Geographical Location Sciences-1998) is in power. Moreover, Azerbaijan participated in such international agreements as Paris Agreement on Industrial Property Protection and Agreement on Literature and Artwork protection.

3.10.4. Financial Help of the State to the Private Sector

The state established Enterprise Assistance Fund. Between 2003-2005 the Fund planned to assist private entrepreneurs and budgeted 250 billion Manat for that. Credit was given in order to do that in 2003 and 2004. The clarity of the planning system, management of general standards and prevention of lack of roads were seen by the investors as important to the goal and were positively assesed as supporting the economy. Inspite of some weaknesses in the legal improvements, the distance taken in this topic can be considered as a success in the market economy.

In June 2000 President Aliyev signed the Law on Preventing Bribery. In 2001 a Law on State Service was accepted. This law stated the regulations on behaviour of state employees and their service, promotion during service and payment of the fees and related regulations. The Law planned to strengthen the state service and lower the factors resulting in corruption. The State, at the same time, started reforms in the prosecuting organs in order to develop the authorization and independence of the courts. The new changes applied to Civil Procedures and Criminal Procedures Codes brought new authorizations to judges. In September 2002 as per the President's decree, private authorization and documentation lowered from 240 to 30. This removed unnecessary bureaucratic preventions in front of the entrepreneurs and lowered extra payments in speeding the permission receiving process.

3.10.5. National Change

The Law on Protection of Foreign Capital aimed to give at least equal rights to both foreign and local investors.

The only exception showed in the Law was: while considering the location of where the foreign investor wanted to invest the capital, and if it does not negativetly affect any local investors profits he is considered advantaged.

3.10.6 Nationalization, Condemnation and Compensation

The Law on Foreign Capital Protection protects the properties of foreign investors from nationalization and condemnation. Only when country nation's profits or local population hazard is the issue or during a natural disaster or war, the

abovementioned operations could be made with compensation of the actual value of the industry.

Nationalization can only be approved by the Parliament of Azerbaijan Republic. Condemnation is only approved by the Cabinet of Ministers. The country has not had any nationalizations for the past several years. The compensation of hazards resulted from activities without state legal authorization is guaranteed.

3.10.7. Transfer of Profit or Re-Placement

Moreover, it is guaranteed that the profit of the foreign investor will go to his country. Foreign investors will be able to tranfer their profits to external banks after paying realted taxes on currenty and income.

Foreign investors are able to re-invest with the profits received in Azerbaijan, invest them into Azerbaijani banks and purchase currency with the exchange rate determined by the National Bank of Azerbaijan Republic.

3.10.8. Solution Of Disagreements

Solution of disagreements with jurisdiction may have its disadvantages, however important reforms happened in that direction in Azerbaijan. The International Law on Arbitrage has been in power since 2000. As per the Law, the parties may apply to any foreign court upon their desire. The verdict of the foreign court will be executed if it does not disturb the political stability.

The Parliament also approved the New York Agreement of 1958 on Foreign Arbitrage Acceptance and Validity. This provides with an authority of not reviewing a law suit between the Azerbaijani Government and a foreign investor in an Azerbaijani court, but solving the problem in the International Arbitrage Court. Some disagreements between the Azerbaijani Government and third parties give the foreign investor an

opportunity to apply to the International Center on Solution of Industrial Disagreements (ICSID). Azerbaijan is an actual member of the “International Agreement on Solution of Disagreements Risen Between One State and a Nationality of Another State” signed under ICSID. Mutual Industry Agreements were made upon mutual industry protection between Azerbaijan and China, France, Georgia,Ggermany, Great Britain, Italy, Kazakhstan, Kyrgystan, Lebanon, Moldova, Pakistan, Poland, Turkey, Ukraine, USA and Uzbekistan.

Because Azerbaijani local legislation depends on international agreements, mutual industrial agreements may provide positive conditions for some investor in trusting the country.

3.10.9. Assistance and Additions to Investments

In accordance with the decree signed by the Presdent in September 2002, in order to help investments a Union of Businessmen was created. The union will continuously be engaged in solution and analysis of existing problems. The union will also deal with problems of foreign investors and will assist in hearing out their issues.

3.10.10. Taxes and Tax Rates

The establishment capital of the companies and foreign companies established in Azerbaijan with foreign capital can be exported exempted from the property customs tax and VAT added in Azerbaijan. In other investments made later, the investment materials as machine-facilities unless some exceptions are subject to 5% taxation. They are exempt from VAT.

