PRIVATE SECTOR ASSESSMENT: AZERBAIJAN

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LIST OF ABBREVIATIONS

AED	Academy for Educational Development
AUA	American University in Azerbaijan
CAD	Children's Aid Direct
CARE	CARE International, with reference to Azerbaijan Mission
CIS	Commonwealth of Independent States (Russia used as term of convenience)
EBRD	European Bank of Reconstruction and Development
EU	European Union
FDI	Foreign Direct Investment
FINCA	Foundation for International Community Assistance
FSU	Former Soviet Union
GDP	Gross Domestic Product
GTZ	Gesellschaft fur Technische Zusammenarbeit
IBRD	International Bank of Reconstruction and Development
IDA	International Development Association
IDPs	Internally Displaced Persons
IFAD	International Fund for Agricultural Development
IFC	International Finance Corporation
IFRC	International Federation of Red Cross and Red Crescent Societies
IMF	International Monetary Fund
IOM	International Organization for Migration
IRC	International Rescue Committee
IREX	International Research & Exchanges Board
ISAR	Initiative for Social Action and Renewal in Eurasia
SMEDA	Also, KOSIA-SMEDA, Small & Medium-sized Enterprises Development Agency
MCI	Mercy Corps International
NBA	National Bank of Azerbaijan (Central Bank)
NK	Nagorno-Karabakh (Armenian-occupied region of Azerbaijan)
NRC	Norwegian Refugee Council
NGO	Non-Governmental Organization (national and international distinguished)
OSCE	Organization for Security and Cooperation in Europe
OXFAM	Oxford Committee for Famine and Relief
RI	Relief International
SME	Small and Medium Size Enterprise
SPC	State Property Committee (Azerbaijan authority for privatization)
SSC	State Securities Committee (Azerbaijan authority for stock/equities regulation)
TACIS	Technical Assistance in the Commonwealth of Independent States (EU)
UNDP	United Nations Development Program
UNHCR	United Nations High Commissioner on Refugees
UNICEF	United Nations Children's Fund
USAID	United States Agency for International Development
WHIA	World Hope International, Azerbaijan
WHO	World Health Organization
WVI	World Vision International

I. EXECUTIVE SUMMARY

Azerbaijan is a relatively small country bordered by powerful neighbors, yet geographically positioned to be a hub of development and trade in the Caspian region. Oil and gas reserves are the foundations for economic growth, but at the moment, the country is struggling with internal difficulties in governance, exploitation, and economic displacement. During recent years, there has been a noticeable effort to generate a market economy, introduce governance and laws that would support growth, and move toward commercial systems more congruent with Western practices. Unfortunately, neither the political leaders nor the business community have yet generated the capabilities to establish these systems, and few Azeri citizens have had experience with market economies or democratic institutions.

During eight years of independence, Azerbaijan has faced substantial problems, and the country suffers from a Soviet legacy that has hamstrung the nation in many ways. Inadequate government systems thwart regeneration of industry, corruption is pervasive, reforms are slow, privatization has nearly stopped, and the **tax** system is a failure. **Also,** institutional development has set back commercial expansion, **poor** infrastructure and large deficits strain national resources, and socio-economic problems have serious human resource implications. Indeed, the nation may lose a generation in transition.

This study expands on relevant issues that have implications for private enterprise development. Specifically, the report examines economic factors, credit, legal and regulatory issues, human resources, privatization, and market opportunities for new businesses. International donor assistance was also studied in relation to private sector development, including briefings with more than 100 officials, business leaders, ministers, and program managers. The team also surveyed more than 50 enterprises of various sizes in diverse economic sectors representing a broad geographic area. Nevertheless, the report leaves many questions unresolved by its limited scope. Valid statistics often were difficult to find, and access was often difficult to government ministries. Consequently, there are issues that USAID will wish to pursue in an effort to formulate effective development programs.

A. MAJOR FINDINGS

The final sections of this report articulate more than 20 important findings and **11** major categories of constraints, each with several critical implications for private sector development. In this summary, five primary findings are presented with selected points of emphasis to solidify the most salient issues.

1. Private Enterprise Activities and Opportunities

- Private businesses are responsible for economic growth in virtually all sectors, and there has been a rapid increase in new business formations in high-potential sectors. However, many are micro-enterprises that lack resources for expansion, and they are not prepared to compete effectively in a market-driven environment.
- Nearly **all** agricultural holdings and small service enterprises have been privatized, yet privatization of larger assets, banks, and industry has ground to a halt. Consequently, many opportunities exist through restructuring to generate medium-sized enterprises capable of substantial growth.
- There are opportunities in all sectors for private enterprise development, but six areas of concentration stand out, which are prioritized in the following list:

- ***Agribusiness,*** including multiple cash crops, food processing, meat packing and fish canning, intermediate distribution, and wholesale exporting.
- ***Manufacturing,*** including light production of fabricated electronics, tools, small appliances, cable, and heavier production primarily in oil field equipment.
- ***Construction materials*** with high value-added, including fixtures, doors, windows, glass, lighting and wood accessories.
- ***Textiles,*** including commercial fabrics, especially silk, cotton, and cotton yam, and value-added finished clothing and household furnishings.
- ***Trade and merchandising,*** excluding retail stores and shops, but including wholesale distribution, transport services, and trade expediting.
- ***Professional business services,*** including business consulting, information systems networking, Internet marketing, and business communication systems.

2. Finance and Banking

- Bank lending satisfies only one-tenth of the financial requirements for credit in the private sector, and is very expensive. there is neither access to liquid funds nor adequate long-term lending.
- Azeri citizens have little trust in banks, and household savings deposits are so scarce that there is no intermediation of national income to underwrite private sector growth or investment.
- The securities market is primitive with only a legal skeleton for a securities commission and exchange, yet both can be achieved with little investment and reasonable assistance.
- There is little venture capital, except for a trickle of oil-related interest, no leasing, and no formal risk-capital alternatives.

3. Legal and Regulatory Environment

- The enabling environment for private enterprise growth is changing slowly and lacks adequate laws and effective procedures in terms of real property, intellectual property, enterprise regishation, commercial banking, and civil recourse, among others. Lack of "due process," audit standards, and transparency in governance are disincentives to business and investment.
- Taxes are high, but not as debilitating as capacious tax assessments, complicated tax regulations for business operations, onerous tax penalties, and blatant extortion that drive businesses underground.
- There are widespread institutional weaknesses with respect to financial intermediaries, the judicial system, customs and port authorities, and administrative efficiency in virtually all state, regional, and local agencies that make "doing business" risky and difficult in Azerbaijan.

4. Education and Human Resources

- Public education had deteriorated in terms of capabilities, facilities, and quality. The next generation will be poorly served by a system in rapid decline. However, private education has emerged rapidly among professional schools and in universities. These have momentum, but they cannot alone meet the requirements of a diverse and expanding youth population.
- Public vocation/technical schools today are half those that existed in 1995, and they do not address required skills. However, the number of private schools has quadrupled. Although unable to meet demand and primarily urban, they succeed because they prepare students with marketable skills.

- Education that addresses management, marketing, process engineering, product design, leadership, organizational development, finance, internationally accepted accounting methods, competitive strategy, and other important business and industry topics exists only in pocket programs. These are often donor-supported, but lack capable faculty, facilities, equipment, and materials.

5. Assistance Programs Related to Business Development

- Income generating activities by most donors are not conducive to enterprise development, but they do often reach disadvantaged individuals and engender a certain success in assisting rural communities with services such as individual health care, subsistence farming, and handicrafts.
- Micro-credit programs work as "safety net" income generation programs, not as business development strategies. **As** subsistence support instruments, they do not provide a financial base to **"seed"** or "grow" a business opportunity.
- Some isolated and innovative activities are taking place that have business potential, such as grants-in-kind for computers that encourage youth to learn programming or data-entry **skills,** sewing equipment that permits some cottage industry activity, and basic medical instruments that help rural doctors to pursue fee-for-service private clinics.
- From the viewpoint of this study, the most important finding may be that ***there is no effective program of business development in Azerbaijan.*** Isolated improvement occurs, but a sufficiently broad, cohesive effort to develop business enterprises, including the elements of effective intervention, finance, supportive associations, and management education does not exist.

B. BUSINESS ENVIRONMENTAL, CONSTRAINTS ON PRIVATE SECTOR DEVELOPMENT

The major findings include constraints that inhibit private sector development, yet many of the issues can be addressed and present opportunities for intervention assistance. We point out several more constraints, some of which are prominent and cannot be easily addressed by assistance.

- Corruption. Human frailties surface in every society, but in Azerbaijan, corruption is pervasive. **Most** people are caught up in a system that is unable to accommodate their economic needs, and a society that is unable to enforce lawful behavior. This perpetuates a cash-and-cany economy that erodes the ability of individuals and enterprises to conduct business while weakening national income budgets. Everyone is cynical about a system that cannot progress toward a transparent environment where doing business and providing for employees cannot be legitimate. There is little **trust** is systems of banking, justice, police protection, taxation, and government.
- Kon-Convergent Management Psyche. The prevailing psyche of systems of "entitlements" inherited from a command economy coupled with hierarchical authority based on affiliations rather than leadership capabilities or merit cripples enterprises. This managerial culture is embedded in, and perpetuated by, an older adult population currently in control **of** organizations and government. There is little likelihood that many of these politicians and directors will converge toward western values that will result in more than marginal changes in behavior or business ethics that require ideological paradigm shifts.
- Weak Purchasing Power. **As** long as wages remain **low,** taxes burdensome, and a large part of the population near poverty, effective demand will act as a brake on economic growth. The crucial requirement for any sector expansion is spending power for consumption with ample savings for investment. The collective effects of assistance may improve this situation, but this is a long-term

problem that will frustrate business growth. Indeed, prolonged economic despondency may threaten political stability, raise the country's risk profile for foreign investment, and prompt social strife.

- **A Polarized Economy.** There are two distinct economies in this nation. One is urban, close to government and major oil interests, and intensely controlled by those in power. The top end of society prevails here and can benefit from, or exploit, the most promising opportunities. The second economy is rural, far removed from power centers, and controlled by circumstances. The bottom end of society exists here and can rarely benefit from any opportunities. They are the least likely to see the effects of infrastructure or policy changes, and most likely to lose from even the smallest economic contraction. Clearly, this is a major concern of humanitarian projects, but the structural polarization of society is severe, and it will present extraordinary challenges to government and international donors to introduce private sector development measures than can be sustained.

C. PROGRAMMATIC RECOMMENDATIONS

The point of departure for programmatic recommendations is the observation that ***presently there is no assistance program with an effective business development profile in Azerbaijan.*** A core program is proposed as a strategic direction for USAID, but more extensive options are articulated in the body of the paper. These are not summarized here, but they include ways to address post-privatization problems, improve access to capital assets, enrich the education system, and address special needs of economically disadvantaged persons and women.

A coordinated business development program will provide the greatest leverage of foreign assistance funds, and can incorporate many of these innovative options for assistance. With that in mind, the following is a summary of the major business development program elements:

- **Business Finance Component.** An integrated business finance activity would focus on medium-sized companies, and those entrepreneurial enterprises with high-growth potential, thus offering loans in a range of $50,000 to $500,000 and providing some $25 million per year in total finance. This includes technical assistance to Azeri banks to improve their credit administration, coordination with other donor credit programs, and support for capital markets initiatives that would provide a comprehensive approach to financial underwriting. The activity could also pursue appropriate initiatives for deposit insurance, leasing, and access to venture capital and equity investments.
- **Management Performance Component.** This activity would provide in-company assistance to business finance borrowers in strategic and business planning, marketing and sales management, financial management, and managerial accounting. Activities would include underwriting due diligence on potential borrowers, thereby coordinating assistance with business plans and client proposals, and subsequently conducting aggressive follow-up monitoring to ensure adherence to plans and loan repayments.
- **Technical Assistance.** The focus of this activity is on operational and technological intervention for client companies to address specific problems in equipment planning and purchasing, process technology, organization, productivity improvement, and quality assurance. This is an ideal situation for utilizing volunteers, implementing technology transfer programs, and integrating educational or management development initiatives.
- **Business Capacity Building.** Assistance in improving the business environment would include supporting private sector associations, establishing sustainable indigenous business support organizations, and strengthening business connections with foreign buyers and potential investors. Capacity building would also entail grants to foster market research, industry studies, surveys, and database information resources to support business development.

These are the minimum necessary components of an effective business development program. Some activities within the component areas are being addressed in limited ways through various donor **programs,** but they are isolated efforts. This proposal orchestrates business development assistance, and if pursued, will permit other donors to concentrate on their primary responsibilities while optimizing USAID resources. Finally, there is nothing in this proposal or the enhanced recommendations at the conclusion **of** the report that would violate restrictions of Section 907 of the Foreign Assistance Act. However, the consultants preparing this report are unanimous in the opinion that without Section 907 restrictions, the **scope** and effectiveness of business development assistance could be enhanced tremendously in Azerbajian.

II. AZERBAIJAN – INTRODUCTION TO THE STUDY

A. COUNTRY BACKGROUND

Azerbaijan is a relatively small country bordered by powerful neighbors, yet geographically positioned to be a hub of trade in the Caspian region. Oil and gas reserves are clearly the foundations for economic growth, but they are also contentious as vital exports to Russia and Iran. Oil pipelines and future petroleum developments are of great interest to the heart of Europe, and to American and European oil companies. Consequently, Azerbaijan has at once the natural resources to be a pivotal participant in major international markets, and also to become victimized by its endowments. This is a fragile situation, further hampered by the country's internal difficulties in governance, exploitation, and economic displacement.

1. Transition in Perspective

Soon after the break-up of the former Soviet Union, Azerbaijan entered an era of severe social and economic disruptions. Prior to events in 1990, for example, the former Soviet Union relied on Azerbaijan for nearly 20 percent of its total fossil fuels, more than 70 percent of oil exploration and extraction machinery, **30** percent of its fresh fruits, and 80 percent of its cotton. Of course, there were many other important "inter-republic'' trade goods, but these stand out for their complementary importance to Azerbaijan, together representing approximately 75 percent of the country's economic activity. In all instances, markets and production demand for these threatened collapse with the country's independence. Meanwhile, economic reforms in Azerbaijan were hindered from the outset by conflicts with Armenia in Nagorno-Karabakh that lasted until a cease-fire was negotiated in 1994. Also during this time, three different governments came to power, with two coup attempts, before the present administration of President Heydar Aliyev could provide some near-term stability.

a) Future Prospects

The prospects for Azerbaijan in the new millennium are likely to rest with major social and economic changes that have yet to occur. With only a brief eight-year history of independence, the country has little precedent on which to establish these changes. Indeed, independence did not begin with a fresh slate, but with a social and economic deficit inherited from a crumbling state in the extreme hinterlands of the former Soviet Union. Consequently, much of this emergence stage has not been concerned with "resurrection of an economic state" but with survival of a population largely at drift. Azerbaijan came to independence with chaotic institutions, and with a centuries-old legacy of recurring dominance by different foreign powers with diverse ideologies.

Azerbaijan leaders initially faced the challenge of governing a nation where self-governance and national economic institutions existed only in the shadow of Soviet influence. To those ends, the leaders had no experience with governance and no ideological foundation that would support self-rule, a market economy, or democratic processes. Almost immediately, the nation was drawn into war, devastating border disputes, and a defensive military posture against Russian intervention. To those ends, the nation had no experience of military strategy, and no legacy of military leadership. In effect, it could not manage *a* war any more than it could govern a market economy. Consequently, the country struggled through the first several years of independence on the verge of political and social collapse. With international assistance, Azerbaijan regained some semblance of control, and entered the latter half of the decade with some promise of a meaningful transition.

b) Progress Toward a Market Economy

During the past several years, there has been a noticeable effort to generate a marker economy, introduce laws that would support growth, and move toward commercial systems congruent with Western interests. Unfortunately, neither the political leaders nor the business community have yet generated the capabilities to establish these systems, and few Azeri citizens have had sufficient experience with market economies or democratic institutions to be able to implement these plans. To the contrary, those of an older generation in command of government and commercial resources seem to be entrenched in Soviet ideology. This may seem harsh, perhaps too conclusive, yet they demonstrate a collective psyche that will not be easily changed by laws or pressure by an international community.

As transition efforts began in earnest, there was early enthusiasm for privatization, legal reform, democratic institution building, introduction of commercial banking, trade development, land reform, and so on. The results, however, have been mixed. Privatization was mismanaged and, at best, a form of legal transfer of title to small enterprises and agricultural holdings occurred. These transfers by the state were largely to those who were already identified with the enterprises or assets. For the agricultural sector at the farm level, this was very successful, and today, more than 90 percent of agrarian holdings are private. Ironically, an interesting profile of commerce emerged in which a majority of small business holdings came into the hands of foreign interests. In effect, the small business sector, retailing, most domestic services, and more than half of all commercial trade, came into the hands of Turkish owners or managers with some Iranian interests, and a smattering of other ethnic groups. The Azeris became employees of foreign owners/managers who controlled economic activity. Very little remained in the hands of Azerbaijan nationals in the main urban centers and port areas. In the regions, personal services such as small cafes, barber shops, and labor-intensive construction were firmly in Azeri hands. Banking, industry, commercial infrastructure, transport, and mainstream production remain in state hands, and they continue to be managed by a generation unaccustomed to market economics.

2. Progress on the Eve of the Millennium

A general profile of economic disparity remains today, much inherited from the "emergent years" of transition. There are material and human consequences of war, massive refugee problems, internal displacement of nearly 12 percent of the population, and foreign occupation of 20 percent of the nation's land mass. These huge economic and human displacements require equally huge humanitarian and economic interventions, which marks the efforts of most international organizations as the century closes and a new one emerges. The major difference between the "early" stage of transition and the "recent" stage is that the nation's prominent comparative advantage of petroleum resources attracted significant foreign capital. Most FDI was channeled into a very narrow range of the economy, itself controlled by relatively few individuals in the most advantageous government positions. These individuals often were able to exploit oil interests and corrupt the economy.

