

Economic change and the business environment in the South Caucasus

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Abstract

On gaining independence in 1991, the three countries of the South Caucasus, Armenia, Azerbaijan and Georgia, faced similar economic and political challenges. Their industries and infrastructure had been devastated by the break-up of the Soviet Union. But while these challenges were similar, among them inter-ethnic strife and external threats, the resources at hand to deal with the birth pangs of nationhood were very different. Azerbaijan, with its larger population and oil and gas wealth, had a real advantage over Armenia, with its mineral wealth in the form of diamonds, and resource-poor Georgia. The surprise was that Georgia and Armenia, despite their relative disadvantages, managed to keep pace with Azerbaijan in economic development for the first 14 years of independence. Thereafter, Azerbaijan pulled ahead with increasing rapidity. Throughout these years, similar problems have bedeviled the economies of all three nations: corruption, political and economic oligarchies, narrow wealth distribution, and an absence or decline of skill bases. The erratic and inconsistent attempts to address these challenges have left much to be desired.

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On gaining independence in 1991, the three countries of the South Caucasus, Armenia, Azerbaijan and Georgia, all faced similar economic challenges. Their industries and infrastructure had been integrated into the Soviet Union, and its collapse caused severe disruption in all three countries. The demand for their manufactured goods, often shoddy in quality and poorly designed, fell dramatically. The loss of skilled labor when many of the ethnic Russians who had held senior positions emigrated to Russia and elsewhere, damaged chances of a quick recovery. Political crises in all three countries, including a war between Armenia and Azerbaijan (with large-scale movements of refugees and internally displaced peoples in Azerbaijan) and breakaway tendencies in parts of Georgia, hampered recovery efforts. The loss of markets and collapse of industry led to mass unemployment, hyperinflation and a dollarization of the economies. To this extent, all three countries were in a similar state of chaos at the outset. Since then, each has faced its economic challenges with elements of success and failure. Perhaps surprisingly, given their different levels of economic resources and potential, each country has, at the prompting of international agencies such as the International Monetary Fund (IMF), faced its challenges in a similar way, and reached a similar level of economic development, with business

environments across the three states now comparable.

Azerbaijan with its abundant hydrocarbon wealth has emerged the most economically developed of the three. But both Georgia and Armenia, though they have fewer obvious economic advantages and lower GDPs, have social indicators not markedly different from Azerbaijan.

Until 1995, the whole South Caucasus was pretty depressed. Azerbaijan and Armenia did not arrange a ceasefire until May 1994 but there were sparks of dynamism, especially in the former after the signing of the 'Contract of the Century', the contract for the development of the Azeri, Chirag and Deepwater Guneshli oil fields, in September 1994.

The economic development of the region can best be judged by looking at a range of factors, including infrastructure, the health of the banking and finance sector; inflation and other statistical data; corporate law; corruption and other business-inhibiting factors; bureaucracy, and so on. However, we will start with a look at natural resources, important for Azerbaijan and Armenia and, indirectly, for Georgia as well.

Natural resources: a curse or a blessing?

Until 1995, the whole South Caucasus was pretty depressed. Azerbaijan and Armenia did not arrange a cease-fire until May 1994 but there were sparks of dynamism, especially in the former after the signing of the 'Contract of the Century', the contract for the development of the Azeri, Chirag and Deepwater Guneshli oil fields, in September 1994.

That contract spawned a climate of optimism. The oilmen were starting to arrive in larger numbers, though it was well into 1994 before the oil workers started to outnumber the Christian evangelists and humanitarian aid workers. At the time, this spirit of optimism was evident everywhere in Baku, if not in rest of Azerbaijan or the South Caucasus. It was manifested in the sudden crop of new banks, many of which were little more than pyramid (or 'Ponzi') schemes - many of which went bust within a year. And whoever said smoking was bad had never lived in a city with unlit streets - the arrival of 'Big Tobacco', with their advertising light boxes, at least meant lights on the street at night. Baku's economy was starting to move out of the doldrums.