It is observed that Azerbaijan has two different types of tax regimes by the tax policy applied by the Tax M ınistry and tax collections. As per the Production Sharing Agreements (PSA) companies who operate in the petroleum and natural gas sector the most are dependent on the petroleum consortium tax regime and are under it. The official tax regime is valid for all other juridical persons.

The characteristic make of taxes in Azerbaijan is as follows: Operation Income (profit) tax from local and foreign investors is 24%. Human aid organizations profits,

grants, membership fees and all oher assistances accepted by the other non-trade organizations are not considered taxable profit. Withholding tax withdrawn from the foreigner's income changes with the income to 4%, 6% or 10%.

Individual income tax is between 0%-30% and changes progressively. Income tax of those foreigners who stay for less that 182 days, incomes of embassy and consulate employees are exceptions.

VAT rate is 18%. Consumption tax changes. Properties (vehicle, building and tc.) are not taxed duet to property type. Again, the incomes of those foreigners staying for less that 182 days, diplomats and consulate workers are exempt from taxation.

Territories are divided by type and regions in different rates. The natural field tax is between 3-26%.

The vehicles belonging to those foreigners entereing Azerbaijani territory are taxed in accordance with their type, capacity, distance and etc. Moreover, under the name of simplified taxing system, the entrepreneur or an individual are taxed 4% in Baku and 2% in other region independently on their activities, materials and services sale. VAT is not included into property and income tax payments.

3.11. Applicable Investment Locations for Investors

After the collapse of the Soviet Union, Azerbaijan, as every other country in the CIS started to experience periods of complete inaction while transfering into a country that just started to learn independence in economy. The centralized and planned economiy did not leave a great legacy. Previously Azerbaijan was purchasing raw materials from abroad, after the collapse of the Union even the big factories stopped operating due to lack of raw materials.

Some factories that were operating were not in their optimum capacity. In these negative condition of economic make there was a need in external sources. From this time one, underground treasures are under control of Azerbaijan, and in order to raise the manufacture capacity and competition strentgh these sources and factories needed foreign investment to sign agreements to work together in the global market.

This way, foreign capital investors may invest into major fields in Azebaijan:

Raw petroleum and natural gas production and operation

Field production and exploration

Fruit-Vegetable sun-drying operations facilities establishment

Wine and water bottling facitites establishment

Tobacco manufacture and operation

Cotton and wool operationss facilities establishment

Synthetic detergent, soap, shampoo and other cosumer good production

Plastic particles production facility establishment

Sanitary facilities and ceramic materials manufacture

Cement and other construction materials production

Sun collector, aluminium, wood or other materials manufacture

Electronic home appliances, radio, televions manufacture

Digital phone stations and eqiuipment manufacture

Establishment of business center and hotel complexes

Iron and steel materials manufacture facilities

Chocolate and sweets facilities establishment

Confection production

Leather clothing and shoes manugacture

Milk and Dairy products manufacture and production.

Establishment of Hospitals and polyclinics

Production of agriculture equipment and machines

Establishment of Animals and fish selling

Procution and marketing of Autobomile, Trucks, their manufacure and credit.

Establishment of flour landmill

Establishment of a new factories

PART IV

4. MODEL STUDY CONCERNING EFFECTS OF FOREIGN DIRECT INVESTMENTS ON AZERBAIJANI ECONOMY

4.1 Literature Review

In theoretical and empirical studies analyzing the relation between Foreign Direct Investments (FDI) and economic growth (Gross Domestic Product), different conclusions have been reached. In some studies performed, it is found that FDI affects GDP positively and in other studies it is determined that the positive effect is from GDP toward FDI and in some other studies, it is found that there is no relation among these variables.

For example, Borensztein vd. (1998), Xu (2000) have concluded that the Foreign Direct Investments affect growth positively win the case that the countries' education level is high. Gruben and Mclead (1998) and Zhang (199, 2001) have supported Borensztein (1998) in their studies and revealed that direct foreign capital entries stimulate the growth. Alfaro vd. (2004), Durham (2004), and Hermes and Lensink (2003) have emphasized that the positive effects of Foreign Direct Investments would be possible only if the countries have developed financial markets.[161]

By using Toda-Yamamota causality analysis by Chowdhury and Mavratos (2005), the causality relation between Foreign Direct Investments anSd economic growth in Chili, Malaysia and Thailand in the period of 1969-2000 was investigated. In consequence of the study, it was determined that the causality direction in Chili was one-way and was from economic growth toward direct foreign capital investments. And in Malaysia and Thailand, it was found that there was a two-way