Corruption persists, but this may be little more than an extension of corrupt government that existed during the Soviet era. The presence of foreign investments coupled with ineffective checks-and-balances following independence probably accelerated the problem. In effect, the chaos of eight years of early transition has bred a pervasive environment of corruption. At the same time, privatization has bogged down in an unmanageable process (and with a voucher system that borders on a numbers racket). The banking system, once laden with nearly 250 licensed banks (few of any legitimacy), now has 70 active banks, four of which are state-owned and control more than 60 percent of all portfolio assets. The only bank that is a viable candidate for privatization is the International Bank of Azerbaijan. However, as this report will show, several banks are making progress, developing agricultural credit programs, and improving their professional capabilities.

Although government appears to be stable at the moment, it is stable in the sense that a powerful base of well-connected politicians hold very tight reins on decisions, ministries, and justice. The tax system functions much in the self-interest of those in control and cannot administer tax policies or collect fiscal revenues efficiently. The government is in deficit and cannot underwrite investment or infrastructure growth, and the monetary system, although able to support the currency, does not provide liquidity or adequate institutional capability for capital market development. The government has passed a number of important laws, and it continues to pursue a viable civil code (with components of a commercial code).

To its credit, Azerbaijan has worked diligently to improve economic cooperation with the Central Asian states. In 1998, Azerbaijan was instrumental in pursuing the "Baku Declaration," which is a 12-nation agreement to implement the EU-sponsored Traceca Program (Transport Corridor Europe-Caucasus-Asia). Also known as the "Silk Route Initiative," Traceca is a tremendous opportunity to rehabilitate transportation infrastructure across a wide berth, develop new transshipment systems, encourage cross-border cooperation, and vastly enrich all the member nations through rail, port, air, road, and telecommunication development.

B. INFRASTRUCTURE

Azerbaijan is uniquely positioned to be a major player in the southern Causacus region, but the national infrastructure is outdated. From a domestic viewpoint, it is inadequate to support sustained economic growth. With that said, the World Bank has 13 projects for infrastructure development in various stages, the EBRD has five major projects, the IMF under its Structural Adjustment Program has at least 11 component initiatives, and the Government of Azerbaijan has 52 individual projects under investment. In effect, there are many activities in progress.

a) Port *and Cargo Capacity.*

From a trade and investment perspective, port facilities are crucial. The Baku Port is the principal seaport on the Caspian, and unfortunately its cargo handling facilities are poor. Even with reduced port activity over the past several years with respect to bulk and container goods, the existing stevedore and warehousing capacity cannot safely meet current demand. According to those who are closely associated with port activities, dry cargo and ferry tonnage in 1998 and early 1999 increased slightly over prior years, yet the total volume today may be less than a third handled in 1990. The number of people employed under Azerbaijan's port authorities is roughly 800 persons – down from more than 3,000 in 1990. Meanwhile, requirements for oil shipping is expected to rise by as much as 10 percent each of the next four years. The EBRD has a commitment to assist in rehabilitation of the Baku port system, and EC-Tacis has more than $4 million in technical assistance grants to revamp the port's traffic management and customs processing systems.

Approximately 3.0 million metric tons of registered products passed through the country's ports during the past year, yet the State Statistical Committee reports that seaport capacity is only 2.85 million metric tons. This suggests a backlog queuing at the port (imports or exports) of at least 15 million metric tons, or roughly three weeks of tonnage caught in a port bottleneck. If this information is accurate, expectations for demand growth in handling would overwhelm facilities and raise handling and storage costs dramatically. The Tacis Intermodal Transportation Project may relieve part of this problem through modernization of the General Cargo Terminal and Ferry Terminal at Baku. Once completed, the port will be able to accommodate large numbers of containers via "block" trains by sea (across the Caspian Sea) to Aktau (Kazakhstan) and by road. The possibility for a freeport at Baku also is being studied.

b) Airport Facilities

Air transport is equally important, with seven major international carriers and nine major cargo contractors landing at Baku's terminals. However, the EBRD concluded in its feasibility studies that the existing runway capacity and terminal facilities require more than $13 million to bring them up to minimum standards for an international airport. EBRD subsequently signed a $13.7 loan agreement for airport construction that wilt double runway capacity and increase passenger terminal facilities nearly ten-fold. Part of this package is coupled to Azerbaijan's investment program through the Civil Aviation Authority to modernize the country's air navigation system.

A critical consideration is that the Nakhcivan region is cut off from land or rail routes to the rest of Azerbiajan. It is accessible only by one of the international air carriers. The country has no inter-regional carrier or a cost-efficient small-craft regional airline to link this or other areas within the country. Cargo to Nakhcivan is generally transshipped via Iran, or imported from Turkey through a narrow road frontier, which severely restricts business or industry development in the Nakhivan region.

c) Telecommunications

Telecommunications have become a high priority for the GOA, and several international joint ventures, contracts, and grant-based projects are focused on major development. Approximately 87 percent of the country's communication transmission system relies on hard-wired lines and switching exchanges installed before 1969 (half or more date to the 1950s). With that said, Alcatel-Teletas from Turkey upgraded (but did not replace) exchanges in the Baku and Quba districts in 1998, and Daewoo of South Korea recently launched a project in Nakhcivan to install a $12 million new exchange system. Baku can currently handle about 16,000 subscribers, while demand is estimated at more than double that number. Quba can handle 5,000 lines, with regional demand estimated to be at least 12,000. There are 14,000 subscribers in Nakhcivan, with a five-year projected demand of more than 34,000. By allowing private registration of GSM, the government has alleviated this shortfall, and the wireless market may now exceed 20 percent of the telephonic voice market. State statistics do not capture the nature of the telecommunications industry apart from hard-wire line access, and there appears to be no reliable information on Internet connections or international voice or data traffic. Anecdotal evidence from Intrans (a leading Internet company in Baku), and from the Ministry of Economy suggest that mobile and data systems could quadruple and still be inadequate to meet demand, yet the physical infrastructure and cost efficient networks do not exist to meet those expectations.

d) Energy and Power Resources

Energy production had declined significantly between 1990 and 1995, but since mid-1997, there has been a steady increase in power generation. A thorough evaluation of the power sector is beyond the scope of this report, but major projects are underway that may solve the nation's electric generating shortages by the year 2003. These include more than $400 million in loans and grants from international donor agencies that was initially committed in 1998 for new hydropower plants in the Mingechaur area, hydroelectric plants with substations in the Baku region, and upgrades for nine thermal power plants that will be restructured. Meanwhile, some relief from power outages and low-efficiency fluctuations in service has been achieved by rerouting power allocations away from downsized state-owned industries in rural areas.

e) Water arid Waste

Safe water resources and waste capacity have become chronic problems throughout the country. World Bank reports and a working paper by the EBRD indicate that existing water and sewage systems were poorly designed and generally ignored throughout Azerbaijan. Exactly how these problems will be addressed is unclear, although a study commissioned by EC-Tacis in 1997, and conducted by the Strategic Research Center for Development and International Collaboration, concluded that 80 percent of

Azerbaijan's population is at risk from water and sanitation that do not meet basic WHO standards. Subsequent to that report, more than $100 million has been earmarked for a series of reconstruction tenders on core municipal water systems. Additional projects for refurbishing pumping stations will stretch into the year 2004, but the consensus is that a major long-term effort is needed. Even if such programs are possible, rural areas and prime agricultural regions cannot be addressed for years.

f) Ground Transport

Rail and road transport is wholly inadequate to support commercial traffic. The national rail system reaches all major points in the country, but there are discontinuous trunk lines, and the system in Nakhcivan is inoperable. The main lines linking ports and Georgia have been maintained well enough to support a dramatic increase in freight (a 28-percent increase in 1998, and 22-percent increase over the first six months of 1999). However, demand is expected to increase by 10 percent or more every year, primarily through alternative routes for oil products. If oil pipeline issues can be resolved, the transshipment problems of oil (which could choke the rail system) can be averted, according to the Minister of Trade. Also, the projected transportation corridor improvements under Traceca may result in a road and rail construction boom during the next decade.

Azerbaijan faces many more infrastructure challenges, including major improvements in municipal streets, lighting systems, renovation of deteriorating buildings, attention to a metro system on which many people rely, regional public transportation, and intercity passenger and commercial transport systems. The crucial point is that a pervasive physical infrastructure that is old, inadequate, and not being maintained severely restricts all commerce. Even with the best agricultural processes, farmers and breeders cannot get their products to market efficiently. Even if industry were to mysteriously blossom, materials or end products could not be effectively transported. With electricity still being imported, inefficient and costly water systems, sporatic access to limited truck and rail transport, and problematic air and sea portal capacity, virtually every economic sector has major impediments. Those enterprises in proximity to required transport and utility facilities will be most promising, but the limitations of location requirements may cause future displacements and more polarized patterns of development.

C. SOCIAL AND HUMAN RESOURCE ISSUES

The population of Azerbaijan was approximately 7.6 million at the end of 1998 (expected to reach 8.0 million by end of 1999), with 41 percent of its people living in and around Baku. It is a relatively homogeneous nation with 91 percent of the resident population being Azeri. This has been a significant change since the late 1980s when 20 percent or more where ethnic Armenians or Russians, and as many of 12 percent were of other ethnic minorities. Independence and conflicts created a rapid influx of Azeri refugees, while there was an equally rapid out-migration of non-Azeris. Unfortunately, those who left did not leave behind employment vacancies, and the influx of Azeris came into a social and economic void. This has resulted in high unemployment among an adult (and economically active) population, depressed real wages, and prolonged pressure on social resources.

a) Demographic Factors

From a demographic perspective, Azerbaijan has an accentuated problem with the highest fertility rate in the South Asia and Caucacas regions. Between 1990 and 1995, the fertility rate averaged 2.78 (double that of Turkey, for example), but even though it dropped to 2.06 by 1998, Azerbaijan still has the second-highest fertility rate in the region after Kyrgrystan. Today, 39.8 percent of the population is under 18 years of age. One consequence of this large demographic group is that the nation's primary and secondary school systems are overburdened by nearly 60 percent. Part of this burden is due to the loss of 800 schools in the occupied region (20 percent of the nation's total system prior to occupation), and the subsequent displacement of that population into domestic areas where educational facilities, already sparse, were often seconded to house refugees. **A** World Bank study in 1997 found that nearly 15 percent of all schools in the IDP settlement areas were occupied by IDPs, and as many as 75 percent of children in rural enclaves were not able to attend school regularly.

More than half of the population are impoverished, and there are nearly 900,000 IDPs or refugees near destitution. The per capita GDP is second lowest among the World Bank's list of low-middle-income countries. This is worsened by the exceptionally high tax and withholding rates that place an even larger number of the population well below the poverty line in terms of net disposable income. The combined effect of these situations foster corruption, bartering, black market behavior, and a growing shadow economy. Consequently, there is a confusing set of parallel economies within the country. One has extraordinary promise for development and economic prosperity derived from international support. oil, and Caspian trade, while a huge part of an impoverished population survives in a shadow economy: or, alternatively, is dependent on humanitarian aid.

b) Dislocation Problems

Social displacement and economic destitution coupled with a bulging population of youth present several crucial problems. First, the adult literacy rate that was nearly universal in 1990, edged **down** to 96 percent by 1995, then plummeted to below 90 percent by 1998. ***An*** emerging generation may therefore become socially disadvantaged unless education systems reverse their downtrends. Still, Azerbaijan's adult population is very well educated, and the current generation has one of the highest percentages of science and technology graduates among the former Soviet republics. **A** second implication is that a majority of the displaced population, and a majority of those who have transited to urban areas, have agrarian backgrounds. Therefore, those most in need of employment are least prepared for jobs. Having lost homes and farms, they also reside in areas where they can rarely gain access to land for crops or livestock, and they are disenfranchised from ownership. ***An*** agricultural boom would not necessarily benefit them without public reallocations of land or rights of use. **A** third consideration is that when the younger generation reaches maturity, there easily could be widespread disillusionment exacerbated by a swelling population of young adults in need of employment or access to higher education opportunities.

c) General Education Profile

The post-perestroika era witnessed a decline for Azerbaijan's educational system – a system which turned out literate and well educated (Soviet style) adults. Today, the state educational **system** and **its** various levels continue to experience difficulties. There simply are not enough financial resources available to improve the system. The necessary financial investments at all levels of education have been sharply reduced, and this has had deleterious effects. Specifically:

- Reforms carried out by the state educational institutions are far from having raised the educational system to a level consistent with Western standards.
- **Staff** qualifications have declined as a result of a "brain drain," which also results from very **low** teacher's salaries. Indeed, the average teacher's salary is barely equivalent to $18 a month, and senior school directors only average $27 a month.
- There has been no evidence of improved pedagogical techniques, preparation of new and revamped courses, or retraining of teaching staff.
- Public school cumcula is narrowly defined with little choice for students, but more importantly, as students apply for university or technical institutes, they are assigned to faculties (majors) according **to** standardized exams similar to those imposed on secondary students throughout the Soviet era.

- Materials, textbooks, computers, fax machines, photocopiers, AV equipment are all in short supply. For example, a spot study by the Akhundov National Library of Azerbaijan, which is part of a current on-going project under a Eurasia Foundation grant, found in 1998, that although all but one of the state universities had computer laboratories, the number of work stations would only accommodate 11 percent of the registered students. Of those, only 5 percent had limited Internet access, and overall, no more than 10 percent of all university students had basic knowledge of electronic media or computers. Preliminary information from this study suggests that school computers do not exist in a majority of primary and secondary schools, and library materials have not been noticeably updated or replenished since 1991.
- The education system permits only limited inter-university exchanges for resources, research, or faculty interaction. Consequently, some institutes are making substantial progress (such as Khazar University and Baku State University), yet the remaining state universities have deteriorating facilities, declining enrollments, less-qualified faculty, and out-of-date curricula.

Table 1 **EDUCATION PROFILE OF AZERBAIJAN, 1995-1998**

	Institutions			Students		Teaching Posts	
	1990[a]	1995	1998	1995	1998	1995	1998
Pre-schools	1,640	1,880	1,990	116,108	158,000	16,738	14,200
General Schools 1-9	4,419	3,916	3,890	1,376,142	1,600,000	119,558	94,000
Secondary Schools 10-12	804	603	614	189,808	220,000	40,068	32,000
Vocational/Technical[b]	180	77	78	44,581	42,000	11,400	6,800
Universities'	41	44	46	63,160	64,500	18,846	14,200

b

c

d) Business Education

Since 1991, 17 new private universities and business schools have been licensed to teach business curricula. Western University, Khazar University, and the American University also provide English language instruction, and each has agreements for faculty exchange and assistance with US and European universities. These programs are well-founded, but not yet widely enrolled, yet they have generated outreach programs to begin to assist other private schools and some state institutions to introduce business curricula. Khazar University, Baku State University and the Azerbaijan State Oil Academy have received grants from international donors for curriculum development, and at the moment, Georgia State University and the University of Maryland have implemented faculty exchange programs and provided US. faculty consultants to these institutions.

e) Vocational/Technical Education

There were 78 licensed professional-technical schools, and 77 licensed vocational-technical institutes in 1998 (see Tables 1 and **2),** but this data is not consistent in different offices under the Ministry of Education, However, even based on the optimistic reports, there has been a drastic decline in both professional and vocational-technical education. In ***1990,*** there were 180 licensed professional institutes, and 78 voc/tech schools. Enrollments in professional institutes have dropped steeply from more **than** 85,000 in ***1990*** to barely 23,300 now, and from approximately 68,800 voc/tech students in ***1990*** to 31,400 now. The number of qualified instructors in professional schools has halved sine ***1990,*** and declined by 10 percent in voc/tech education.

This scenario suggests that "professional" education has declined, but **in** fact, it has increased with more than 120 new private professional training institutes and 44 foreign-operated schools (see the statistical appendix on enterprise development). Enrollments are estimated to have increased by 438 percent **in** private schools versus state institutions. However, there is a distinct difference between the state and private institutions. Only state licensed schools (and specific programs listed under foreign-operated schools supported through international donor grants) can issue "official" diplomas. The private schools are largely commercial training centers with short courses, but the ***private schools are addressing marketable skills*** such as computer programming, telephonic repair and maintenance, IT network hardware maintenance, construction skills in carpentry, masonry, and blueprint reading, machinery repair, auto maintenance, bookkeeping, retailing, insurance sales, and other specialties. In contrast, the state technical institutes offer some courses in computers and accounting, but their largest enrollments are for "sewers" (seamstresses), tractor drivers, rug weavers, and similar occupations.

	Number **of Schools**			**Enrollments**		
	1990	***1996***	***1998***	***1990***	***1996***	**1998 est.**
Professional Technical Schools (Public)	74	70	68	20,600	6,023	5.800
Professional Training Institutes (Public)	106	48	10	67,400	17,100	***2.900***
Vocational/Technical Schools (public)	78	77	77	58,800	31,400	31.000
Retraining Institutes **(MOL** Public)	***91***	112	120	22,000	24,500	27,000

D. FOCUS OF THE STUDY

During the brief eight years since independence, Azerbaijan has faced substantial problems, and the country suffers from a Soviet legacy that has hamstrung the nation in many ways. This study is not meant to be a comprehensive review of those problems, yet they are vital concerns for aspiring entrepreneurs and advocates of private enterprise development. Problematic government systems retard effective regeneration of industry; corruption frustrates individuals and business interests; slow reform coupled with mistakes in privatization, taxation policy, and institutional development has set back commercial expansion; poor infrastructure and requirements for major reconstruction strain government resources; and socio-economic problems have serious human resource implications. Indeed, the nation may lose a generation in transition. This study will expand on many of these issues, but focus on implications for private enterprise development.