The region experienced a mini-boom in 1997-1998; however, it was a false start. Though by the end of 2002, Azerbaijan had some 17 active ex-

ploration, development and production sharing agreements in the hydrocarbons sector, some had already collapsed, either due to lack of success in the exploration stage, or because declining oil prices in the late 1990s made development non-economically viable. The 2000 - 2004 period was a time of commercial depression for Azerbaijan. The price of oil was down to as little as \$25 a barrel in 2002. It was not until the oil pipeline from Baku to the Turkish Mediterranean port of Ceyhan started operating, in May 2005, that the Azerbaijani economy began to take off. It was a happy coincidence (helped by the 2003 U.S. invasion of Iraq) that there was also a jump in oil prices. A year later, gas was being pumped through the new South Caucasus Pipeline to Erzurum.

The new oil and gas pipelines brought indirect economic benefits to Georgia, which receives transit tariffs. Georgia's position is neatly summed up by a report of the NATO Parliamentary Assembly: "Bolstered by the construction of the Baku-Supsa oil pipeline, GDP grew by 11% in 1997. By 1998, economic and structural reforms ceased, and a period of stagnation ensued. The slow pace of economic growth between 1998 and 2003 (3-3.5%) served only to widen the gap between the impoverished majority and the wealthy few, and an estimated

52% of Georgians were living below the official poverty line”.¹

Armenia has its own natural resources, notably diamonds, and its diamond cutting industry is, or at least was, an important foreign exchange earner. The price of diamonds is not as volatile as the oil price has been in recent decades, though diamond prices have also increased about 60% since 2005². In 2000, diamonds accounted for 40% of Armenia’s net exports³. However, the diamond processing industry has been hard-hit by the appreciation of the Armenian dram, which began in 2003. In the first half of 2007, Armenia’s diamond production was down by almost half on the previous year⁴, though it has since recovered a little.

One might assume that with its rich natural resources, Azerbaijan would be developing at a significantly faster pace than the other two South Caucasian republics. But this does not seem to be the case. Under the IMF’s reckoning, Azerbaijan and Armenia will have grown at about the same rate during the 2010-2012 period,

and Georgia will have outstripped them both. Unemployment, which is a good indicator of economic performance, is high in all three countries. According to official data, Azerbaijan’s unemployment rate is about 10%, compared to 19% in Armenia, and 17% in Georgia (2009 figures)⁵. However, official statistics in all the countries are suspect and real unemployment rates are probably higher, and considerably higher if one includes the under-employed.

One might also expect that Azerbaijan, suffering from the resource curse, would have much higher rates of inflation than in the other two republics. But this is not the case. Georgia and, especially Armenia, have also had high inflation rates⁶.

Economic spinoffs

Each of the three South Caucasus nations has experienced a construction boom (more accurately, a number of mini-booms), though in each case the capital city has benefitted more than the rest of the country. Baku was probably the first of the capitals to experience a significant expan-

1 NATO Parliamentary Assembly, paragraph 8, 170 ESECEW 07 E rev 2 - Economic And Political Transition In Georgia, <http://www.nato-pa.int/default.asp?SHORTCUT=1171>

2 See, http://www.diamondse.info/for_diamond_price_trends. Viewed for this article on 7 December 2011.

3 See the statement of 16 November 2011 of the Government of Armenia Minister of the Economy, Mr. Tigran Davtyan, reported in <http://www.panarmenian.net/eng/news/83950/> viewed on 8 December 2011.

4 See, <http://www.armtown.com/news/en/rfe/20070723/200707231/>, viewed for this article on 7 December 2011.

5 See IMF Regional Economic Outlook, 31 October 2011, <http://www.imf.org/external/pubs/ft/survey/so/2011/car102711a.htm>, viewed 7 December 2011

6 In 2010, consumer price inflation in Armenia, Azerbaijan and Georgia respectively was 8.2%, 5.7% and 7.1%. This information is derived from the World Bank based on official data. <http://data.worldbank.org/indicator/FP.CPI.TOTL.ZG/countries>. However, official statistics can be notoriously unreliable. For instance, the American Chamber of Commerce in Azerbaijan’s inflation survey puts 2010 inflation for Azerbaijan at 6.53% - see <http://www.amchamaz.org/default.html?ProjectPage=3>, viewed on 10 December 2011.