[161] Alagoz Mehmet, Erdogan Savas, Topallı Nurgul, Direct **Foreign Investments and Economic Growth: Turkey Experience 1992-2007**, p.81 (Online) www.sbe.gantep.edu.tr/hournal/index.php/sbd/article/viewPDFInterstitial/25/24.07.02010

strong causality between Foreign Direct Investments and economic growth.[162]

Carkovic and Levine (2002), at the research carried out for the period of 1960-1965, couldn't find a significant effect of Foreign Direct Investments on growth in developed and developing countries, but encountered that there was irregular effects in 5-year periods. [163]

Mencinger (2003), in the study carried out for the period of 1994-2000 for transition economies, couldn't find a causality relation between FDI/GDP and Fixed Capital Investments/GDP and this conclusion has revealed that Foreign Direct Investments are bound to acquisition investments and privatization applications performed quickly and make the effect on growth indistinct.[164]

Sen and Karagoz (2007) investigated the effect of Foreign Direct Investments on export and growth by using 1994 first quarter and 2004 second quarter data. In consequence of the study, a strong relation of %86.6 was encountered between growth and export, whereas a medium-strong relation of %54 was encountered between growth and direct foreign capital investments. And according to the result of causality test made in the study, export was a cause for GDP whereas no causality was found in other combinations.[165]

4.2 Data Set and Method

In this study, the causality relation between FDI and GDP and Export was analyzed by using SPSS 15.0 package program. For this purpose, time series of quarter year (1995:Q1-2009:Q4) concerning FDI, GDP and Export variables were used.

Data used in the study were taken from the Electronic Data Archive of The National Bank of Azerbaijan Republic (NBAR) and The State Statistical Committee of the Republic of Azerbaijan (SSCRA). Data concerning all three variables were expresses in dollar as currency. The data is presented in Table: IV.1.

[162] Ibid. p.83
[163] Ibid p.83
[164] Ibid. p.82
[165] Ibid. p.82

Table: IV.1 Quarterly Data concerning GDP, EXPORT and FDI Belonging to the Period of 1995-2009 (Million USD)

DATE	FDI	GDP	EXPORT	DATE	FDI	GDP	EXPORT
Q1 1995	39,8	272,8	201,8	Q3 2002	528,2	1576,1	722,2
Q2 1995	40,2	475,5	203,7	Q4 2002	738	1894,4	826,7
Q3 1995	31,7	660,4	160,5	Q1 2003	681,3	1677,4	779,3
Q4 1995	43,1	725	218,7	Q2 2003	853,4	1669,6	779
Q1 1996	151,9	467	203,9	Q3 2003	900,1	1980,5	653
Q2 1996	153,3	599,3	205,8	Q4 2003	936,2	1948,5	845,2
Q3 1996	120,8	778,2	162,2	Q1 2004	1338,9	1915,2	838,6
Q4 1996	164,6	888,2	221	Q2 2004	1157,1	2094,4	1067,6
Q1 1997	274,5	552,2	295,7	Q3 2004	1021,8	2233,6	1045,8
Q2 1997	277,1	702,1	298,5	Q4 2004	1057,7	2436,7	1283
Q3 1997	218,4	820	235,3	Q1 2005	1078,2	3131,5	1258,2
Q4 1997	297,6	113,9	320,6	Q2 2005	1128,9	3128,3	1872,7
Q1 1998	305,1	658,7	259,6	Q3 2005	1298,2	3279,5	2362,9
Q2 1998	395,3	730,6	262	Q4 2005	1387,9	3695,1	2838,1
Q3 1998	465,2	1001,5	206,5	Q1 2006	1345,9	4235,5	2652,3
Q4 1998	306,4	837,9	281,4	Q2 2006	1394,1	5929,9	3179,8
Q1 1999	277,8	611	329,9	Q3 2006	1325,8	5583,8	3901
Q2 1999	379.4	722,1	332,7	Q4 2006	987	5234,4	4221,5
Q3 1999	441,9	987,4	262,3	Q1 2007	1537,2	5145,4	4291,9
Q4 1999	371,4	971	357,3	Q2 2007	1659,6	6894,3	5518,5
Q1 2000	251,3	1198,4	544,6	Q3 2007	1698,2	9072,4	5382,9
Q2 2000	271,7	1274,2	549,7	Q4 2007	1779,3	11789	7323,5
Q3 2000	220,4	1389,2	433,3	Q1 2008	2345,1	13456,3	12615
Q4 2000	183,6	1411	590,4	Q2 2008	2459,5	15698	10424,5
Q1 2001	247,2	1358	579,2	Q3 2008	1098	12345	4291,9
Q2 2001	268,1	1142,6	605,5	Q4 2008	944,8	6893,2	5518,5
Q3 2001	287,5	1556,1	624,5	Q1 2009	967,9	7.894,0	5615
Q4 2001	289	1651	559,5	Q2 2009	1589,4	10.897,3	5424,5
Q2 2002	429,6	1328	529,1	Q3 2009	1837,4	13.745,5	6291,9
Q2 2002	539,1	1425,2	589	Q4 2009	1073,9	10.784,2	5518,5