III. ECONOMICS & THE PRIVATE SECTOR IN AZERBAIJAN

A. MACROECONOMIC PROFILE

Azerbaijan has had a difficult year after a fall in world oil prices in 1998 depressed trade and reduced national income expectations. The economy is not expected to make a significant recovery in the near term, although a turnaround in oil prices has resulted in a modest recovery in late 1999. The President's health has also been a major concern as he ages and recuperates from heart surgery. In effect, the President determines economic and foreign policy. Early in the year, the Minister of Finance and the bead of the tax department were dismissed in the wake of a serious shortfall in fiscal revenues (21% below projections) and so-called "financial irregularities." Meanwhile, monetary policy was tightened, crimping demand and suppressing consumer prices, but there was a commensurate contraction of industry and public service projects. Trade dropped off sharply early in the year, but recovered briefly as the manat slightly depreciated (and probably will continue to depreciate at a small rate of change).

With a shortfall in state revenues, the government's answer has been to tighten fiscal spending (reducing expenditures by 27% between January and June 1999). This was probably motivated by a pending World Bank disbursement loan which stipulated progress toward a lower budget deficit, and by the IMF, which has an agreement with the government on structural adjustment loans that the state budget deficit would be held to 3.0 percent. The deficit did not decline, but rose slightly above 4.3 percent, prompting further expenditure cuts. However, an economic policy based on expenditure cuts cannot be sustained, and, indeed, it retards economic development. Unfortunately, there is no evidence at the moment of government initiatives to strengthen revenues, and the country's trade and investment opportunities continue to be constrained where stability is a question and governance is suspect (i.e., corruption is pervasive, and control over banking, taxation, and regulatory reforms is not apparent). In addition, Russia's domestic economic problems coupled with conflicts in neighboring states, cripples trade relations, and the continuing difficulties with Armenia have not been satisfactorily resolved.

This introduction barely reveals Azerbaijan's economic problems. It is a country is earnest need of international support, and constructive reforms. With that said, the nation has made progress with an emerging private sector, several promising growth sectors, and the physical resources needed to foster a vibrant economy in the 21st century. It has the human resource capabilities to pursue economic growth, the groundwork for institutional reforms, and oil and gas reserves capable of underwriting a prosperous country if its leaders can rise to the challenge. With these points in mind, this section of the report examines economic trends, sector performance, employment and wage data, and the status of banking and finance.

1. Overall Growth Trends

Azerbaijan has experienced several years of positive growth in GDP with subsequent evidence of a degree of stability since early 1996. This falls short of being a "trend," and it would be difficult to conclude that the economy can sustain growth. Several factors argue for guarded optimism, and Table 3 summarizes key indicators that reveal difficulties in the economy. The most noticeable statistic is that in 1995 (used as base year), the country emerged from an economic roller coaster ride, but even with strong positive rates of gain in per capita GDP in 1995 and 1996 (as percentages), the absolute level of per capita GDP has remained disappointingly low.

Table 3: MAIN ECONOMIC INDICATORS FOR AZERBAIJAN					
Indicator	1995	1996	1997	1998	1999(est)
GDP (at market. in AZM billion)	10.668.2	13.732.0	15,352.1	15,930.0	16,917.6
GDP (in USS billion)'	2.4	3.2	3.9	4.1	4.31
Change in GDP (% on prior year)	-11.8%	1.3%	5.8%	10.0%	6.2%
Per Capita GNP (in nominal US$)	324.3	421.1	513.2	539.5	558.4
Change in Per Capita GNP (% of prior year)	49.3%	29.8%	21.9%	5.1%	3.5%
Inflation (% change in Consumer Prices)	411.8%	19.9%	3.7%	-0.8%	-9.5%
Exports FOB (in US$ million)[b]	612.3	643.7	808.3	611.8	770.0
Percent of GDP	25.4%	20.1%	20.7%	16.5%	17.9%
Petroleum as Percent of Exports	51.9%	52.8%	41.7%	41.4%	46.0%
Imports FOB (in US$ million)[b]	985.4	1,337.6	1,375.2	1,723.9	1,810.0
Trade Balances (in USS)[b]	-373.1	-693.9	-566.9	-1,046.1	-1,040.0
Exchange Rate (AZM to US$, Avg/year)[c]	4,414.0	4,300.0	3,986.0	3,869.0	3,910.0
Current Account Balance (in US$ million)	-400.7	-931.2	-915.8	-1,364.5	-1,400.0
Current Account Balance (% of GDP)	-16.6%	-29.3%	-23.8%	-33.1%	-32.6%
Net Foreign Investment (in US$ million)	155.1	591.2	1,051.0	918.2	980.0
Net Foreign Investment (% of GDP)	6.4%	18.5%	26.9%	23.1%	22.8%
Gross Reserves (in US$ million)[d]	121.0	214.0	467.0	449.0	460.0
Months of Import Coverage	1.5	1.9	4.1	3.1	3.0
External Debt fin US$ million)	216.0	434.0	614.0	719.0	760.0

Notes: [a] -- Calculated on annual-average exchange rates AZM:US$; [b] – exports and imports exclude income on services and current transfers; [c] -- exchange rates are average monthly spot markets; [d] – reserves exclude gold and net credits. ***Sources:*** European Commission, TACIS & Minstry of Economy, ***Azerbaijan Economic Trends***, Quarterly issue, January-March 1999; ***WorldBank Report No. 19586-AZ***, August 16, 1999.

In effect, the progress made in GDP growth has been dampened by hvo separate forces. First, internal policies to defeat inflation and to improve fiscal income (e.g., more rigorous enforcement of tax collection) have, indeed, reversed earlier periods of hyper-inflation, and they have incrementally increased budget receipts. Unfortunately, the rate of change in consumer prices went negative, indicating over-correction. At the same time, per capita GDP has been stifled for nearly hvo years, rising at a rate far less than national GDP. Specifically, Azeri citizens are earning slightly more in recent years, but they are also paying more in taxes and subsequently enjoying less disposable income.

Even with suppressed consumer prices and a stable currency, Azerbaijan has a lower standard of living in 1999 than in 1995, and a significantly lower standard of living than in 1990. The second force acting on the economy has been external pressure on trade and investment. Azerbaijan is vulnerable to external economic factors. Small changes in world oil prices can have major effects on national income and trade balances, and when oil prices slumped in early 1998 (down 32%), the international oil producers quickly cut back production and trimmed operations in Azerbaijan. These decisions had immediate effects on jobs, revenues, trade balances, and foreign investments, yet oil exploration and volume from drilling was down for several years following the difficulties with Russia in 1992.

The actual impact of oil and trade relations with Russia is hidden in the national statistics where export trade remains positive (but at a lower rate of change than imports), and the contribution to GDP by the petroleum sector seems to remain strong but could have been far stronger with increased pumping and pipeline capacity. (See statistical appendices for complete details on GDP decomposition and sector performance.) A detailed sector analysis in provided in a following section of the report, it is revealing to note that a few key sectors have dramatically pulled down the economy. At the same time, several sectors, primarily dominated by private sector enterprises, have made significant gains. These have helped offset trade and domestic expansion difficulties, but they are far from sufficient.

Trade was not only disrupted by difficulties in Russia, a major trade partner of Azerbaijan, but by war in Chechnya, which cut off trade routes overland into CIS republics. Atronger Turkish imports also skewed trade balances, particularly for non-oil products, processed foods, and value-added fabricated clothing, machinery, and furniture. This combination of factors deepened trade deficits, but also accelerated an already-rapid decline in domestic industry. In effect, the trade balance and the current account balance have worsened, but relative to earlier transition years, the deficits are growing at slightly slower rates. This suggests some reason for optimism, yet there is little hope in the near term for significant reversals as the structure of trade and investment for Azerbaijan is heavily dependent on CIS and regional relationships. Deficits are likely to remain, and they are likely to become larger, until well into the new century when there is a possibility that world oil markets will provide cyclical profits and attract new foreign investment.

These particular economic concerns are explored in several sections that follow. As a general statement, the Azerbaijan economy reveals several paradoxes born of internal inconsistencies in policy management and fiscal performance, and a fragile structure with too little diversification to be insulated from external circumstances. With that said, there are bright spots in some economic sectors, yet, again, many paradoxical results in others.

2. Employment Characteristics and Human Capital

Azerbaijan has a well-educated work force and a history of technical, engineering, and scientific endeavor. Just as important, the country has had excellent agricultural development, particularly in exportable crops such as cotton, fruits, nuts, and livestock. Unfortunately, these capabilities have suffered in the wake of major land reform, depleted markets for industrial products, and the inability to compete with foreign products on an equal technological footing. These problems are part of the larger picture of economic displacement that has redefined the country's entire pattern of employment.

a) Labor Force and Employment

The total labor force of qualified adults has grown incrementally every year by a small percentage – most recently by less than 1.0 percent per year. Employment opportunities have expanded periodically since 1990, but over the past decade, there is barely the same number of positions filled in 1999 as there were in 1990. Consequently, an annual gap between those searching for work and available employment has run up the unemployment statistics dramatically. Table 4 illustrates this trend, but the official data are openly questioned. Unemployment, listed at less than two percent in any given year, is false from several viewpoints. First, EC-Tacis data and the actual base data used by the State Statistical Committee reveal unemployment between 25 in 1990 and 40 percent in 1998. (The table presents years 1995 through 1999 only to reflect a relevant period of analysis). EC-Tacis, in its annual *Economic **Trends*** report, points out that this range of unemployment is also false because official data only count "economically active and registered" adults, while ignoring the number who circumvent registration or work for themselves. Their best estimate of real unemployment accounts for periodic estimates of those employed in the informal sector (between 14 and 16 percent). Thus the actual unemployment rates may range between 17 and 20 percent.

Table 4: EMPLOYMENT AND UNEMPLOYMENT					
	1995	1996	1997	1998	1999 est
Total Resident Labor Force (thousands)	4,036	4,060	4,101	4,135	4,172
Total Registered Employment (thousands)	2,837	2,895	2,902	2,914	2,910
Registered Unemolovment (thousands)[a]	28	32	38	42	43
Percent Registered Unemployed (%)	1.0%	1.1%	1.3%	1.I%	1.5%
Total Active Adults Unemployed (thousands)	967	948	984	1,006	1,008
Percent of Active Adults Unemployed (%)	33.7%	32.4%	33.5%	34.0%	33.8%
Total Informal Emplovment (thousand)[b]	444	417	441	454	(noest)
Percent Employed Informally (%)	15.5%	14.2%	15.0%	15.4%	(noest)
Distribution of Official Employment:[c]					
Public Sector (% of active labor market)	57.2	51.5	46.4	42.1	41.0
Private Sector (% of active labor market)	18.5	21.0	26.6	29.4	31.8

Notes: [a] – Official data on employment and unemployment tracks adult population aged 16 to 60 who have registered for employment or for benefits; [b] -- Informal employment and unemployment has been estimated by EC-Tacis; [c] – Excludes cooperatives and "registered unemployed on leave from SOEs. *Sources:* European Commission, TACIS & Minstry of Economy, ***Azerbaijan Economic Trends,*** Quarterly **Issue,** January-March, 1999; State Committee of Statistics of Azerbaijan Republic, ***Statistical yearbook 1999.***

If the officially defined labor force is used as a basis for evaluating employment patterns, we can assume that approximately 20 percent of the resident labor force is unemployed, a minimum of 15 percent work are not registered, and approximately 55 percent of the population is outside the labor market. The last statistic is perplexing because the demographics of Azerbaijan indicate that **about** 64 percent of the population should be "economically active" and counted. Therefore, a logical conclusion is that a large number of these individuals have income from informal activities. The informal sector could therefore be much higher than 15 percent, and unemployment could be higher than 20 percent.

b) Sector Employment

Looking at the sector data in Table 5, employment in agriculture has declined modestly, but actual agricultural production (shown in statistical appendices) is sharply lower than early in the decade. This indicates either convoluted data or "underemployment" coupled with "optimistic" employment reports for farm and livestock activity. The industry sector is probably accurate as the data since 1995 takes into account job displacement in state-owned enterprises, but the percentage of employment at 8.0 percent of the labor force is dismal. More importantly, those officially on the **SOE** rolls are heavily underemployed. The reported jobs in the "other" category (public services, utilities, and government) also are probably accurate.

The most significant sector employment figure is the dramatic increase in private trade and **services** – nearly double in less than five years. This figure is probably substantially understated for two reasons. First, according to EC-Tacis, much of the informal employment occurs in construction, services, and trade. Second, a study by **SIGMA** in 1997 on labor force reforms found, for example, that as many as a third of all public sector employees actually have unregistered part-time or side jobs. In particular, the study noted that public school teachers work less in their official posts and more in unofficial posts. Many teachers in rural areas actually hold 1.5 "official" positions (register for a regular teaching load plus a half-time second shift), then mentor or tutor. Nearly 30 percent of rural teachers are unregistered farmers, clerks, or trade workers, further bringing into question the size of the informal sector and the accuracy of agricultural production.

Table 5: EMPLOYMENT BY SECTOR					
	1995	1996	1997	1998	1999 est
Industry (includes Food Proc, % of total)	12.4	9.8	**8.3**	8.2	8.0
Construction & Transport (% of total)	6.5	5.7	5.3	5.3	6.0
Trade & Services (non-gov., % of total)	18.5	21.6	25.1	27.3	28.0
Other (in. public services. % of total)	31.8	31.1	31.7	30.4	29.0

Notes: [a] -- Food processing is officially listed under Manufacturing in Industry data. ***Sources:*** EC-TACIS & Minstry of Economy, ***Azerbaijan Economic Trends,*** Quarterly, January-March 1999.

Several encouraging trends appear in the relative changes between public and private sector employment. The percentage in public service has consistently declined since 1995, while the private sector has grown at a similar rate. Employment at cooperatives has remained almost dead even in actual numbers, and slightly down in percentage terms. Early agricultural reforms and SME privatization drastically reduced *the* cooperatives prior to 1995. If the informal sector is taken into account, excluding the side employment of public sector workers, the percentages would alter further. The World Bank reported in August 1999 that its most recent information indicated that employment in the private sector had actually matched the public sector for the first time, and if actually economic activity was registered, Azerbaijan's statistical profile would dramatically improve.

c) Gender and Age Issues

Employment data is not tracked for gender, except in official public service positions, but it is encouraging to note that the percentage of women employed has actually increased each year. Too much should not be read into this, however, because public sector jobs are systematically lower paying positions (on average, only 61 percent of comparable positions across the economy), and studies by the Eurasia Foundation, the IOM, and AED indicate that women in all sectors are paid at rates 58 to 64 percent lower than men in similar posts. Consequently, employment opportunities for women may have improved for less-attractive jobs, but there is no evidence that income-producing opportunities for women have changed during the transition years. One additional note provided by the 1999 EC-Tacis Economic Trend report is that between 8 and 10 percent of the "economically inactive" population on pensions hold down jobs, but by working less than 12 hours a week or working informally as casual employees, they retain their pensions, yet add to the nation's total employment.

As the official number of registered job seekers increases, the balance of gender issues remains similar. Over time, there seems to have been no structural shift in employment or unemployment toward either men or women. An emerging problem, however, is the proportionate rise in unemployed youth. More young people under 18 are coming into the labor force and becoming unemployed, and more young adults (under 30) are unemployed than any other group. Nearly 53 percent of total unemployment occurs among those aged 29 or younger, and demographics of the country promise a rapid rise in the younger generation that could lead to widespread social problems. (See statistical appendices)

d) Wages ***and*** Sector *Trends*

Since 1995, which is used as a base year after earlier periods of rampant inflation and currency instability, the nominal wages in Azerbaijan have grown at a respectable annual rate. Unfortunately, a tripling of the nominal average monthly wage since 1995 still leaves the country 59 percent below its 1990 level as estimated by the World Bank. Table 6 illustrates the recent wage experience, and shows that wage rate growth has slowed in late 1998 and 1999, yet is a "real wage" gain on each year. These ***are*** gross incomes from earnings, and they do not account **for** tax effects (described in a later section). Consequently, even with huge percentage gains, the equivalent monthly gross income of US S47 in 1999 is not sufficient to maintain effective demand in the economy.

The more disappointing trends occur in specific sectors where many people are losing ground. Agricultural wages have consistently deteriorated more rapidly than any other economic sector: and they are now barely 25 percent of their 1995 level (-84.1 percent against the monthly average). In effect, a wage-earning person in agriculture has the equivalent of gross income USS 7.02 a month. Education is second worse, some 57.9 percent below the national average with an equivalent gross monthly income of USS 18.24 for all teachers. Statistics for primary and secondary school teachers are not shown, but a report by ***the*** Ministry of Education in January 1998, indicates that they comprise 81% of all teachers **with** an average gross income of approximately 51,000 manats (US$ 11.80). If this is accurate, most teachers (certainly those in rural districts) earn just slightly more than agricultural workers.

Table 6: **WAGES AND WAGE DIFFERENTIALS BY SECTOR**

	1995	1996	1997	1998	1999e	Differential To 99 Avg
Nominal **Monthly** Wages (AZM)	62,467	89,370	**141,643**	168,419	**187,060**	
Monthly Wage (in current USS)	14	21	36	44	47	
Percent Change ***on*** Year (%)	**n/a**	**43.1%**	**58.5%**	18.9%	**11.1%**	
Sector Wage Averages:						
Agriculture (ex. Food Processing)	51,244	46,413	44,311	38,009	29,650	**-84.1%**
Industry (In. Food Processing)	153,187	156,722	162,731	154,202	148,250	**-20.7%**
Construction	153,198	179,940	180,847	224,109	257,600	**37.7%**
Trade Services	113,921	132,069	145,101	178,882	201,500	**7.7%**
Government Administration	94,318	86,671	75,617	94,299	100,500	**-46.3%**
Healthcare & Social Security	72,119	70,246	72,201	81,004	96,500	**-48.4%**
Education (teachers, non-admin.)	70,546	68,919	68,114	76,004	78,822	-57.9%

Sources: European Commission, TACIS & Minstry **of** Economy, ***Azerbaijan Economic Trends,*** Quarterly Issue, January-March 1999; State Statistics Committee, ***Statistical Yearbook*** 1999.