sion and modernization in its housing stock, initially to cater for the oil workers, but also the increasing influx of people from poor rural communities. The Hyatt Regency was Baku's first quality hotel, opening in 1995. That was when the city started to buzz. Not only did it provide a key symbol of modern living, it was also the first public space where western businessmen could feel relaxed and comfortable. "It also had an important economic impact on the city. Before the hotel opened, British Airways had already started scheduled flights to Baku to meet the growing demand from the oil companies and oil service sector. But the flights went through Bucharest. Now, with an acceptable hotel for their crew, British Airways could fly direct. Once it could do that, more businessmen were willing to visit. And with a good quality hotel, more senior executives, unused to roughing it in Soviet-era hotels, were ready to explore new opportunities. Other airlines, such as KLM, also saw the opportunity to develop routes, and to use Baku as a stop between Tehran and Amsterdam"⁷. The construction of a single luxury hotel changed the whole economic development dynamic- if not for the country as a whole, then at least for the capital, Baku. The boom that was taking place in Baku also led to the blossoming of casinos, which

7 Bati, A., *The Rise and High-Rise of Post-Independence Baku, Impact Azerbaijan*, issue 12, summer 2011, based on a similar piece posted on the author's blog on 11 October 2010: see stirringpottage.blogspot.com.

spilled over from Baku to Tbilisi and Yerevan. Casino-tourism had arrived, with players flying in from Israel, Turkey and Iran. While Azerbaijan has since clamped down on casinos, they continue to thrive in both Georgian and Armenian.

Both Tbilisi and Yerevan were behind Baku in the hotel stakes, understandably, given that they have neither the oil wealth or nor a comparable population. For a while, they almost caught up, with the Marriott opening in both cities and the Golden this and Golden that in Yerevan⁸. But Azerbaijan's success in the 2011 Eurovision Song Contest has spurred more development in Baku in readiness for hosting the 2012 extravaganza, and it will soon leave the other capitals far behind in terms of upmarket hotel accommodation. And Azerbaijan has, given its larger coffers, been more prone to wild splurges that have yielded little in the way of long-lasting public benefit. Nevertheless, Azerbaijan early on realized the importance of maintaining and upgrading oil and gas infrastructure.

However, thriving economies require electricity and other sources of power. The depressed nature of demand in the 1990s did not encourage the South Caucasus to develop more supply or to properly maintain the

8 For a report on Armenia's economic growth, see S Mitra, D Andrew, G Gyulumyan, P Holden, B Kaminski, Y Kuznetsov, E Vashakmadze: *The Caucasian Tiger, sustaining economic growth in Armenia*, World Bank, 2007

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existing sources of supply. So when the recovery came, it was held back by power shortages. Even today, all three countries face power difficulties and low or fluctuating voltage. Nonetheless, the countries have started to tackle the problems, raising tariffs and modernizing and upgrading the infrastructure.⁹

There is one curious economic fact that merits mention. Workers' remittances and the earnings of non-resident workers in all three countries have increased significantly. Normally, one would expect workers' remittances from migrant workers to be strong where the local economy is not doing well and causes workers to seek employment abroad. Russia has been an obvious destination for migrant workers from all three republics. World Bank data reveals that in 2000 remittances/non-resident worker earnings were significant for Georgia (\$273m) but less so for Armenia (\$87m) and Azerbaijan (\$57m). However, by 2010, this had become a much more important category of income for Azerbaijan (up 25 times to \$1.4bn) than the other two (for whom it nonetheless continues to play a

⁹ For a study on Azerbaijan's power sector as it was in 2003, see *Sector Study for Power Sector in Azerbaijan Republic*, Oct. 2004, a study financed by the Japan Bank for International Cooperation.

significant role), presumably due to well-paid foreign oil workers¹⁰.