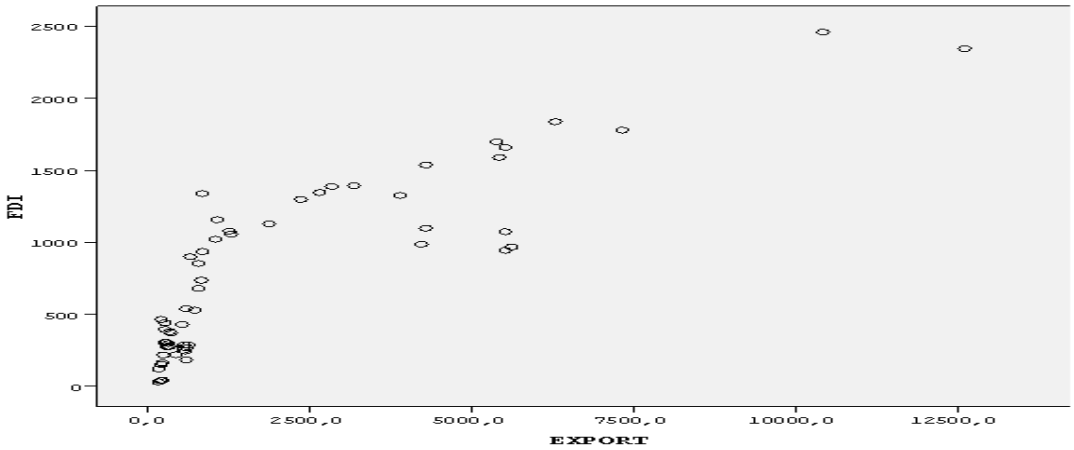
Source: The National Bank of Azerbaijan Republic (NBAR) and The State Statistical Committee of the Republic of Azerbaijan (SSCRA)

To see whether there is a relationship between FDI and GDP, also between FDI and Export I used Correlation analysis. The correlation is one of the most common and most useful statistics. A correlation is a single number that describes the degree of relationship between two variables. While using correlation analysis the three points should be considered.[166]

1. Relationship should be linear.
2. Number of data should not be less than 30.
3. There should not be inconsistency on values.

To find weather the relationship is linear or not, can only be determine by visual way .Therefore, before using this analysis we should test the linearity of these relationships by using Scatter Plot. A scatter plot can suggest various kinds of correlations between variables with a certain confidence interval. Correlations may be positive (rising), negative (falling), or null (uncorrelated). If the pattern of dots slopes from lower left to upper right, it suggests a positive correlation between the variables being studied. If the pattern of dots slopes from upper left to lower right, it suggests a negative correlation.

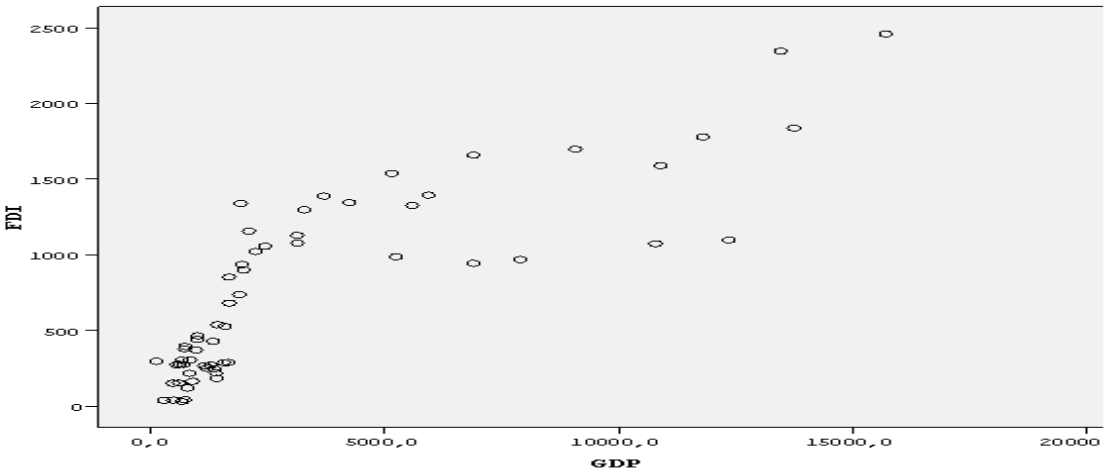
Figure IV.1 Scatter Plot (FDI & EXPORT)