Industry wages have drifted down recently, but, ironically, they rose in 1996 and 1997 during a period of general manufacturing downturn and restructuring. They are still low relative ***to*** the national average. Those in healthcare have benefited from strong wage increases during the past hvo **years,** yet the heathcare professions are still paid lower than average (lower than government administration as well), and only slightly better than teachers. This study has not found comparisons behveen private sector and public healthcare incomes structures, but anecdotal information suggests that public service positions have declined, and government-defined wages have only marginally increased. In contrast, private sector clinics and medical positions have increased by more than 160 percent in the past four years, and for those in private situations, healthcare wages may be double those in public practice. In contrast, construction and trade services have had strong positive wage gains. Construction workers now earn about **38** percent more than the national average, and they are the highest paid group in Azerbaijan – more than double the incomes in healthcare and government, nearly triple those in education, and ten-times higher than in agriculture. Trade service employees also earn a premium wage, with growth rates that will widen that gap substantially.

The official wage data reflects known incomes and registered employees. The obvious caveat is that all reported wage information apart from government administration employees will be substantially understated. It is unlikely than the majority of employees in any sector do not resort to informal means *to* earn a livable income, but the opportunities in each are probably proportional to the disparities that exist. Therefore, agriculture, industry, or other workers are unlikely to have informal sources that would "catch them up" to others. We can be reasonably confident that the sector differentials are accurate, even if the absolute earnings are understated, and we are confident that the wage magnitudes are small so that understated income, if corrected, would still leave the population largely impoverished.

B. SECTOR AND COMPANY SURVEY

This section surveys the actual and potential private business sector in Azerbaijan. Our goal is to answer the following question: Are there truly viable businesses and business opportunities in Azerbaijan, and if so what are they and where are they?

The information provided in this section is based on over 100 direct interviews that our team has conducted in four weeks, including site visits to some 50 companies throughout the country engaged in a broad variety of commercial activities. These contacts and companies are summarized in a database submitted with this report. In this section:

- We first discuss economic factors and "enabling environment" conditions affecting all businesses in the country.
- We then present a 5-sector "taxonomy" of Azerbaijan's commercial economy that seems to us most useful for analytical purposes.
- We describe each of these sectors in detail, discuss their strengths and weaknesses and constraints, and the potential for expansion within them.
- Finally, we present a summary of the commercial opportunities across all sectors, providing a targeting framework for a USAID business development program.

1. Conditions Common **to All** Sectors

The business community in Azerbaiian is faced with a number of common constraints and opportunities. These are described in the following passages.

a) Weakness of Overall Purchasing Power

Overall purchasing power in the Azeri economy is and has always been very weak – this is a poor, underdeveloped country. However, there is a striking contrast between the aggregate production of a wide variety of agricultural and manufactured goods that were coming out of the economy ten years ago, and the wealth of the population then and now. Anecdotal information supports the statistical evidence that total output of the non-oil manufacturing and agricultural sectors in Azerbaijan was at least five times higher in the late eighties than it is today. Yet beyond the building of cheap, multi-story public housing projects throughout the country, and the construction of the production facilities themselves, little of the value of this production remained in Azerbaijan. Common to the entire Soviet system, the expropriation of the vast majority of this value was the only real source of financing the huge military>space, and infrastructure expenditures of the central state. Unemployment did not exist, but the people shared a poor economic condition that by the late 1980's was in severe decline, exacerbating problems of internal social cohesion.

After the disruptions caused by the war in the first half of the decade of the nineties, the economy experienced an oil-related boomlet over 1995-97. This came to an abrupt end in 1998, however, with the double blow of both the collapse of world oil prices and the crash of the Russian economy. Purchasing power has been stagnant or declining since then.

There is little a direct intervention project can do to solve this problem, yet the sustained expansion of purchasing power is the ultimate goal of a development program. The problem is circular: purchasing power comes from wage and salary payments for productive employment, but productive employment depends on adequate purchasing power. A development program focuses on stimulating production and job growth in the areas most capable of self-sustaining expansion, by injecting a small amount of purchasing power into the system and better marshalling the purchasing power that is already there.

b) Delay in Large-Scale Privatization

Though delayed and imperfect in design, the process had a reasonably promising start in 1997-99, with the privatization under the first privatization program of virtually of the small-scale enterprises in the country, as well as about 1,000 medium and large-scale enterprises. In addition, the farm privatization program succeeded in the transfer of collective and state farms to private owners with secure property rights. However, three-fourths of all medium and larger sized SOE's remain to be privatized, and only a relative handful of the very large operations have been privatized, on a case-by-case basis.'

Of a recent listing of 83 larger companies privatized outside the Baku-Sumgait corridor, only eleven showed a capital valuation of more than $1 million. The great majority of the vouchers issued to citizens for privatization have not been used in auctions. Some 50% of the vouchers are controlled by foreign investors, who bought most of them soon after initial issue at prices considerably above the current market value. Based on the average market price for vouchers since they were first issued and the proceeds already received by the state from privatization (roughly $100 million), the total market valuation of state-owned enterprises is in the area of $500 million. This is less than one-tenth of the ***S6.5*** billion value the State Property Committee placed on vouchers when the privatization plan was launched.

The privatization process has presently more or less ground to a halt **in** anticipation of the second privatization program, which remains stuck in negotiation between the legislature and the administration. The second phase program will combine voucher privatization with case-by-case privatization, and should create a more effective and transparent process once it finally gets going. The delay in privatization is a major obstacle for private sector development. There are many industrial companies, especially in the **Baku-**Sumgait and Ganja-Mengechevir regions, which could restart at some level of activity, but can do so only after privatization. Where privatization has occurred, such activity is going on. Even if the SOE's restart in private hands at only a fraction of their original level, such activity does put useful and valuable equipment back to work, and through new jobs and domestic production inseminates the circular expansion of purchasing power that is essential to sustained economic growth.

As in other transition economies, delayed official privatization has given rise to other ad hoc privatization techniques. In the oil field equipment area, "revenue sharing agreements" have **been** proposed

[1] The Siyazan **poultry** operation, the Karadag cement plant, the Baku heavy welding machinery plant, **the** Khazar vegetable oil factory, and **a** few others.

to attract foreign investment into major production operations that the state is not ready to divest. Elsewhere, new joint venture companies have been set up with majority private ownership, to which the SOE has downstreamed or divested particular production assets. Such methods can at least get some assets re-employed while the overall privatization process is dragging, but are no substitute for a vigorous wholesale privatization program.

The World Bank has actively supported qualified international technical assistance to vigorous privatization programs in other countries. It has stated that its primary objective in the industrial sector is assisting in the privatization of the many remaining medium and large enterprises. Were the government to adopt a strong program, World Bank financial support for it would be likely.

c) Taxes, the Payments System and Corruption

These issues are dealt with at length throughout in this report. Taxes are high and capriciously applied, depending on the individual tax official and the "connections" of company management. The payments system is avoided whenever possible because of the difficulty in withdrawing funds once they are deposited, and the ability of financial police to review and block company accounts at any time and for any reason. Payoffs are expected and absolutely routine throughout the system for every necessary registration, license or permit – and there are many required. Generally, the larger the company the more able it is to "manage" its taxes and payoffs, but medium- and smaller-sized companies face constant nibbling away of their cash flow and substantial time devoted to dealing with bureaucratic lines and procedures and the settlement of assessments and unblocking of accounts for various tax and accounting infractions. In our company interviews, some business heads stated that they would be able to finance their expansion plans out of internal funds, rather than needing outside credits, in the absence of these constant cash drainings, which were reported to amount to 50-80 percent of operating income.

d) Scarcity of Loanable Funds

Business development requires (1) competitive, viable business concepts, (2) capable management, and (3) adequate equipment and working capital finance. The domestic supply of bank-intermediated financial savings is almost nonexistent. What domestic savings do exist are held in cash, outside the banking system, because of the absence of deposit insurance and the potential for loss of control over funds when they go into the banking system and fall under the scrutiny of financial police. This robs the economy of the circular multiplying affect of the lending and redeposit of financial capital.

For very large companies, foreign direct investment can be attracted and the large, selective investment and credit programs of the IFC and EBRD are available. For small-scale enterprises, intra-family savings are probably the major source of business finance, supplemented to some extent by the "black" loan market, and by donor small loan programs ($10,000 - $50,000) such as those administered by Shorebank (IFC funds). The International Bank of Azerbaijan has some credit activity in the range of $100,000 to $500,000, but the number of loans are very limited. Medium-sized companies capable of employing 25-250 people, which are among those capable of the most rapid job expansion, there is little finance available in the necessary range of $50,000 to $350,000.

e) Real Exchange Rate Appreciation

Turkey represents 25-30% of Azerbaijan's exports and imports, and Russia and Iran each represent 15-20%. Consequently, due to sharp devaluations of the Turkish lira in 1995 and 1997, and of the Russian ruble in 1998, the Azeri manat has appreciated significantly in real terms against the currencies of Turkey and Russia the late 90s. This has been partly offset by a moderate real depreciation of the manat against the Iranian currency.

Destination of Exports	% of total	Origin of Imports	% of total
Turkey	26.5	Turkey	30.9
Russia	19.9	Russia	19.8
Iran	21.6	Iran	16.1
Georgia	11.4	Georgia	8.1
Ukraine	8.8	Ukraine	8.6
Italy	7.7	UAE	4.0
Other	4.1	Other	12.5

The effect of the manat's real appreciation may be described as significant, but marginal. As shown in the table below, two-thirds of Azerbaijan's exports are oil products, which are dollardenominated with prices set on world markets, and therefore not affected by the exchange rate. Much the same goes for cotton, the country's second-largest export. The manat appreciated moderately in real terms against the dollar during the 1996-97 economic expansion, but now is only marginally higher than in 1995. Meanwhile, a majority of Azeri imports are agricultural products for which there are no domestic comparative advantages (motor vehicles, steel), or products that have been produced in Azerbaijan in the past and could be competitively produced again if industry is resuscitated (wheat, flour, oil field hardware, poultry, cement).

Table 8: MAJOR TRADED PRODUCT GROUPS. AZERBAIJAN 1998			
Major Exports	% of total	Major Imports	% of total
Oil Products	65.1	Wheat & Flour	7.1
Cotton Products	8.0	Oil Production Eqp	6.7
Alcohol, Wine, Spirits	2.7	Motor Vehicles & Tires	6.5
Oil Production Equipment	1.7	Iron & Steel Products	3.7
Nuts	1.6	Wood	2.1
Tobacco	1.6	Electricity	1.7
Crude Aluminum	1.1	Poultry	1.4
		Food Production Equipment	1.3
		Cement	1.3
		Pharmaceuticals	0.9
Total in $ million	606		1077

The real appreciation has probably had a significant effect on the position of some consumer products companies that compete with traders bringing in products from Turkey and Russia. It is easy to say that this needs to be corrected, but it is a difficult balancing act for the Azeri monetary authorities, because of the importance of the dollar not only in export earnings but in the cash economy in general. A significant nominal depreciation of the currency in order to address overvaluation versus Turkey and Russia would have an immediate and pronounced inflationary effect in the domestic economy, where larger cash balances are mostly in dollars which are exchanged for manat only when necessary. This appreciation would substantially increase the domestic money supply and, in turn, prices.

The fact is that the real appreciation problem originated in Turkey and Russia, not in Azerbaijan, and is appropriately corrected only by real appreciation of their currencies, not by across-the-board depreciation of the manat. Such real appreciation will occur naturally in time because of the substantially higher inflation rates of Turkey and Russia. Indeed, for this reason the manat has come off of its highs in real terms against both currencies over 1999. Unfortunately, periodic further currency crises in these countries are not unlikely, so that the Azeri consumer products companies are likely to face a chronic competitiveness problem against them. Azeri producers can address this only by their careful control of costs and production quality.

2. Sectoral Taxonomy

There are various ways of breaking down the economy for analytical purposes. The broadest categories, using World Bank data, are agriculture (19% of the Azeri economy), industry (43%), and services (30%). However, for purposes of presenting and analyzing the country's business potential, we prefer a sectoral breakdown according to five major product groupings: Agriculture and food products; The oil sector; Other manufactured products; Construction services and construction materials; and Other commercial services.

Table 9: SECTORAL BREAKDOWN OF THE AZERI ECONOMY, 1998

Product Sector	% of GDP	$ MM
Agriculture and Food Products	**21.8**	**899**
Crops and Primary Agricultural Products (incl. ginned and carded cotton, flour and bread)	11.3	465
Livestock (incl. meat, poultry, fish)	7.8	322
Processed Foods and Oils	2.7	112
Oil Sector	**26.6**	**1094**
Oil and Petrochemical Products	25.0	1030
Oilfield Equipment Manufacturing	1.5	64
Construction and Construction Materials	13.7	566
Services (incl. transport and communications)	13.7	566
Total Commercial Economy	**79.9**	**3288**
Electricity and Other Public Utilities and Services	**20.1**	**828**
Total GNP	**100**	**4117**

Sources: *Statistical Yearbook of Azerbaijan, 1999,* European Commission, TACIS & Ministry of Economy, *Azerbaijan Economic Trends, Jan-March 1999;* World Bank, *Report #10586-AZ, August 16, 1999;* Economist Intelligence Unit, ***Country*** *Report Azerbaijan 3rd Quarter 1999.*

This segmentation is presented in the table above, showing estimates of GDP share and values for 1998. The table focuses on the actual and potential "commercial" part of the Azeri economy – everything but electricity and other public utilities and services – estimated to represent about 80% of total GDP. This taxonomy allocates "industry" across its major product groupings. It shows that the oil sector including manufacturing of oilfield equipment is the dominant product group, representing **27%** of GDP, that agriculture including primary crop and livestock products and food processing represents **22%** of the economy, that construction services and materials are very important at 15% of the economy, that other services are a strong 14%, and that other manufacturing is quite low, at only 3% of the economy. In the following sections each major sector is discussed in turn.

3. Agriculture and Food Products

Agriculture is vital for Azerbaijan. The country's rich soils, wide agricultural plains, and varied climatic conditions make it possible to efficiently produce a broad range of agricultural commodities. Thirty percent of the population is currently engaged in agriculture, making it the most important sector in terms of employment. However, there has been an enormous decline in agricultural production since independence. The following table summarizes these changes, which are discussed below.

Table 10: PRODUCTION VOLUMES OF AGRICULTURAL AND FOOD PRODUCTS

Item	Unit	1990	1998	% Chg
Cereals	tons	1,413,600	950,300	-33%
Fruits & Vegetables	tons	1,361,300	1,205,600	-11%
Dairy Products	tons	970,400	923,900	-5%
Meat	tons	175,500	94,700	-46%
Eggs	thousand	985,300	507,200	-49%
Wool	tons	11,200	9,900	-12%
Meat Livestock	head	3,986,950	3,740,250	-6%
Dairy Livestock	head	3,420,050	3,591,350	5%
Cotton	tons	542,900	112,900	-79%
Processed Fruits & Vegs	cans	709,600,000	85,600,000	-88%
Grapes	tons	1,196,400	144,000	-88%
Alcoholic Beverages	liters	251,000,000	4,900,000	-98%
Fish & Processed Fish	tons	66,800	12,400	-81%
Tea	tons	30,700	900	-97%
Tobacco	tons	53,300	14,600	-73%
Cigarettes	cartons	32,500,000	1,000,000	-97%
Silk Cocoons	tons	4,900	120	-98%

Sources: Ministry of Agriculture; *Statistical Yearbook of Azerbaijan, 1999.* State Statistical Committee

a) Production of Staple Products

In general, production of "staples" has held up fairly well over the 90's. These are subsistence items and can continue to be raised for immediate household use or for local sale through the small kiosks and bazaar markets that are seen all over the country. The biggest declines in staples have occurred in cereals, reflecting the deterioration in harvesting equipment and the lack of fertilizer, and in meat and eggs, reflecting deterioration in feed quality. Because bread is an absolute essential, the decline in cereals production has made wheat and flour now Azerbaijan's largest single import, as seen in a previous table.

Some poultry is also being imported, but it is likely that meat consumption per capita has declined over the decade with the reduction in domestic production.

b) Production of Cash Crops

In contrast to the more moderate declines in production of staples, every one of Azerbaijan's cash crops and processed food products has plunged in production over the decade, and as a whole are perhaps 10% of their 1990 volume levels. In the 1980's Azerbaijan was a key food source for Russia. These declines began with the market disruptions caused by the breakup of the Soviet system and the fighting both in Azerbaijan and to the north in the Caucasus region. Once equipment went out of use or was damaged, resources were not available for repairs and to finance the working capital needed to and build production back up. While restoration of the levels of ten years ago cannot be expected in several cases because of advances in production capability elsewhere, at least some recovery is feasible in almost products, and in certain natural comparative products such as cotton, silk, fish and fish products, and tobacco, major recovery is feasible.

With respect to the potential value of production, it is worth noting that at current prices, the value of the nation's agricultural and food output alone in 1990 would be in the area of $5 billion, itself 20% greater than current total GDP. Again, this evidences how little of the value of Azerbaijan's substantial product under the former system managed to benefit the country itself.

c) Key Constraints to Agricultural Expansion

The agricultural sector has now been largely privatized, even including some large food processing companies. Therefore, lack of privatization is not a significant constraint for expansion in agriculture. Moreover, the government has simplified and reduced taxation in agriculture more than in any other sector. Recovery of the agricultural sector therefore depends mainly on two factors:

- ***Finance.*** Commercial agriculture is a credit-hungry undertaking. All agricultural businesses require extensive capital equipment, whether in harvesting food or in processing it. In addition to equipment finance, primary agricultural businesses are large users of working capital because they naturally tend to have a lot of "work in process". Seeds and fertilizer must be purchased long before crops are harvested and sold. Feed must be bought and consumed by livestock throughout the fattening process. There is no feasible way for the Azeri commercial agricultural sector to recover without access to business finance. Programs are now being launched to encourage and finance agricultural credit cooperatives, which will provide some necessary finance for primary agricultural businesses. With respect to further processing of primary agricultural products, including meat packing, processed meat products, and processed fruit and vegetable products, credit is essential to business development.