The Caucasian dilemma

In order to foster economic development¹¹, each of the three republics had to stabilize the economy and restore confidence; to adopt new legislation more appropriate to a capitalist economy and designed to encourage investment; and to tackle corruption, business ethics and corporate governance. The records of all three nations are mixed but, perhaps surprisingly, Azerbaijan has been least successful overall.

In terms of stabilizing the economy and restoring confidence, each republic has had a degree of success. They have closely followed the advice of the IMF and their macro-economic management has been good. The banking sector, although constricted by the global financial crisis, has not suffered significantly, though the region is 'over-banked'. Azerbaijan's management of the banking sector has been careful, though not careful enough to prevent the exit in 2002 of the only global bank operating in the country, HSBC. HSBC continues to operate in Armenia and Georgia. Still, confidence in the banking sector in all three countries has greatly

¹⁰ Cf. World Bank <http://data.worldbank.org/indicator/BX.TRF.PWKR.CD.DT/countries>.

¹¹ In a different form a part of what follows appeared on the author's blog (<http://stirringpottage.blogspot.com>) on 10 April 2011, entitled: *From Humble to Jumble: the Role of Law in Post-Independence Azerbaijan*

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improved since independence, when citizens were very wary of banks altogether. One example of this confidence in banks and currency stability can be seen in bank deposits and lending in Armenia: resident deposits have increased eight-fold in the period October 2000-October 2011, while lending has increased almost 12 times over the same period. At the same time, the proportion of lending in foreign currency has decreased by 25% and lending to households has increased by 11%.¹²

Although none of the three stock markets is very active, Armenia and Georgia have done more than Azerbaijan in creating an environment that facilitates the raising of capital – in 2008 Yerevan's exchange was bought by the Nasdaq-OMX group and Tbilisi has 135 companies listed on its exchange. In comparison, issuers on the Baku Stock Exchange exist largely in name only, being mainly banks and insurance companies, the liquidity of whose stock is almost non-existent,

¹² <http://www.cba.am/en/SitePages/statmonetaryfinancial.aspx>, viewed 4 December 2011.

Each of the South Caucasus nations faced similar legal challenges in trying to bring about an ordered economy. Their legal systems had a shaky, and strife-riven, start to life. When the Soviet Union collapsed in 1991, the new nations were left with a legal dilemma. There were essentially two co-existing bodies of law – the laws, rules and regulations passed by the legislative bodies of the Soviet Socialist Republics; and the legislation of the Soviet Union, including all the multilateral and bilateral treaties to which the Soviet Union was party. Azerbaijan, for one, in large part denounced the laws of the Soviet Union, including most of its treaties, retaining a handful of fundamental laws, primarily the Codes covering such matters as civil, housing and employment law. Faced with war with Armenia (the ceasefire was not agreed until May 1994), a dislocated and collapsing economy, and a loss of faith in the Azerbaijani currency, the country moved quickly to try to attract foreign investment and foreign advisers. Georgia and Armenia moved with similar intent.

In 1992, Azerbaijan ratified the law *On the Protection of Foreign Investments*, a piece of legislation still in force (in an amended form). As part of this early investment-friendly climate, in 1994 Azerbaijan also signed the first of its new double taxation treaties, with the United Kingdom, which was about to become Azerbai-

jan's biggest foreign investor. That treaty was the first on what is now a well-trodden path.

And, with great fanfare, in September 1994 the Contract of the Century was signed with oil companies for the development of the Azeri, Chirag and deepwater Guneshli fields. From a legal perspective, this agreement was an important milestone, as it was subsequently passed into law and thereby set a precedent not only in the realms of offshore exploration, development and production of hydrocarbons, but also for some onshore fields, the main oil and gas export pipelines, and for certain gold-mining ventures. Although the exact legal status of such private contracts passed into law has never really been clear, they have formed a foundation for the economic development and political stability of Azerbaijan¹³.

The double tax treaty between Azerbaijan and the United Kingdom was not only the first of many, but perhaps also exemplary of a problem which Azerbaijan, more than its South Caucasian neighbors, faced in its early days: the English-language version was the only official text, as an Azerbaijani draft apparently could not be prepared in time for the signing ceremony. The reasons for this could

be many but the possibility remains that Azerbaijan's senior lawyers and ministers did not have a sufficiently sound knowledge of the Azerbaijani language to draft and scrutinize laws (or treaties) in Azerbaijani, even using the Russian Cyrillic alphabet.