[166] Beril Sipahi, E.Serra Yurtkoru, Murat Cinko,"Sosyal Bilimlerde SPSS'le Veri Analizi", second edition, February, **2008,** p.146

As it is seen in the graph above, the pattern of dots slopes rises from lower left to upper right; it suggests a positive correlation between FDI and Export. It means FDI has linear relationship with Export.

Figure IV.2 Scatter Plot (FDI & GDP)



As it is seen in the graph above, the pattern of dots slopes is looks like graph of FDI and Export. So there is a positive correlation between FDI and GDP and also linear relationship.

Table: IV.2. Correlations Analysis (GDP & FDI)

Correlations

		GDP	FDI
GDP	Pearson Correlation	1	,840**
	Sig. (2-tailed)		,000
	N	60	60
FDI	Pearson Correlation	,840**	1
	Sig. (2-tailed)	,000	
	N	60	60

**. Correlation is significant at the 0.01 level

The most familiar measure of dependence between two quantities is the Pearson product-moment correlation coefficient, or "Pearson's correlation." It is

obtained by dividing the covariance of the two variables by the product of their standard deviations. As it is seen in the above table, Pearson correlation coefficient is 0.840.In this case, there is a perfect positive (increasing) linear relationship between FDI and GDP.

Table: IV.3. Correlations Analysis (EXPORT & FDI)

Correlations

		FDI	EXPORT
FDI	Pearson Correlation	1	,858**
	Sig. (2-tailed)		,000
	N	60	60
EXPORT	Pearson Correlation	,858**	1
	Sig. (2-tailed)	,000	
	N	60	60

**. Correlation is significant at the 0.01 level (2-tailed).

While analysis correlation table above shown, the pearson correlation coefficient was 0.858, which is explain the higher linear relationship between FDI and Export.

For a linear correlation, the best-fit procedure is known as linear regression and is guaranteed to generate a correct solution in a finite time. Regression analysis helps us understand how the typical value of the dependent variable changes when any one of the independent variables is varied, while the other independent variables are held fixed.Therefore, in this thesis regression analysis was used with the help of SPSS Program. The hypothesis that used in this part are:

H0: FDI has not explanatory power on GDP.

H1: FDI has explanatory power on GDP.

And

H0: FDI has not explanatory power on EXPORT.

H1: FDI has explanatory power on EXPORT.

Here, GDP is independent variable, while GDP and Export are used as dependent variables.

Table: IV.3. The result of regression analysis -Model Summary (GDP & FDI)

Model Summary(b)

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	,840(a)	,705	,700	2172,5491	1,328

a Predictors: (Constant), FDI
b Dependent Variable: GDP

While analysing R and R square in the above model summary table, the explanatory power of the model will be understood. As a result of regression analysis FDI variable explains GDP variable in 70.5 % ratio at the level of significance.As the value of Durbin-Watson is higher than 0.8, there is not auto-correlation.

Table: IV.4. The result of regression analysis -ANOVA (GDP & FDI)

ANOVA[b]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	6,5E+008	1	654287142,3	138,621	,000[a]
	Residual	2,7E+008	58	4719969,627		
	Total	9,3E+008	59			

a. Predictors: (Constant), FDI

b. Dependent Variable: GDP

As it is seen in the ANOVA table, because the value of F was 138,621 and p value (sig.) was ,000, was decided to reject the H0 (null hypothesis). In generally, it constituted that the regression model is statistically significant. In other words, it is possible to estimate GDP with the help of FDI.

Table: IV.5. The result of regression analysis -Coefficients (GDP & FDI)

Coefficients [a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-771,100	453,598		-1,700	,094
	FDI	5,488	,466	,840	11,774	,000

a. Dependent Variable: GDP

If we look to t (11,774) and p (.000) values in the above table, GDP can be estimated by FDI.