- ***Market organization.*** A negative result of the agricultural privatization process was the collapse of the large-scale organization of production and marketing that accompanied fragmentation of land holdings and the exit of the state from the market. Many private landholdings are now only one or two hectares. As has been observed in other transition economies, this has resulted in an increase in subsistence farming and a decline in the production of cash crops. Small farmers who never had to deal with marketing issues now must individually determine what they should plant, and they must manage the marketing of the product. In the absence of large and reliable wholesale buyers/distributors willing to work with farmers and guarantee purchase, individual farmers face substantial market uncertainty and therefore revert to ensuring subsistence for their families.

d) *Who are the Buyers?*

The market solution to the agricultural problem has encouraged development of domestic businesses that constitute viable wholesale buyers of primary food products in volume. There are hvo primary groups:

- ***Food Processors.*** The country has room for several large slaughterhouse/meat packing operations which would provide a ready market for fat hogs, cattle, and sheep. Presently most meat is sold through informal village markets. Medium-sized packing plants each capable of processing at least 5,000 tons of meat annually would dramatically improve the organization of this market, as well as providing jobs in themselves and improving public health. In the poultry area one such processor, the large (25,000 tons/year) Siyazan chicken facility, has been purchased by foreign financial investors and will come back on line in 2000 after a 5-year shutdown, probably eliminating single-handedly the entire present volume of imported chicken meat.

  Processors of fruit and vegetable products should also provide ready markets for farmers in the case of primarily exportable processed foods. (See discussion below as to domestic market limitations.) We learned of the substantial decline in hectarage devoted to apple production in the Guba area, despite the fact that apple juice concentrate is an international market commodity. In this case, the large juice plant in Guba would purchase far more apples than are currently being supplied to the market by farmers. Farmers need technical assistance in organizing marketing cooperatives that would anticipate the needs of food processors and thereby encourage expansion of commercial production. In the case of canned tomatoes, a traditional Azeri export, assistance may be needed in the redevelopment of esport markets.

- ***Food Wholesalers/Distributors.*** The marketing and distribution of food products within Azerbaijan is far too fragmented. In our company survey, we met businesspersons interested in converting what are now bazaars in good city center locations into legitimate large supermarkets, with on-site meat packing facilities. The success of such businesses would allow fanners to focus on fanning and sell product on a wholesale basis to the supermarket, instead of having to devote time and resources to subsistence bazaar marketing. **Purely** wholesale operations should also be encouraged with technical assistance and credit.

e) *Recovery of Purchasing Power*

It **is** commonly observed that recovery of the agricultural sector in Azerbaijan depends on expansion of food processing industries. It appears however that purchasing power in the domestic market is a serious limiting factor in the development of such businesses. Household income in Azerbaijan is on the order of $17.5 per month. With basic food and drink staples costing $80-90 per month, processed food products are to some extent luxuries in Azerbaijan. While exports of certain processed food products is feasible, the domestic expansion of these businesses can be expected to occur only gradually over a period of years as domestic purchasing power expands.

4. The Oil Sector

Oil itself is by far the largest of Azerbaijan's exports, and in time, oil and petroleum products have the potential to enrich the nation. Oil itself is not a focus of this study. Clearly, to the degree that exploration and production of oil are viable, major international oil companies will **work** with SOCAR to finance and exploit this resource.

The oilfield equipment industry is more relevant to the present study. This once-huge Azeri industry used to supply the majority of the equipment used in the Soviet bloc. There are at least 45 manufacturing operations within the industry, most of them under the umbrella of a very large **SOE,** Azneftechimmash. With the collapse of the Soviet system and the entry of Western oil companies, substandard equipment quality became a major issue and the local industry greatly declined. This industry should be a priority for revitalization, because it has a very large local market in the Azeri offshore fields, and a large regional onshore market in Khazakstan.

Presently, serious American-led efforts are underway to bring equipment quality up to API standards and to secure foreign investment. Delay in the privatization process is a constraint. No foreign investor would consider acquiring the entire SOE. It must be broken up and sold off.

5. Other Manufacturing

There are major idle production facilities throughout the country. As in agriculture, output from these facilities ten years ago was enormous and they employed thousands. In the case of many of these operations, the collapse of the Soviet system means permanent disappearance of markets. At the same time, however, domestic and regional markets for certain product lines can be identified, and equipment to revive production and exploit these market opportunities can be renovated. Production may be only a fraction of its former level, but this is far better than facilities sitting idle as they are now, and it creates the basis for the emergence of new businesses.

Table 11 below gives an indication of the kinds of products that were produced in volume in the country ten years ago, showing dramatic production declines. This is followed by a focus on certain manufacturing sectors more likely to be viable.

The total value of the 1990 production volumes of the products in Table 11 was over ***$2*** billion, while at today's production the total comes to less than $100 million. Some of these products lines are dominated by global firms with production somewhere in the region, so that they are unlikely to be competitive if restarted, including tires, detergent, cardboard, refrigerators and stoves, air conditioners, and bicycles. Having said this, during the privatization process there may be certain production units that would be considered worth picking up by global brand producers in order to better service the local market with their brand names, for example in air conditioners, white goods, tires, or detergent. These businesses would not be the target of a business development program; their viability would be determined by foreign strategic investors through the privatization process.

a) Textiles and Apparel

In terms of value, at $1.5 billion, the textiles (fabric) and apparel (clothing) sector was the third largest domestic product line grouping in Azerbaijan ten years ago, after agriculture and oil. The most valuable single textile item was silk fabric, and the second was cotton fabric. These products relied on the country's important natural capabilities for production of raw silk and cotton. Silk production has now practically disappeared, and cotton fabric output is less than one-tenth of its former level.

- ***Textiles.*** With respect to fabric, there is one large factory for silk production in the country. This is located in Sheki, at the center of a low mountain region ideal for harvesting silk cocoons, which, for centuries, was an important supply stop on the "great silk road". This operation is at a virtual standstill due to its failure to hold its markets and the unavailability of finance. For similar reasons, the cotton fabric mill in Mingechevir, the largest in the country, is operating at a very low level. These factories are situated in the middle of the growing areas for their respective primary agricultural inputs, technologically adequate, and certainly capable of being revived at some level. They are not yet privatized, and if the government is holding them back from privatization in the hope of attracting a foreign buyer, this is a mistake, because they do not need a foreign strategic partner for business to be viable. These are not industries characterized by large multinational holdings. As long as their products are of good quality, and their marketing activities are aggressive and professional, they should be able to find enough of a market to consolidate, and with moderate financial assistance re-emerge as viable businesses on their own. Had they been privatized earlier with good management and aggressive marketing, they probably could have avoided sinking to their current levels of inactivity.

Table 11: **PRODUCTION VOLUMES OF SELECTED MANUFACTURED GOODS**

Item	**Unit**	**1990**	**1998**	**% Chg**
Textiles and Apparel				
Carpet	m2 000	2,243,000	34,000	-98%
Silk Fabric	m2 000	33,500	5	-100%
Footwear	Pair	15,207,000	327,000	-98%
Cotton Fabric	m2 000	119,490	17,620	-85%
Wool Fabric	m2 000	9,100	26	-100%
Apparel	Pcs	18,899,000	265,000	-99%
Socks	Pair	37,800,000	1,700,000	-96%
Knitwear	Pcs	36,700,000	1,400	-100%
Fabricated Metal Products, Machines				
Electric Motors	Units	268,400	10,100	-96%
Electric Cable	Tons	32,700	400	-99%
Refrigertors	Units	330,000	3,400	-99%
Stoves	Units	45,000	700	-98%
Cast & Formed Metal Products	Tons	155,000	5,800	-96%
Fans and Ventilators	Units	464,000	100	-100%
Air Conditioners	Units	309,000	10,000	-97%
Children's Bicycles	Units	130,000	0	-100%
Kitchen Utensils & China Crockery	Units	21,100,000	5,500,000	-74%
/AluminumPots and Pans	Units	2,460,000	26,000	-99%
Window Glass	m2 000	5,320	637	-88%
Paints and Plastics	Tons	68,4001	18,300	-73%
Tires	Pcs	1,123,000;	300'	-100%
Detergent	Tons	81,500'	600,	-99%
Cardboard	m2 000	11.609	750	-94%

Source: *Industry of Azerbaijan,* State Statistical Committee

We learned that a foreign financial investor does intend to acquire a large cotton spinning facility in Baku which is currently mostly idle, purchasing domestic carded cotton as its input, for re-entry into the regional yam market. The restarting of these textile operations will of course provide a wider market for underemployed domestic cotton and silk farmers.

- ***Apparel.*** With respect to clothing, Azerbaijan faces exactly the same serious problem as other transition economies, most of whom had major apparel production facilities supplying their own and Russia's needs. With the opening of trade, these operations initially had **no** chance of competing with western design styles and quality standards. However, this business is beginning to achieve some success again in the transition economies. There are a number of examples of these companies refocusing on high-quality on-time production and becoming viable contract production units for western labels. Other apparel manufacturers have ,upgraded their design capabilities and successfully focused on domestic market niches, often with "Italianized" label names and copied designs. These options are available to well-managed Azeri apparel operations.

Azerbaijan should be able to restart some of its cotton knit facilities, which produced fully half of the value of apparel production ten years ago. Vertical integration in cotton knit operations is typical in the industry, because the cost of cotton is such a major variable in profitability. Given the country's comparative advantage in cotton production and the local availability of both carding and spinning facilities, knitted cotton goods (socks, T-shirts, underwear) should be competitive at some level. Privatization in this industry has occurred, with, for example, a major apparel operation in Sumgait that is now moderately active.

b) Metal Products, Machines, and Other Manufacturing

As discussed above, aside from those units producing the kinds of major appliances and goods that are supplied by well-known multinational firms, which if regionally viable will be acquired by these strategic partners, other manufacturing facilities should be able capture some market share. Heavy industry must become light industry, and large diversified conglomerates must focus on single product lines in niches where they are truly competitive.

For example, almost all of the electric cable produced in the country prior to Perestroika came from the large plant in Mingechevir (a planned industrial city built from the ground up in the 1950s, along with its own hydroelectric plant). The cable factory employed nearly 6,000 people, and supplied products throughout the FSU. It is entirely idle now, and may never fully recover, but this does not mean there are no feasible domestic or regional markets. Even if the plant was reduced to a corner of its industrial complex, employment of 200 people making only small-guage wire would be a good light industrial business that would generate purchasing power and it could grow. The factory is still unprivatized.

The expectation that such operations can be restarted at some level is supported by evidence of vibrant businesses re-emerging in large formerly state-owned plants that were privatized into Azeri hands in the first round. Two examples observed by the team are in Ganja. One was formerly the largest furniture factory in the region, with 800 employees, before shutting down in the mid-90s. It was acquired by entrepreneurial Azeri owners in 1998 and is now operating effectively with 40 employees, a much smaller but profitable business very aware of its market. The other was a 1500-employee producer of extruded metal and plastic products, also in Ganja and taken private by Azeri owners. This company has refurbished a part of the equipment and is becoming a manufacturer of a varied line of plastic and metal home and school products, and now has 130 employees. It is presently constructing a car battery facility, since it can extrude the heavy plastic battery boxes, which will directly substitute for imports. Its highly entrepreneurial owners have taken what was a completely defunct facility and with limited investment re-created an aggressive viable business.

Looking at more recent data for some manufactured products, textiles and apparel have continued their dramatic decline in the late 90's, along with production of household appliances. Cardboard production, however, while still far below its 1990 level, has expanded over this period, probably reflecting the growth of trading activities. Paint and plastics production has held up reasonably well, and some recovery in light manufacturing as seen in kitchenware has occurred.

Item	Unit	1995	1998
Fabrics	m2 000	59,300	7,000
Apparel	pcs MM	14.6	2.0
Refrigerators, Air Conditioners	Units	89,000	13,400
Cardboard	m2 000	684	750
Paints and Plastics	Tons	19,700	18,300
Kitchen Utensils, Pots & Pans	pcs MM	2.8	5.5

6. Construction

After the oil sector, construction has contributed most to the economic growth that has occurred in Azerbaijan since 1995 (detailed information is presented in appendix tables). Similar to agricultural and other manufactured products, production of construction materials is well below its level of ten years ago, although some product lines have expanded during the late 1990's, as shown in the Table 13.

Table 13: **TRENDS IN PRODUCTION OF CONSTRUCTION MATERIALS**

Item	Unit	1990	1995	1998
Cement	Tons	989,000	196,000	199,000
Window Glass	m2 000	5,320	528	637
Roof Tiles	pcs MM	65.5	8.0	13.8
Bricks & Blocks	units MM	1,317.0	161.0	95.2
Ceramic Tiles	m2 000	1,159.0	170.1	65.6*
Sand & Gravel	c3 000	10,982	2,888	342*

Note: 1997 Data. ***Source: Industry of Azerbaijan,*** State Statistical Committee

Construction of major office and oil sector building projects has sustained the sector in recent years, as reflected in the cement and window glass figures, but construction of homes has weakened with the failure of purchasing power to expand. This is reflected in the figures for bricks, blocks, and tiles. Major infrastructure and public works projects, which would consume large quantities of sand and gravel, have not yet had an impact. What home construction has occurred reflects the fact that there is a small portion of the population whose wealth has increased, and families with potential savings find that real estate investments are far more preferable than bank savings. Large family houses that one sees driving around the country are the physical counterpart to the savings denied the banking system. Fortunately, exterior building products are domestically produced, and assist the Azeri economy, however interior fittings are imported. Most wood elements are imported because domestic forestry output is limited and does not appear to be well-managed?[2] However, there is some new production of floor parquet, and several businessmen have initiated small businesses in door and window production.

There has been a strong expansion in registered construction trades businesses in recent years, evidencing the promise of this sector to local entrepreneurs. Growth in the number of privately-owned construction businesses accounts for substantially more than the total increase, as a number of construction-related SOE's have privatized. The large donor-supported infrastructure projects that are in view will underpin the expansion of the construction sector over the medium-term. Home construction and improvement will see some growth as the economy moves out of its current stagnation. With the privatization of the Karadag cement plant finally completed, Azerbaijan should turn from a net importer to exporter of this commodity after the plant comes back on line.

7. Services

Service businesses, which have low barriers to entry and can employ an individual's skill in a sole proprietorship, have expanded by nearly 50% in number since the mid-90s'~. This is certainly the busiest sector of the private economy, and now represents nearly 14% of GDP, approximately as large as the GDP contribution from construction.

Table 14: SERVICE-RELATED ENTERPRISES

Enterprise Type	1995	1998	% chg
Trade, Horels, Resraurants	15,906	20,094	26%
Financial Intermediation	299	742	148%
Transport Services	2,917	6,550	125%
Postal & Communications	82	246	200%
Real Estate & Rental	1,668	1,771	6%
Education, Training	214	583	172%
Health & Social Services	477	1,242	160%
Audit & Accounting	188	1.984	955%
Other Trade & Personal Services	34,116	50,807	49%
Total Enterprises	**57,870**	**86,025**	**49%**

Sources: State Statistics Committee survey for the Ministry of Justice and Ministry of Labor, *Summaries of Industry in Azerbaijan,* 1996 & *1998*

a) *Trade Services*

Wholesale and retail trade have expanded rapidly in recent years, reflecting the transition of the economy to a market system. In Azerbaijan as in other transition economies, many of these are small traders, opportunistically purchasing and selling a variety of goods. This activity has mostly facilitated the large influx observed over the 90's in foreign consumer appliances, household goods and apparel. Nevertheless,

[2] Payoffs fo forestry officials were reported to be necessary to secure timber.

even when goods handled are not domestically produced, such operations do create employment and domestic income in themselves. They will certainly continue to expand. As seen in Table 14, roughly 40% of all registered businesses in the country are trade, hotel, or restaurant establishments – far more than any other sector – and their number has grown by more than 25% over the late 90's.

There are major deficiencies in domestic wholesale and retail distribution, and therefore opportunities for expansion in Azerbaijan. Still, there are far too many small kiosks and bazaar stalls, and too few major wholesalers and large retail distribution outlets.

b) Business Logistical, Office, and Professional Services

The table shows sizable growth in transport services. The growth of audit and accounting firms, mostly private sole proprietorships, despite all the problems noted in this report, is a strikingly healthy development, and evidences the broad expansion of the private sector. The expansion in the number of financial intermediaries must cover the ubiquitous currency exchange shops, because the number has actually contracted significantly. Nevertheless, significant expansion of employment in the financial sector, even with a few surviving banks, can be expected in the years ahead. The number of lawyers is growing, and other business office support services such as copying and printing are beginning to expand. The team visited several successful business services companies, including a freight forwarder in Astara, a graphics/printing company in Ganja, and several consulting and market research firms in Baku.

c) Health Services

The team also visited a successful privately-owned and well-equipped health clinic in Baku, and a number of such establishments can be observed. Table 8 shows an enormous expansion of registered businesses in this area of opportunity, which is supported by the detailed tables in the statistical appendix showing very rapid growth in private clinics, healthcare facilities, and employment in private or mixed-ownership enterprises.

C. THE SME SECTOR AND ENTERPRISE DEVELOPMENT

The pace of private enterprise development will eventually determine the economic progress of Azerbaijan. This necessarily includes a vibrant growth in small and medium-sized enterprises (SMEs), and a shift from cumbersome large state-owned enterprises toward smaller more efficient private-sector organizations. In many instances, this shift has begun to occur, which reinforces the optimistic view that Azerbaijan can overcome its economic limitations with constructive assistance and patience.