In Azerbaijan at least, before independence the best lawyers were educated in the Russian-language sector. They struggled with legal texts drafted in Azerbaijani (first introduced in the Cyrillic script and then in a modified Latin script). They would first compose their sentences in Russian, and then put them into a stilted form of Azerbaijani. Matters were made even worse when foreign consultants were involved: they would draft in a foreign language, which would then be translated into Azerbaijani by lawyers whose primary language was Russian and, when used by foreign lawyers, translated back into English via the same convoluted process. The result was often a jumble of words making little sense. To this day, though the situation is much improved, a sound command of Azerbaijani legal terminology continues to be a problem for legal draftsmen in Azerbaijan.

It is in the area of taxation that Azerbaijan can justly claim to some impressive advances, both in the technical knowledge of inspectors and also in the increased accessibility of the system through the introduction of electronic tax filing. The Azerbaijani

¹³ For the constitutional status of oil and gas production sharing agreements made in the 1990s, see Alum Bati, *The Legal Status of Production Sharing Agreements in Azerbaijan*, *Journal of Energy & Natural Resources Law*, vol. 21, no. 2, 2003

Ministry of Taxes has, perhaps chief of all ministries, shown itself willing to engage with the business community.

As for Armenia, legal reform was summed up by the European Bank for Reconstruction and Development (EBRD) in 2009, as follows: “Although commercial laws have improved, both the quality of individual commercial laws and their implementation require substantial reform. Thus the capital market’s legal framework according to a recent EBRD assessment was rated as “medium compliance”, revealing a state-dependent market regulator, a lack of framework for collective investment vehicles and of a clear policy towards market development.”¹⁴ Nonetheless, the EBRD’s 2008 Transition Report still placed Armenia and Georgia ahead of Azerbaijan in terms of development of core commercial and financial laws and the state of economic transition. The World Bank in its “ease of doing business” table ranks Georgia (16th) well ahead of Armenia (55th) and Azerbaijan (66th)¹⁵. That is probably an overly pessimistic assessment of Azerbaijan (or perhaps an overly optimistic one of Georgia).

The problem of the rule of law in all

¹⁴ See *Commercial Laws of Armenia, an Assessment by the EBRD*, July 2009, p. 3, <http://www.ebrd.com/downloads/sector/legal/armenia.pdf>

¹⁵ *Doing Business 2012, Doing Business in a More Transparent World*, <http://www.doingbusiness.org/reports/global-reports/-/media/FPDKM/Doing%20Business/Documents/Annual-Reports/English/DB12-Chapters/Country-Tables.pdf>, viewed on 11 December 2011.

three countries is less a matter of the existence of good laws as their effective and equal application, however well-connected the parties involved may be. Corruption remains endemic, even in Georgia, which according to anecdotal evidence seems to have greatly reduced petty corruption: high-level corruption is tougher to eradicate. Transparency International’s 2011 Corruption Perceptions Index puts Georgia at 64th place (out of 182 countries), Armenia at 129 and Azerbaijan the worst of the three at 143. Azerbaijan comes out particularly badly, being the only one of the three to have slipped below its 2010 ranking.

The Millennium Bug

All three nations have seen an abundance of new legislation, often under the advice and guidance of foreign aid agencies who have not always demonstrated a full understanding of the markets with which they are dealing. In too many cases, foreign development assistance in the field of legal reform has been wasted or used recklessly. In many ways, there has been too much new legislation.

The second half of the 1990s saw some major legislative developments, especially during the initial stages of privatization. From the outset, the process was mired in controversy. It was launched, with the assistance of the World Bank, under a flawed voucher

scheme whereby all citizens were given vouchers that were in theory meant to represent a share in the state's property but in practice were almost worthless (except to a lucky few). By the end of the 90s, privatization had begun in earnest in each of the republics. In Azerbaijan, Qaradagh Cement was amongst the first of the major state-owned enterprises to be privatized¹⁶. Each republic has faced similar problems relating to transparency and effectiveness in the privatization process, though Azerbaijan seems to have suffered most.