Table: IV.6. The result of regression analysis -Model Summary (EXPORT & FDI)

Model Summary(b)

Model	R	R Square	Adjsted R Square	Std. Error of the Estimate	Durbin-Watson
1	,858(a)	,735	,731	1385,5811	1,450

a Predictors: (Constant), FDI
b Dependent Variable: EXPORT

While analysing R and R square in the above model summary table, the explanatory power of the model will be understood. As a result of regeression analysis FDI variable explains Export variable in 73.5 % ratio at the level of significance. As the value of Durbin-Watson is 1,450 which is higher than 0.8, there is not auto-correlation.

Table: IV.7. The result of regression analysis -ANOVA (EXPORT & FDI)

ANOVA[b]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	3,1E+008	1	309486339,8	161,205	,000[a]
	Residual	1,1E+008	58	1919834,876		
	Total	4,2E+008	59			

a. Predictors: (Constant), FDI

b. Dependent Variable: EXPORT

Table: IV.8. The result of regression analysis -Coefficients (EXPORT & FDI)

Coefficients [a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-887,219	289,290		-3,067	,003
	FDI	3,774	,297	,858	12,697	,000

a. Dependent Variable: EXPORT

As it is seen in the tables IV.7 and IV.8., the value of F was 161,205, t value 12,697 and p value (sig.) was ,000, was decided to reject the H0 (null hypothesis). In generally, it constituted that the regression model is statistically significant. In other words, by looking FDI figures it is possible to estimate Export.

At the end of the regression analysis, it has been esteemed that within the time period of this study, FDI affects the economic growth (GDP) in Azerbaijan. This result was against to the studies of Alagoz, Savas and Topall ı (2008) , make discrepancy to the study results of Carkovic and Levine (2002), Mencinger (2003), Sen and Karagoz (2007).

CONCLUSION AND SUGGESTIONS

Following the “Contract of the Century”, which has been signed between Azerbaijan and international petroleum companies in 1994, regarding the production of energy reserves in the Caspian Sea, the flow of direct foreign capital investments, especially for energy sector, has begun. Within the past sixteen years, Azerbaijan has come to the fore among the other Commonwealth of Independent States (CIS), in terms of attracting foreign capitals. In parallel with this development, the macroeconomic indicators, such as Gross Domestic Product (GDP) and export, have distinguishably increased.

In this study, definitions on Foreign Direct Investments (FDI), various approaches to FDI in literature, decision making process in FDI, the factors that affect FDI in terms of foreign and host nations, the importance of FDI in Azerbaijan, investment climate, investment potential etc. subjects have been reviewed. In the last chapter, a regression analysis has been conducted with the help of SPSS 15.0 packaged software to find out the rate that FDI affects GDP and exportation. At the end of this analysis, there were relation and correlation between FDI and GDP, it has been seen that the regression coefficient was meaningful, after the parameter estimation of the model for these variables, thus, it has been seen that FDI can explain the variances in GDP.

After the theoretical and statistical reviews of the importance of FDI, investment climate and investment potentials in Azerbaijan, the following suggestions, which are considered to be beneficial for the country, may be given:

Along with satisfying all conditions to strengthen and protect the flow of foreign investments, emancipation from “Dutch Disease” should be placed among the essentials of the economic policies. This leads to an economic growth, which is built up on the export of natural resources, depletion of the reserves, and poor living standards,

except for a small group of people.

To avoid industrial dependency, the sectors other than petroleum must be supported sensitively and intensely supported. The primary sectors to be supported are agriculture, stock farming, and food industry. The foreign capital must be attracted to these sectors in the first place.

In order to prevent the return of foreign capital and its profit, policies that encourage and support foreign capital entrance must be applied. The most important one among these policies is the reclaiming of the investment climate.

The establishments, which try to provide the flow of foreign investments, must be more actively coordinated by the government. The attractive advertisements and information must be provided about the sectors other than the energy resources.

Bribery and fraud must be fought against more professionally; the monthly income of the civil servants must be above the minimum subsistence standards.

Bureaucratic procedures must be at minimum level and artificial obstacles must be ruled out. The monopolies that are opposed to free market economy must not be allowed to overcome unfair competition.

The government's influence on the economy must be reduced by taking firm steps in corporatization.

Turkish businessmen and Turkish capital must be more active in Azerbaijan's economy by using historical, geographical and cultural advantages.

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