Table 15 reveals several patterns of enterprise development, and the relative difficulties of state owned enterprises during transition. The total number of juridical enterprises (registered companies) increased by 14 percent between 1995 and 1998, and there was a 58 percent increase in physical persons businesses (individual businesses or proprietorships). Considering the pattern of increased activity in the "informal sector," these registrations represent a favorable growth trend, and in light of many limitarions and economic difficulties addressed elsewhere in the report, the rate of growth in registered enterprises is encouraging. However, there are several caveats to consider. Employment has risen only slightly, and at much lower rates of change, and wages have not kept pace with enterprise development reflecting disproportionate growth in some sectors. In addition, state-owned industry continues to plummet in output and productivity. Nevertheless, there are several remarkable growth trends.

The percentage changes noted in Table 15 do not provide an accurate picture as some sector increases occurred from relatively small base levels of registrations. Postal and communications firms, for example, record the largest percentage gains in all categories (800% change for mixed-property companies, and a 2050% change for privately owned enterprises). Indeed, there has been a major change in sector ownership of business assets with registrations of freight, postal, GSM, and Internet companies. But overall, this sector is still dominated by state enterprises, and partial government ownership occurs in nearly all telecommunication and port-based freight systems that come under the "postal" authority.

Financial intermediation has also experienced tremendous growth in private ownership, and indeed, this has been real growth. Despite problems in the private banking sector that promises a "shake out" in the near future, there are new companies that will stay the course, and there is an embryonic commercial insurance industry coupled with leasing. Based on information from the Association of Entrepreneurs, all but three of approximately 85 insurance companies were greenfield private start-ups that are still relatively small companies, but have secured market niches. Health and social service organizations have also grown remarkably through private clinics and practices. Private health organizations were virtually nonexistent in 1995 (8 were registered as independent practices), yet today, there are more than 400 private enterprises. Foreign assistance has been very important to this sector growth according to Save the Children information, noting that at least 120 rural clinics were founded through development programs.

Table 15: ENTERPRISES IN A :RBAIJAN AND TRENDS

Classification[a]	State-Owned			Private-Owned			Foreign-Owned		
	1995	1998	% chg	1995	1998	% chg	1995	1998	% ch
Companies	**27,945**	**13,945**	**-50%**	**17,982**	**36,825**	**105%**	**410**	**1,596**	**289%**
Fostery, Hunting, Fishing	2,774	874	-68'3	10,078	9,515	-6%	9	11	22'
Industry, Energy, Utilities	6,416	1,429	-789	1,374	2,714	98%	16	130	713'
Trade, Hotels, Restaurants	11,017	2,500	-77'3	4,501	16,558	268%	313	648	107'
Construction Trades	3,129	2,741	-129	494	2,202	346%	18	149	728'
Financial Intermediation	291	351	219	4	355	8775%	0	15	n
Transport Services	510	413	-19'3	164	498	204%	9	87	867'
Postal & Communications	75	173	1319	2	43	2050%	3	12	300'
Real Estate & Rental	1,388	611	-569	252	727	188%	22	407	1750'
Education, Training	163	461	1839	47	103	119%	4	17	325'
Health & Social Services	470	757	619	8	432	5300%	0	50	n
Other Personal Services	1,712	831	-519	1,058	3,678	248%	16	31	94'
Proprietorships				**34,520**	**53,121**	**54%**	**1,399**	**3,469**	**1489**
Rural economy	n/a	n/a	-	213	519	144%	n/a	0	-
Industry	n/a	n/a	-	1,132	1,325	17%	n/a	42	-
Construction	n/a	n/a	-	877	907	3%	n/a	58	-
Trade and service	n/a	n/a	-	30,011	43,373	45%	1,287	2,861	122c
Transport	n/a	n/a	-	2,094	5,139	145%	112	366	227%
Financial Intermediation	n/a	n/a	-	5	13	160%	n/a	9	-
Audit and Accounting	n/a	n/a	-	188	1.851	885%	n/a	133	-

Notes: [a] "Companies" comprises "juridical enterprises" in the Azeri classification, which are registered non-personal legal entities. "Proprietorships" are called "physical person enterprises" in the Azeri classification. ***Sources:*** State Statistics Committee survey for the Ministry of Justice and Ministry of Labor, ***Summaries of Industry of Azerbaijan,*** 1996 and 1998.

Education and training enterprises present a mixed bag where growth has occurred in new public facilities as well as foreign and mixed-ownership organizations. The growth appears to be positive, but devastating losses of rural facilities, displacement by IDPs, and severe budget cuts by the Ministry of Education have more than offset the gains made in education. The net effect, as discussed elsewhere is at least a 20 percent reduction in educational capacity, but this would have bordered on a human resource disaster without the significant increase in private and international institutions.

In absolute numbers, trade and service establishments have had the strongest growth. There has been a four-fold increase in private-owned registered juridical enterprises and nearly 50 percent increase in proprietorships, both from an already strong base of smaller establishments. Close on this track, the construction industry has experienced very strong private-sector growth, a large increase in foreign owned companies, and a significant increase in mixed-ownership enterprises. Coupled with the highest levels of employment change and accelerating wages, the construction industry may be the strongest growth sector in Azerbaijan. At the other end of the spectrum, state-owned enterprises have declined steeply in all industry and service sectors. Public enterprises have increased in health services and social organizations, in education, as noted above, and telecommunications. These improvements would not be unexpected in a healthy economy where most such services are relegated to public ownership. Privatization is at the root of the shift in trade and services, yet there has been far more newly registered private companies than those officially privatized.

There has been a steep rise in professional auditing and accounting services, which suggests an emergent "core" of professionals who typically become watchdog organizations in a market economy. They are capable of influencing companies to accept international accounting standards and providing networks among investors and client companies. It may be premature to read too much into this point, but the sheer presence of public accounting and audit firms coupled with a growing number of foreign-owned professional organizations will have an effect on government transparency and business behavior. Information from PriceWaterhouseCoopers supports this conclusion. During the past 18 months, for example, several PWC clients have won court tax disputes and *two* PEC actions have been *successful* against tax authorities. These successful defenses would have been impossible a few years earlier, and Azeri firms with support of international legal firms, have made some impact on judicial procedures.

Finally, the changes noted for individual (physical person) businesses show that the number of registered rural enterprises has increased by a healthy percentage (14%), but in absolute terms, growth is very disappointing. Barely 500 independent rural enterprises were registered in 1998, and overall, there was a decrease in the number of enterprises registered under Forestry, Hunting, and Fishing (largely a rural-dominated sector). However, the Ministry of Justice does not track registration of independent farmers or land registry of crop allocations from dissolved collectives. Also, food processing enterprises which may be rural – and may represent success stories by donor agencies – are captured in the "*industry*" sector. These are not identified apart from production output statistics, which are described elsewhere in the report under "sector performance."

The profile of registrations in the rural sector is particularly interesting because a significant majority of assistance programs and microcredit projects have focused on rural enterprise development. As noted earlier, many of these have been associated with income-generating activities. One would expect that the millions of dollars of assistance and microcredits, if effective, would have generated a substantial increase in new private enterprises. There is no evidence here to suggest that such activities have been commercially successful other than to sustain a humanitarian effort. Indeed, the sectors with no assistance (or minimum aftention from either foreign assistance *or* government initiatives) have had the strongest growth rates. A safe assumption, however, is that production gains recorded as agribusiness may account for a reasonable percentage of the private-owned registrations in Table 14 for "industry" as the "manufacturing" component of industry has generally declined.

The number of new private-owned enterprises and the rapid increase in individual businesses in nearly all sectors suggests that SME development is strong and sustainable. In addition, growth in the informal economy implies even greater potential than indicated by official registration data. Ironically, the strongest growth has occurred among professions, services, and construction trades where assistance has been minimal. Consequently, there is every reason to be optimistic that new private enterprises will continue to emerge. This phenomenon will occur through determined efforts of individuals, even though they face an uphill battle for capital, technology, and markets. The SME sector may not yet be an engine of growth to compare with the oil industry, but it may incrementally provide the domestic enterprise diversification required to eventually stabilize the economy.

IV. FINANCE AND THE ENABLING ENVIRONMENT

A. BANKING AND FINANCE

1. The Banking System

Since the independence of Azerbaijan in 1991 until the end of 1998: *232* establishments received licenses from the National Bank of Azerbaijan (NBA) to conduct banking business in the country. By the end **of** 1995 there were 180 banks registered, 79 at end of 1998, and about 70 presently.

Table 16: **OVERVIEW OF THE BANKING SYSTEM**

$ Million, unless otherwise indicated	Dec-95	Dec-98	*Change*
Number of Banks	180	79	*-101*
Of which Foreign-Owned	11	12	*1*
Loan Assets	**248.0**	**437.7**	***190***
State Banks	198.6	266.6	*68*
Private Banks	49.3	171.1	*122*
% of Total Loans	*.20%*	*39%*	*19%*
Capital	**25.2**	**153.9**	***129***
State Banks	5.6	35.9	*30*
Private Banks	19.6	117.9	*98*
% of Total Capital	*78%*	*77%*	*-1%*
Foreign Capital	*5.4*	*17.6*	*12*
Savings Deposits	**19.1**	**48.2**	***29***
State Banks	14.8	27.3	*12*
Private Banks	4.3	11.2	*7*
Of which Foreign-Owned Banks	4.1	7.5	*3*
% of Total Deposits	*21%*	*16%*	*-5%*
Other Liabilities *(Implied)*	**203.7**	**235.7**	***32***
State Banks	178.3	203.5	*25*
Private Banks	25.4	42.0	*17*
Profitability	**29.3**	**11.4**	***-18***
State Banks	22.5	6.5	*-16*
Private Banks	6.8	4.8	*-2*
% of Total Profits	*23%*	*42%*	*19%*

Source: National **Bank** of Azerbaijan, except for Implied Other Liabilities

2. Bank **Equity** Base

An important reason for the declining number of banks is the increased capital requirements to become licensed and remain active. At the beginning of 1998, every bank had to have a minimum registered capital of $1.0 million. This amount was to be increased every six months by $250,000, so that by the end of the year 2001 every bank in Azerbaijan would have registered capital of at least $3.0 million. However, new banking licenses now require initial authorized capital of $5.0 million.

At the end of 1998, there were four state banks and 75 private banks (private ownership exceeding 50% of the capital). Three of the state banks were successors to FSU banks, and the fourth (IBA) was newly established in 1991. Twelve of these private banks were totally held by foreign legal or physical persons. As seen in Table 16, these hanks had an authorized capital of $154 million, five times the equity level in 1995. However, this is an average of only $1.9 million per bank, moderately above the minimum capital requirements. Although private banks as a group held 77% of the total capital of the banking system (not portfolio assets, but authorized capital), the average of the 75 private banks was just $1.6 million, barely above the minimum. The equity base of the banks in Azerbaijan is very thin.

3. Bank Lending and Deposits

As seen in Table 17, total credit volume at the end of 1998 reached $437 million, an increase of $190 million since 1995, or an average of $63 million per year. This is a minute amount of bank intermediated credit for a $4 billion economy. The total expansion of credit amounted to only 1.7% of GDP over the three year period.[3] Even this figure somewhat overstates the true flow of new bank credit into the economy, because part of the expansion of state bank loan assets merely represents the absorption of assets and deposits from three former FSU banks and credits given to state-owned companies between 1993 and 1995. Most of these assets are non-performing loans to state-owned companies, some of which no longer even exist. These assets are **a** burden to the banks and a hindrance to their privatization.

The amount of these non-performing assets is not transparent so that a deeper analysis is difficult. However, some range can be deduced. State-owned bank loans expanded by $68 million over the three-year period, financed by $30 million in growth of their capital and $12 million in deposit growth. It can therefore be inferred that other liabilities of state-owned banks' – probably some notes due the state – expanded by $25 million. It is likely that at least half of the growth in state-owned bank loans, some $35 million, was represented by these inherited assets. This would reduce the estimate of total new bank credit to the Azeri economy over the three-year period to $150 million – $50 million per year. This is completely inadequate for the economy's needs.

Furthermore, even this small amount of credit was supplied on highly unfavorable terms. Fully 98% of credits were short-term, with a maturity of less than 12 months and usually less than 6 months. Normal bank interest rates are 2-4% per month, even though the local currency is quite stable against the dollar. The foremost reason for the high cost and unfavorable terms of credit is a scarcity of loanable funds, which gives the banks a very high cost of capital.

In western countries, household and business deposits – domestic savings – are by far the most important source of funds to the banking system. These plentiful funds allow the banks to have a low average cost of capital, and therefore lend on reasonable terms to businesses. Such deposits finance at least 80% of bank credit expansion in the U.S. In the Soviet system, however, household savings were theoretically unnecessary because the state took care of housing, education, and retirement needs – the things people normally save for. Average household income was too low to allow significant savings

[3] In the U.S., the comparable figure would be 10-15% of GDP. At this benchmark bank lending in Azerbaijan would be at least $400 million **annually.**

anyway. The dearth of savings has persisted into the transition era, and as if this were not enough, it is seriously aggravated by two additional factors: (1) the complete absence of deposit insurance, and (2) the fear of losing control over personal funds once they are deposited in the state-controlled central payments system where officials can expropriate taxes and block accounts at will. Domestic savings are therefore kept in cash, deposited in foreign banks (actually shifting loanable funds offshore), or invested in real assets. With respect to both the cost and terms of borrowing and the security of lending, the transition economies, desperate for finance, are forced to face much higher standards than in the west.

These problems are evidenced in Table 17, which shows total deposits of the Azeri banking system to be $48 million – a increase of a pathetic $29 million over the three-year period, or only S10 million **per** year.[4] Based on these data, the total bank savings of the average Azeri household is about S25. Bank deposits cover only 11% of loans. One somewhat favorable indicator is that the proportion of deposits entrusted to foreign-owned banks exceeds their proportion of total bank capital or total number of banks, indicating greater confidence in depositing funds there.

Pulling these observations together, an interesting story emerges. **As** can be seen **in** Table 16, about 80% of the adjusted new bank lending over the three-year period, $122 million, came from private banks. Of this $122 million, only $7 million came from increased deposits in private banks. Of the remaining S115 million, **$98** million was financed by increased bank equity, and the balance, S17 million, must have come from issuing other high-cost liabilities. In other words, almost 95% of the new loans by private banks (about 80% of total new loans) were financed by expensive equity. In this context, the interest rates charged by local banks do not appear exorbitant – they approximate the required rate of return on equity anywhere **in** the world. When banks are Iending equity, they cannot lend cheaply.

The high cost of credit in turn inhibits bank borrowing. Most businesses surveyed by the team were highly cynical about the prospect of borrowing from a bank, because of the high cost, or simply the unavailability, of funds. On their side, bankers complained about the difficulty of finding good loan prospects. But how many "bankable" projects even in the **U.S.** are capable of generating a **40-50%** annual return? Even so, we found businessmen turned to the even more expensive (and potentially dangerous) "black" loan market, confident that their projects would succeed.

$ Millions	Dee-95	Dee-96	Dee-97	Dee-98	Jun-99
Total Loans	**248.0**	**321.6**	390.5	437.7	**392.1**
% Short-Term	83%	92%	93%	98%	97%
% Lea-Term	*17%*	*8%*	*7%*	*2%*	***3%***
Overdue **Loans**	***51.1***	66.1	79.1	**86.7**	n.a.
% of Total Loans	***21%***	*21%*	20%	***20%***	
% Short-Term	*84%*	*96%*	***95%***	***97%***	
% Long-Term	*16%*	***4%***	*5%*	*3%*	

Source: NBA and estimates

[4] And even this increase is probably overstated, due to the transfer of some already existing deposits into the state-owned banks, as discussed above.

The high bank hurdle rate, and the greater degree of risk it introduces for both lenders and borrowers, explain the high and rising proportion of short-term loans relative to total loans in bank portfolios. Developments in 1999 suggest that bank activity has contracted with the stagnation of the economy. There are not yet any official figures produced by the NBA (see statistical appendices for complete profiles on all banks in the system). Credit volume appears to have decreased by 10-15%. About one-fourth of the decline in dollar terms is explained by the exchange rate, but the balance is due to a reduction in credit in manat terms. The deep crisis provoked by falling oil prices and the stagnation in the non-oil economy increased the risk for businesses. Loan defaults increased and banks reduced their credit business. Meanwhile, deposits declined even from their low level.

Based on the team's interviews with many bankers, there could be some turnaround in these trends by the end of 1999. Several bankers stated that there has been definite improvement since August 1999. More money is said to be entering into the country, perhaps because certain customs issues which inhibited export business during the first part of 1999 were addressed, and because the Caucasus-related problems in Russia caused people from the region to return home, bringing in money earned abroad. At the end of the year, credit volume may return to the level of year-end 1998. Some banks indicated an interest in increasing their credit volumes, and increasing the leverage between equity and credit volume. This development can be a first step to a better credit supply, but risk must be managed and banks need assistance to expand.

The proportion of overdue loan principal has remained at about one-fifth of the total loan assets for the past several years, though it has probably risen somewhat in 1999. Adding overdue interest would bring total arrears to ***35%*** of loan assets. The shares of short-term and long-term loans in total overdue loans track their shares in total loans. The bank listing in the statistical appendix shows that only a few banks had larger deposits. The deposits shown by the three old state own banks, as discussed, are mostly those taken over from their old structure and are not available to fund new loans. Many banks keep their credit portfolios at or below the level of their registered capital. Only a few banks seem to have their loan portfolios and deposits (plus other liabilities) roughly balanced.

To get a better insight into the Azerbaijani banking system one needs to look more closely at its major players: National Bank of Azerbaijan, the three old state banks, and the private banks separately. Special attention needs to be paid to the International Bank of Azerbaijan, which is still 50.2% state owned but **a** key commercial bank in Azerbaijan. It is positioned to be privatized in the near future.

4. Major Players in the Banking Sector

a) The National Bank of Azerbaijan (NBA)

The NBA, the central bank was established in 1992, based on a special law. It has at least three different functions: (a) controlling monetary policy, (b) supervising the banking sector, and (c) providing liquidity to the banking sector by giving short term credits to the banks. The interest rate of these loans given by the **NBA** to banks, at the moment 14%, is seen as a guiding figure in the financial market in Azerbaijan, the refinance interest rate. The banking supervision function has promulgated guidelines for prudent banking, shown in Table 18.