The new millennium also brought a spate of vigorous legislative action, infecting the respective legislatures like a virus. The Azerbaijan experience is illustrative: by mid-1999 a new Labor Code had entered into force, updating the old Soviet version and incorporating the requirements of dozens of International Labor Organization conventions to which Azerbaijan had acceded. The Labor Code was followed swiftly by new Tax, Family, Civil, Criminal, Administrative Offences and procedural Codes, in 2000. There would be many more in the years to follow - but the much-vaunted draft law On Oil & Gas remained in the cupboard collecting dust.

This flurry of activity in law-making demonstrated the enormous hope and

16 For the privatisation process in Georgia, see <http://www.greenalt.org/webmill/data/file/publications/Privatizeba-Eng4.pdf>

goodwill there was, at the same time as highlighting some of the deficiencies of the legislative process. On the positive side was the fact that in Azerbaijan, both the Labor Code and the Tax Code genuinely sought extensive public consultation, with drafts of both published in newspapers. Comments were not only elicited but acted upon; this author personally appeared before two parliamentary committees and spent several hours discussing various amendments with the generous-spirited drafters of the Labor Code. Alas, this open consultative process has never been repeated.

The disadvantage of this spewing forth of legislation was its quality. For some of this, the foreign consultants shoulder the bulk of the responsibility. In Azerbaijan at least, the key problem has been the poor command of the national language and legal terminology by all parties involved.

On top of all everything else, the lack of transparency in dealings has posed additional challenges. Although the laws are largely in place in each of the countries, and Georgia maintains a lead over the others in terms of the ease of establishing businesses¹⁷, the absence of effective stock markets and compulsory filing of (and public

17 <http://iab.worldbank.org/Data/Explore%20Topics/Starting-a-foreign-business>, *Investing Across Borders*, 2010, indicators of foreign direct investment regulation in 87 economies. World Bank Group

access to) audited accounts of larger companies makes for poor corporate governance.¹⁸

Conclusion - the next challenge

In order to establish an environment for a thriving economy, good legislation is important. Legislation has continued to pour out of the parliaments, the presidents' offices, the Cabinets of Ministers and a plethora of ministries at an ever-increasing rate. But too much legislation can be counter-productive, distancing parliament from the legislative process, and placing an enormous burden on the presidents' experienced but small and over-worked legal teams. It is surely time for the deputies of the parliaments concerned to shoulder a greater share of this burden and to perform the job for which they have been elected, namely the introduction, scrutiny, and amendment of primary legislation.

The economic record, in general, has been good. In the 1990s, many feared that due to its natural resource wealth, Azerbaijan would be riddled with 'Dutch disease', causing inflation, industrial stagnation and massive income disparities. However, this has not happened and fears have largely been assuaged. Although inflation remains stubbornly high and

income disparities are very noticeable, the extent to which the three South Caucasus republics have developed in line with one another is remarkable. Others have argued that, with its abundant hydrocarbon wealth, Azerbaijan should be well ahead of its South Caucasian neighbors. Only in the last few years has Azerbaijan's per capita GDP really taken off. In 2005, the per capita GDP of all three republics was more or less the same. Since then, although all three economies have shown improvement, Azerbaijan has opened up a widening gap, improving by 357%, compared to 187% and 178% by Armenia and Georgia respectively¹⁹. That economic improvement is not immediately reflected in the overall business environment, but due to increasing business, this will change in time.

¹⁸ For an analysis of corporate governance in particular in Azerbaijan, see Bati, A. (2006), "Eurasia: Corporate Governance Challenges of Non-Listed Companies", in OECD, *Corporate Governance of Non-Listed Companies in Emerging Markets*, OECD Publishing. doi:10.1787/9789264035744-10-en.

¹⁹ Based on data for 2010 in current USD. See <http://data.worldbank.org/indicator/NY.GDP.PCAP.CD>