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The bank listing in an Appendix table shows that only very few banks had any larger deposits. The deposits shown by the three old state own hanks, as discussed, are mostly those taken over from their old structure and are not available to fund new loans. Many banks keep their credit portfolios at or below the level of their registered capital. Only a few banks seem to have their loan portfolios and deposits **(plus** other liabilities) roughly balanced.

It is highly recommended that the NBA stick to its plan to continue the process **of** continuous increases in the minimum capital of existing banks through the end of 2001, so that the planned $3 million will be reached. However, we learned that there are pressures for a moratorium in this plan. In 1998 the NBA as bank supervisor investigated a number of banks. Sixteen were fined and five were closed. A key need is for the **NBA** to enforce greater transparency in the financial relationships between the banks and their main shareholders. It seems likely that that some banks were primarily established to provide concessional credit to a small group of shareholder beneficiaries. The NBA receives support and technical assistance from the International Monetary Fund.

Table 18: **NBA PRUDENTIAL BANKING GUIDELINES**

Item	**Guideline**
Minumum authorized capital	• Existing banks: presently S1.75 million; S2.0 million as of 1/1/2000 • New banks: $5 million
Minimum capital / Risk-weighted assets	10%
Maximum risk-weighted loans to related borrower / total loan assets	• ***25%*** of loan assets
Maximum deposits / capital	• 200%
Maximum risk-weighted loans to shareholders / Total loan assets	• 20% if legal entity • 10% if individual
NBA reserve ratio (depending on liabilities)	• 12% of liabilities

b) The Old State Banks.

The three old state banks – Agroprom, Prominvest and Sber Bank – **are** successors of the important banks from Soviet times. Their loans and liabilities are huge compared to the size of the private banks: 35% and 42%, respectively, of the banking system's totals. Their situation is to a great extent not transparent. Non-performing assets and the corresponding liabilities need to be cleared by the Ministry of Finance. Whether these banks will be liquidated or privatized after a solution for the old debts is not clear. **At** the moment one can only say that large loans and deposits of these three state-owned banks (see statistical appendix) are not actively participating in the economy and will probably disappear **or** be written down.

These institutions could be of some help because of their experience in special sectors of the economy, especially agriculture. his would only be the case if there an aggressive market focus is instilled in bank management. The Agroprom Bank, the old Agriculture Bank that still has more than 60 branch offices in the country, has developed plans for a new start. These plans were developed by an experienced consulting team linked to the French bank, Credit Agricole.

c) The International Bank of Azerbaijan (IBA)

The IBA is the largest and strongest commercial bank in Azerbaijan, state-owned or private. It was set **up** in 1991 as a fully state-owned bank and transferred into a joint stock company in 1992. The bank has

registered capital of $5.1 million, of which $2.9 million is paid in. A slight majority of the bank's capital, 50.2%, is held by the Azerbaijani Ministry of Finance, 8.5% by the **staff,** and the rest hy **twenty-two** companies. The Ministry of Finance has 15% of its shares, and the rest is fully paid in.

According to a 1997 presidential decree, the IBA was to be privatized in 1999, but this has not yet occurred. Plans called for 5% retained by the state, 20% to be taken over by an international strategic investor, and 25% to be sold to other investors. The European Bank for Reconstruction and Development (EBRD) is investigating the possibility of becoming the strategic investor. IBA officials **say** that privatization should take place by the end of January 2000. Bank officials are eager for IBA to become a viable, competitive commercial bank. IBA activities in three major areas can be described as follows:

i) ***Implementing agent for government business development activities.*** IBA loans and advances to businesses totaled $164.9 million at end-1998, of which $127.9 million, or 78%, were guaranteed by the state. Sixty percent of these guaranteed loans were long-term. Some S38 million of these government-guaranteed loans from the 1994-95 period were non-performing at end-1998, and were liquidated by the Ministry of Finance and removed from the IBA's balance sheet in early 1999.

   From its beginning, the IBA has been used by the government to implement agreements and programs with international banks and institutions, mostly in export/import finance to state-owned and other Azerbaijan businesses. This includes S55.0 million in state-guaranteed long-term credits based on import finance agreements with the Turkish Export-Import Bank, the Nichimen Europe Plc., the National Westminster Bank, and HSBC. The IBA will fulfill the obligations towards the international partners, and Azeri companies that have imported the equipment will pay their debts to the IBA. To cover the state guarantee given to the **IBA,** the NBA keeps an account at the IBA. This account has to be kept at an agreed level as a guarantee for the IBA that the government will fulfill its obligations. At the end of 1998, the state guarantee was covered by an NBA deposit account of ***S64.3*** million at the **IBA,** which exceeds current overdue loans by $18.0 million. Additionally, the IBA has its own provisions for doubtful loans of about $18.0 million, and its risk position seems to be good.

   With shareholders' equity of $12.0 million and a credit portfolio of $191.7 million at the end of 1998, the capital:loan ratio would be 1:16, considerably outside the NBA guideline of 1:10. However, deducting the $127.9 million guaranteed by the government, the remaining portfolio for which IBA is fully liable amounts to only S63.9 million, yielding a capital:loan ratio of 15.3, well within the guideline. Nevertheless, **IBA** still has the highest leverage between shareholders' capital and credit volume of all relevant commercial banks in Azerbaijan.

ii) ***The IBA as a commercial bank.*** The credit activities not covered by government guarantees were exclusively short-term in 1998, with a volume of current credits of S43.8 million and overdue credits of **$1** 1.2 million. These were covered by loan loss reserves. The IBA **is** financed by deposits from other banks of $84.8 million, customer accounts of S94.3 million, and credits provided by international banks and institutions of $65.6 million (e.g., the Turkish Exim Bank). These figures include the NBA account of ***S64.3*** million covering the state guarantee. Summarizing these figures, the 12/31/98 balance sheet includes about S160 million in one way or another way linked to the special role IBA is playing for the government of Azerbaijan as an agent for its business development activities. The purely commercial part of IBA thus has a balance sheet of about $85 million, in both assets and liabilities. These figures **still** show the IBA as by far the strongest Azerbaijani Bank.

iii) ***Development of banking services and customer relations.*** The **IBA** plays an important role in developing banking services for the population. It is the key player for all payment transactions and is assisting other banks in these activities. It has been a pioneer in the introduction of such products as flexible interest and local and foreign currency savings accounts, American Express and Thomas Cook travelers checks, Visa and Europay credit cards, and debit cards for employees of such large companies as AIOC, BP, Exxon, Hyatt Regency, Lukoil and others, whose salaries are directly deposited in their IBA accounts.

d) *The Private Banks*

The three private banks Arko Bank, Azerdemiryol Bank and Rabita Bank, shown in the following table are among the small number that are making good progress toward becoming viable, market-oriented financial institutions. Compared to the IBA, all of them are small in terms of total assets, although the equity of the largest, Arko, reaches $5.2 million, similar to that for IBA. These banks all cover about 30% of their total liability positions with shareholders' equity. This is a solid leverage ratio – *too* solid, really, showing that these banks are running a quite small loan business.

In all three cases net fee and other non-interest income is far larger than the net interest income. This phenomenon is typical for banking systems that have not yet developed good household deposit markets and where lending risk is high. But the developing competition between banks is reducing margins on fee-based services, pushing them either to expand their lending business or to leave the market. Costs for staff and administration expenses are growing together with non-interest income.

Table 19: FINANCIAL STA[illegible]MENTS SUMMARY, 3 PRIVATE BANKS

$ Thousands	**Arko**	**Azerdemiryol**	**Rabita**
Total Assets	**16,125**	**12,183**	**767**
Loans & Advances to Cusromcrs	73%	48%	[illegible]
Of which Large Custo[illegible]ners	*68%*	*49%*	*n a.*
Other [illegible]t	27%	[illegible]2%	57%
Total Liabilities & [illegible]lde[illegible] Equity	**16,125**	**12,183**	**5,7[illegible]**
[illegible]it[illegible] from Customers	9%	[illegible]8%	56%
Deposits frc[illegible]anks	[illegible]%	[illegible]	3%
Other Liabilities	4%	4[illegible]	4%
Shareholder Equity	**32%**	**31%**	**27%**
[illegible]	[illegible]	[illegible]	**735**
Net [illegible] Income	38%	[illegible]	9%
Net Fee and Other Income	62%	74%	91%
[illegible] and Operating Expenses	45%	59%	91
[illegible]	**837**	**980**	[illegible]

These banks show some differences in the way they finance their assets. Arko and Azerdemiryol, more or less match their loans to customers with deposits from customers, while Rabita relies mainly on the interbank market for funding. The explanation for this is that the first two are typical of those banks in underdeveloped credit markets which are still very much bound to groups of companies or families who provide the funds to support the bank's business, and in turn consume the major part of the credit portfolio. Azerdemiryol Bank, although private, is closely related with the Azerbaijani railway and gives about 49% of its credits to this and other state owned companies. Arko Bank gives 68% of its credits to nine major clients which are related with this bank. So these banks are sources of concessional credits for their related businesses. They do not violate the prudential standards set by the NBA limiting the credits to shareholders and related parties, but these limits are very high by western standards. Companies outside this system have more difficulty getting the same service. This is a real obstacle for the development of a credit system that addresses the entire economy.

Two of these banks increased their loans in 1998, Arko by about $5 million and Azerdemiryol by about $2.5 million. This expansion reflects credit programs originated by IFC, EBRD and TACIS, rather than from their own sources, but is still a positive development and indeed illustrates the desperate need for such business finance programs if the Azeri banking system is to move toward a western model. These banks' customer bases widened and credits with a maturity of greater than one year espanded.

5. Constraints on the Development **of** the **Banking** Sector

Summarizing, constraints on banking system development in Azerbaijan boil down to **six** major issues:

1. The scarcity of loanable deposits available to the banking system.
2. **An** excessively fragmented banking system.
3. The difficulty of assessing the creditworthiness of potential borrowers because of inadequate accounting standards, untransparent financials, and inadequate business plan preparation.
4. The inherent risks of doing business in Azerbaijan.
5. An inadequate legal basis for sound banking.
6. **A** low level of competence within the banks in their operations and credit processes.

a) Scarcity of Funds

As discussed above, the ability of the household sector to generate domestic savings, and its unwillingness to entrust the limited amount of savings it does have to the banking system, is the biggest constraint to its development. So long as this problem is not addressed, by some form of deposit insurance and by the elimination of arbitrary official interference with the control of bank deposits by their **owners,** the banking system simply cannot develop adequately. Until that time business finance will be greatly compromised and dependent on international support.

b) Fragmentation

Even though greatly reduced in number, Azerbaijan still has far too many banks with a far too **small** average equity base. Much greater consolidation is needed. Acting separately with such limited individual capital, it is normal that aggregate lending risk aversion is considerably higher than it would be if both equity and human capital resources were more concentrated. In other words, the existing aggregate equity base would certainly be geared higher, creating significant additional business finance, if the **banks** were more consolidated. Furthermore, small banks have a hard time developing any degree of general confidence needed to entice household or other third-party deposits, a somewhat increased level of which could be expected even given the problems indicated above. The gradual increase in minimum bank capital required by the **NBA** will continue to stimulate consolidation, and hopefully encourage the development of a small number of much larger banks.

c) Assessing Borrower Creditworthiness

Existing accounting standards do not allow for the documentation needed to get a clear picture of the financial situation of the businesses that apply for credits. ost credit decisions, therefore, are based on personal relations, rather than a proper assessment of the business documented by financial statements and a business plan with financial projections. Businesses without these personal connections have virtually no access to bank credit. In addition to poor accounting standards, businesses typically hide their true results because they do not trust bank confidentiality and expect the financial police to have access to any document submitted to any bank.

This situation is supposedly improving to some extent, with the promulgation of regulations preventing third parties from examining client banking files without a court order. However, this does not prevent the tax authorities from easily ordering the freezing of the bank account of any business against which they assess any **tax** payment shortfall, prior to the completion of any appeal process and however minor the amount allegedly owed. Most business managers are incapable of producing adequate business plans, even if they are willing to provide greater financial transparency.

d) Underlying Project Risk

There is a combination of problems that makes the environment in which Azeri enterprises operate difficult, and so lending to these businesses inherently risky. The main underlying issues are a lack of purchasing power in the population, and inadequate management expertise, particularly in strategy, marketing, and financial management. In addition, serious aggravating uncertainties include the uneven application of customs duties, which makes domestic producers who pay such taxes on imports at a competitive disadvantage with importers of similar finished products who escape customs duties. The internal tax system, with its high rates and capricious application, strains company resources needed to service their bank debt.

Furthermore, as discussed above, the high rate of return on loans required to cover the banks' elevatedcost of capital exaggerates the effect of underlying project risk. As reviewed in the sectoral survey of Chapter III, there are many potentially viable business projects in Azerbaijan. However, projects whose risk profile would be bankable in a western context, where banks' cost of capital is considerably lower because of the wide availability of household sector deposits, are unable to generate the extraordinary rates of return necessary to cover Azeri banks' funding costs.

e) The Legal System

The legal framework for banking is still fragmentary. In the many areas where adequate commercial code has not been developed, bankers have recourse only to the old Soviet civil code, which does not cover much of what is needed in a modem market economy. Some elements of collateral and enforcement legislation have been produced, but these laws cannot be sufficiently implemented, as there is no adequate collateral registration system. A recent decree by the State Property Committee is improving the registration of collateral.

f) Inside the Banks

The banks themselves do not have the experience and the qualified staff to address these problems adequately. Banking know-how is insufficient, especially in credit evaluation and process administration. Furthermore, credit administration is unusually time-consuming because of the nontransparency of financials, weak management, and the difficulties of communication with business managers, so bankers have no choice but to visit projects frequently. The very best projects need to be visited every second month, the goods ones monthly, and the difficult ones weekly.

6. Summary of Needs in the Azeri Banking Sector

Lack of credit is a key constraint for the development of the private business sector in Azerbaijan. The existing credit supply is far too small to provide a suitable environment for the development of even small enterprises in Azerbaijan, let alone medium-sized ones. Many enterprises have no access to credits at

Table 20: SECTORAL FINANCIAL BALANCES – NON-OIL ECONOMY				
	1995	**1998**	**1999**	**2000**
Estimated **GDP ($** millions)	2,400	**4,100**	4,000	4,400
Growth	***-12%***	***5%***	***-2%***	***10%***
GDP per capita ($)	320	520	500	540
Unemployment Rate	50%	**30%**	**25%**	**20%**
Total Employed (000 people)	1,140	1,670	1,811	**1,956**
Avg Monthly Net Wage ($)	**90**	**100**	**90**	**95**
Sectoral Financial **Balances**	Flows **of** Funds, $ Millions			
Business Sector	**230**	377	**296**	550
Government Sector Deficit	10	**94**	64	**70**
Total **Uses**	**240**	**412**	**360**	**620**
SOURCES OF FUNDS				
Internal Corporate Cash Flow	**36**	**205**	110	**176**
Household Sector	87	121	104	**193**
Direct HH Investment In Business	***47***	***74***	***79***	***113***
Banking Sector Intermediation	***40***	***47***	***25***	***80***
Foreign Private Capital	40	75	50	100
International Donor Finance	78	70	**96**	**151**
Total **Sources**	**240**	**412**	**360**	**620**

Sources: **World** Bank, Evaluation **Team** Estimates

By expanding the supply of loanable funds through an adequate business finance program, access to credits for more projects, for smaller projects, for start-ups, and for projects in regions other than Baku – all deficiencies in the current environment – would be improved. A donor-backed, closely monitored program would also improve transparency, counter corruption, and limit influence by power-brokers in obtaining and servicing bank credit. In addition to addressing the basic insufficiency of loanable funds, major assistance is needed in the Azeri banking system to improve operational and credit management skills of bank staff. Such assistance should be concentrated on the stronger banks, in order to encourage consolidation of the Azeri banking system. Finally, support continues to be needed to improve the legal basis for sound banking.

B. ENABLING ENVIRONMENT

1. Privatization

The details of Azerbaijan's privatization program and a critique of this program are not a direct area of focus for this report, however, the difficulties that delay the process of privatization retards business opportunities. Prolonged privatization inflicts human costs in terms of unemployment and capital costs in decaying assets, and the longer delays persist, the higher these costs are to society with commensurate fewer opportunities of recovering the remnants of idled industry. For the record, we briefly review the Azeri privatization program and its progress.

a) Program Design

The privatization program was finally launched in March 1996, almost four years after the formation of the State Property Committee, with 100% cash auctions for small-scale enterprises and individual assets. About a year later, a program was launched to auction all non-strategic state-owned businesses and assets for a combination of cash and government-distributed certificates to citizens. The certificates are also referred to as "checks" and "vouchers", because the government distributed one booklet consisting of four "checks" to each and every citizen. 'This booklet is referred to as a "voucher", i.e., one voucher equals four checks. For discussion purposes these are called vouchers instead of checks in the report. Reflecting the size of the total population, 8.0 million vouchers were authorized and some 7.5 million were actually distributed.

b) Stages of Privatization

The state established three stages in the privatization of a medium- and larger-sized enterprise to which the voucher process applies. These include:

- *Closed* ***subscription.*** 15% of the enterprise's shares are offered to its employees in a closed subscription bidding process using vouchers.
- ***Voucher auction.*** This is an open auction for at least 55% of a tendered company's shares. Such auctions were intended to take place twice a month, to sell 50-100 companies at each auction.
- *Cash* ***auction.*** The remaining 30% of shares were to be sold through open cash auctions.

c) The Privatization Process

The market for vouchers was completely free – they could be bought, sold, and transferred with no restriction. The price of a voucher has fluctuated wildly between $100 and $10, and now stands at about $12.50. Based on the average voucher price since issue of perhaps $45, and factoring in the amount already received by the state, the market value of assets that could be privatized is approximately $500 million. This is far below the $6.5 billion valuation originally set by the State Privatization Committee.

Foreign investors have been free to participate in auctions but face an additional "tax". In order to purchase vouchers, a foreigner must first purchase an "option". Options may only be purchased from the SPC, and their price is arbitrarily set by the SPC. The purchase of four options entitles the foreigner to purchase, at the market price (or any agreed price), one voucher from a citizen (one option for each of the four checks in the voucher). The price of options started out at the equivalent of S2 per voucher, and was increased to as high as $102 in late 1997 when foreign interest in voucher purchases also drove the voucher price up to as high as $100. At effectively $200 per voucher, foreign investors were valuing SPC assets at $1.5 billion. This did not last as the option price was lowered to about $80 by late 1998, and the voucher price collapsed to less than $20.

d) Results to Date

Numerous cash auctions for small-scale privatization and some 50 voucher-andcash auctions have been held since the process started. These auctions have succeeded in privatizing virtually all **of** the small businesses in the country, but only about one-fourth of the medium- and larger-sized companies. Many of the larger companies were designated as "strategic assets" by the SPC, and subsequently exempted **from** privatization. This, and the widely-held view that the process was unfair and nontransparent, caused the privatization process to grind to a halt in early 1999. A few privatizations have trickled through on a case-by-case basis, but the process is essential inactive. Design proposals for "Phase 2" of the privatization process have been circulating since 1998, and the legislature and administration are now battling over the details. The key additional feature of Phase 2 will be the fact that the government **will** retain, hopefully only for the purpose of passive financial upside, a minority stake in privatized businesses.

The program lacks financial intermediaries – privatization investment funds – that have been ***used*** successfully (more or less) in other transition economies. This means that individual citizens must deal with bidding their single vouchers for shares in a company of their choice. There is an option to bid four separate checks within the voucher packet for four separate companies. This is highly unrealistic, so the only real option is to sell the voucher for cash, subsequently encouraging concentrations of voucher ownership. For example, foreigners – a small number of them – now control some 50% of the outstanding vouchers.

e) Program Proceeds

The state has received approximately $100 million in proceeds from the sale of companies and options since initiating the privatization process. The last cash auctions have been unsuccessful, with fewer than 10% of shares offered for cash attracting buyers. It appears that if privatization is to proceed, the Phase 2 design will need to allow for more flexibility in the ratio of share sales between cash and vouchers.

2. The Legal and Regulatory System

a) Legal and Regulatory Status

Azeri law originated in Soviet law, which was unsuited for **a** market economy. The Soviet civil code was a thin brochure, as the needed and possible obligations were limited. Since 1992, the Azerbaijani government and the parliament have created about 80 laws and a large number of decrees, and these form the current legal system. Unfortunately, the laws do not yet form a coherent system.

The key laws for the economy are: the Law on Protection of Foreign Investment (1992), the **Law** on Enterprises (1994), the Law on Joint Stock Companies (1994), the Law on Investment Activities (1995), the Law on Registration of Legal Entities(1996), the Law on the National Bank (1996), the **Law** on Banks (1996), the Law on Insolvency and Bankruptcy (1997), the Law on Trademarks (1997), and the **Law** on Mortgages (1998). Knowing the legal system in other market economies it is obvious that these laws cannot cover all needed decisions. There is no system to fill the gaps. There is no history of court judgments and no precedents for important cases. Last but not least, there are no judges experienced in the market economy.

These gaps are partly filled by ministerial decrees. These are case-by-case decisions with an uncertain legal basis. There are some leading decrees form the President among them the "decree about regulations of governmental control over productive and financial credit activity, sphere of services and prohibition of unjustified examinations." This decree was a valuable reform, in reducing the number of authorities who and the frequency with which they can arbitrarily investigate a businesses. It gives businesses protection against capricious interference and corruption, and several business reported taking recourse to it. Overall, though, implementation and enforcement is as fragmentary and unsatisfying as the legislation itself. There is a lack of know-how and reasonable salaries for experts working in this area.

Improvements are expected during the next two years, beginning with the new civil code and law of civil court procedures, to be passed by the Parliament in Spring 2000. These laws would come into force one year after being passed. They would integrate many of the laws that are already regulating the economy and would add new laws that are still missing. One key element of these laws would be the Law on Obligations which is the core of the Civil Code. The proposed Civil Code is aligned to laws passed in the neighboring countries of Georgia and Armenia. It is a civil code of the type we find in the Netherlands, Austria, Switzerland and Germany. When these laws are passed, they will also require improved courts, better administration, viable land registry and enterprise registry systems, and effective enforcement capabilities.

b) Securities Markets Regulation and Reform

At the moment the market for securities in Azerbaijan is practically non-existent, except for the Baku Interbank Currency Exchange (BICEX) and short-term Treasury bills that have been periodically auctioned by the National Bank since 1996. There are a handful of stock company shares traded on the Baku Stock exchange, a privately-owned venture. Vouchers which were issued for privatization are sold in voucher "shops" or in the street.

Treasury bill auctions provide money for the government's short-term budget needs. In 1998, the NBA carried out 9 auctions and raised about $50 million against T-bills with a circulation period between 30 and 90 days. The interest rate of 14% paid in 1998 subsequently was seen as the market rate for short-term refinance by the NBA.

Since 1996 the NBA has also supervised the issue of shares by joint stock commercial banks as well as the issue of other securities by banks. In 1998, 56 offerings for a total amount of about $40 million equivalent were issued by banks, and purchased primarily by the NEA. For the issue of securities in the banking sector the NBA worked out several instructions as this field lacks any legislation.

In 1999 the State Securities Committee (SSC) was formed to establish a working securities market in Azerbaijan and to control its operations. This institution needs to cooperate closely with the NBA that has done most the work up to now. Whether and how this cooperation is given cannot be said. The SSC employs 22 experts, most of them lawyers. It reports directly to the President of the Republic of Azerbaijan. The legislation for the future securities market is still to be developed. EBRD and the World Bank are interested in that sector and have promised their assistance to the SSC.

One key element will be the establishment of the stock exchange. SSC Chairman Babayev is advocating an institution with a 51% government share in the beginning, in order to ensure proper development and supervision, with full privatization later. Three small private stock exchanges have been registered, but only one, the Baku Stock Exchange, is still open, but at a very low level of activity. At the moment the SSC lacks funds to organize itself, obtain IT equipment, and carry out its work.

A functional capital market is crucial. It can make a significant contribution to the channeling of domestic and foreign funds to the corporate sector, particularly given the unsatisfying situation in the banking sector. It would also be an important step to more transparency in the accounting system. Companies that use the securities markets will be forced to produce understandable reports and show real figures consistent with international accounting standards. Such a transparent and safe security market could attract foreign investors who are very much needed outside the oil industry. And finally, such a market could give a decisive push to privatization, especially when these shares are tradable in the secondary market.

3. Taxation and Fiscal Policies Relevant to Private Sector Development

Second only to corruption, the structure of taxes in Azerbaijan is devastating to both individuals and business enterprises. In 1999, there were 27 categories of taxation. Tax reforms forthcoming in 2000 **will** reduce these to 22 categories, but essentially leave unchanged the core tax requirements. Slight changes have occurred, such as a recommended reduction in enterprise profit taxes from 32 percent to 30 percent, and a personal income tax surcharge established by decree on high-income individuals that exceeded 50 percent now seems to have been abandoned. The primary taxes on individuals, businesses, and custom activities are shown in Table 21. These data are displayed according to the individual or type ofbusiness that is liable for taxes, however, actual taxes are withheld on salaries and wages by employers who subsequently are fully liable for remittances to the tax authorities. In addition, companies withhold social fund and employment contributions levied against employees. These apply to all workers regardless of employment status, to proprietors, and to business partners.

Business-related taxes apply to registered joint-stock companies, limited liability companies, taxable associations, and state-owned enterprises. There are several categories of exemptions, including foreign-invested joint ventures under oil development agreements, which enjoy reduced tax rates, certain not-for-profit national nongovernmental associations, recognized nonprofit international NGOs, and various agencies and business-support organizations granted profit-tax relief on a case-by-case basis.

There is tremendous latitude in tax assessments, rulings on exemptions by local tax inspectors under the Department of Taxation, and arbitrary rulings on individual and organizational rights generated through periodic decrees issued by government. Corruption is rampant throughout the tax system resulting in huge losses to government from assessed but uncollected taxes, collected taxes that never reach the state budget coffers, and payoffs to tax authorities that convolute assessments or that represent an outright bribe to escape taxation. In effect, there are few accounting standards or verifiable books in Azerbaijan, with the possible exception of large international companies, government agencies, and the multilateral organizations that exist at an official level of public transparency. There appears to be no incentive for anyone employed, or any company with employees, to truthfully register their salary and wage schedules. And because companies are liable for all employee tax liabilities and social contributions, there are structural disincentives to either hide as much economic and employment information as possible, or to payoff tax authorities. Even if payoffs are very large, they are likely to be far less than the legal tax liabilities. With this said, categories of taxes are described below.

a) Personal Income tax and Contributions

Taxes on physical persons (common personal income taxes) are progressive, and they currently range between 12 and 40 percent. The average tax rate is unknown, but estimated from the number of individuals actually paying taxes, the aggregate wage levels, and the state revenue from taxes on physical persons at 34.5 percent. This is a point estimate for 1997 (the last fully recorded year of tax revenues). Officially, a 12 percent bracket is levied on gross income that exceeds the equivalent of US S7 per month. The rates accelerate rapidly, and at approximately US$80 a month, the maximum bracket of 40 percent is applied. There are **hvo** caveats to this profile. First, the assessed rates seem to be subjectively applied and inconsistent among tax inspectors. Second, there is substantial confusion among tax payers who generally have no clear idea how their taxes are assessed, nor do they understand tax laws or their legal liabilities. **As** a result, this team has been advised that employees may be taxed at 50-55 percent levels, which their companies must pay (those who do comply and pay), with the implication that, at most, taxes representing the maximum rate of 40 percent are remitted to government coffers. Consequently, a naïve population coupled with official tax "misinformation" provides a ripe opportunity for corruption, and there is little reason to believe that those who benefit from such corruption would advocate reforms.

An important point to bear in mind, however, is that the official basic income tax rates and the effective average level of personal tax assessment (34.5%) are ***not excessive*** relative to European countries or to composite state and federal income taxes in the United States. Consequently, if the income tax codes were properly administered and collection procedures fairly implemented, it would be hard to argue that Azerbaijan has imposed an inappropriate system of income taxation. The difficulty occurs in administration and collection, but the tax regime is onerous because basic income taxes represent about half of the total mandatory taxes and contributions. The second-largest bite comes from required contributions to the Fund for Social Protection (FSP). This is a progressive rate between 15 and 35 percent, with an estimated average liability of approximately 28 percent. It is applied on gross income prior to exemptions and other contributions. This is a form of social security, and in part a discretionary fund for social adjustments, retraining programs, and state-supported old age payments.

All physical persons also are liable for a two-percent (2.0%) contribution to the Center for Work and Employment (CWE), which is generally concerned with redundancy payments, re-education and training for qualified persons who become unemployed by State Enterprises, and programs under the Ministry of Labour and Social Protection. Under pending tax reform legislation, this contribution will be raised by 1.0 percent annually until it reaches 5.0 percent (5.0%) in 2003. These remittances will be earmarked for pensioners under the SPF. **A** study was made for this fund by the Netherlands Economic Institute in 1998, with the conclusion that financial management of the fund could not be validated with respect to actual disbursements or appropriate assessments. The team for this study interviewed the ranking official of the Employment Department, and was told that they were not prepared to provide information on their programs. **A** final contribution category, closely associated with the CWE, is a one-percent levy (1.0%) on gross income, payable to the FSP for "Invalidity." This appears to be a form of disability contribution, but administration of the funds involves several government branches, including the military, and further information is unavailable.

Using the calculated average tax rates and contributions, individuals earning the medium income of $82 per month will pay (or have withheld) 65.5 percent of theie gross income. Those with gross earnings at $46 a month (roughly at the per capita GDP) will be liable for 42 percent, and those earning more than $121 a month will be liable for 78 percent. The net effect of taxation on official income statistics would result in approximately 75 percent of the entire population being at or below the World Bank's poverty line of $1.00 a day. Only 13 percent of those registered as having paid taxes in 1997 (latest year for complete data) would have a net income above the equivalent of US$100 per month. Statistics do not permit a more refined analysis than these estimates.

b) Business Taxes

The current official tax on business profits is 30 percent, which is levied on gross profits after allowable expenses. This is defined as a tax on all industrial enterprises and those service firms "related to" industry, which is a holdover from state ownership of productive assets and consolidated industry groups with a variety of service-related activities ranging from child care to company stores. The profit tax generally applies to all registered business enterprises, but in addition, those involved in trade (retail, wholesale, distribution, private transport, and personal service activities) also pay three percent tax assessed on "value of volume traded." Anecdotal evidence from companies surveyed and response by U.S. representatives of public accounting firms in Azerbaijan suggest that the trade-volume tax is "fuzzy," with only limited collection on enterprises with transparent records. For most retailers and other traders, there is no clear way to assess "volume value." For example, petrol stations are supposed to collect this tax on all services and products other than fuel, but in a cash-and-carry environment, taxes passed through on fuel are the only retail activities where tax can be effectively collected. A tax of 15 percent exists for fuel and combustible or lubricating materials, which includes heating fuel, petrol, cleaning solvents, and oil-related consumer products.

As shown in Table 21, there are several additional taxes, such as the 0.5 percent tax on business property, a 2.0 percent tax on vehicles and so-called wheeled engineering, and several variable rate taxes on patents, profits from patents, imported vehicles, and bulk sale of combustible materials. There appears to be no clear information on exactly how these taxes are assessed or collected, nor what the rates might be. Several anecdotal responses by government and business persons interviewed during this study may provide some insights. First, luxury imported cars, such as new S-class Mercedes, are supposed to be taxed between 65 and 100 percent, depending on a formula that includes the year of make, value, and motor capacity size. When questioned on this, a ranking government minister said "look outside, there are many new $600 Mercedes." Apparently, one can get a car registered and assessed for a fictitious value and a side payment, thus avoiding the taxes. There also is an "entry tax" on foreign vehicles administered through the Customs Department. This is "assessed" on a case-by-case basis, and further details are not available.

The tax on bulk combustibles, however, is more transparent as it involves international oil companies and various co-production treaties with the CIS, Turkey, and Iran. Officially, the assessments result in tax rates that can be exempted under treaties up to 15 percent. However, the country manager of a multilatemal donor agency running programs in Nakhichevan suggested that combustible products, mainly crude oil, flow into Iran, are refined, transported back into Azerbaijan, and then trucked into Turkey. This is part of the formal agreement for "allotments" which move through an "informal system" without tax **or** custom duties. Asked how prevalent this was, the respondent said that as many as 17 tanker trucks per **hour** transit this route continuously, every hour, every day.

Businesses also collect and pay excise taxes, usually passing these along to the end consumer, and, of course, these vary widely depending on the item sold. One must assume that the bigh official rate of 65 percent (the top bracket) on luxury goods and tobacco products is circumvented by black market goods. Likewise, the VAT at 20 percent is collected or paid through business enterprises, but is somewhat more tightly controlled. This is reflected in the structure of the national budget receipts which showed that **VAT** provided 61 percent of the government's tax revenues in 1998, up from **54** percent in 1997 after more rigorous policing by the tax authorities. Indeed, VAT income exceeds formal tax revenues from business profits, customs, and personal incomes. The burden of accounting and collecting is firmly placed on the individual business owner or company manager, which presents yet another avenue for corruption as tax inspectors effectively validate the level of sales for an enterprise.

Business owners and managers interviewed for this study reported that taxes were **among** their most serious constraints on doing business. However, they did not seem to be concerned about the rates of taxation as much as the procedures for assessments and collections. Like the official rates for personal income taxes, the flat-rate 30 percent on business profits is ***not excessive*** when compared to European standards or corporate US taxes. **If** all enterprises paid **their full** tax liabilities, the effective rate of taxation would range between 30 percent and 52 percent. This is well within the range of taxation elsewhere, and significantly below rates in many countries. Corruption and inconsistencies in the system, however, result in a prevailing cynicism and common efforts to circumvent the system. More specific issues that could be constructively addressed, including methods of assessment and accounting. For example, there are **no** clear guidelines on what expenses are deductible, no clear provisions for costs of capital, and no provisions for property costs. Depreciation is not addressed consistently in the *tax* code, and contributions common in western countries for charities, employee insurance, liability insurance, and so on "can exist" for companies operating under International Accounting Standards, but generally are not recognized in Azerbaijan.

c) Other Taxes

Customs duties have been greatly simplified, and export taxes have been removed to encourage trade and investment. Currently, there are three categories of taxes on imports, including 0.0 percent (zero) on most productive machinery, intermediate goods, and 72 exempt classifications for products viewed as essential for Azerbaijan, but that do not compete with indigenous production or agriculture. **A** rate of 5.0 percent is currently assessed for approximately 80 categories of items. The highest official rate is 15 percent on all nonexempt products, processed goods, consumer goods, and raw materials. The country has effectively reduced the weighted average import tariffs from approximately 47 percent in 1992 to 8.9 percent at the end of 1998, according to World Bank estimates. This has been part of a government policy initiative to bring customs duties closer to expectations as Azerbaijan positions itself for trade agreements, and as the country pursues membership in the WTO.

Table 21: **TAX RATES AND LEVIES IN AZERBAIJAN**

For 1999, in percentage unless otherwise noted

Definition of Tax in Law	Responsible Entity or Person		
	Industry & Service	**Trade Enterprise**	**Physical Person**
1) Tax from total income of physical persons	(note a)	(note a)	12 to 40
2) Contribution from income of physical persons to Fund for Social Protection (FSP)	(note b)	(note b)	15 to 35
3) Contribution from income of physical persons to Center of Work & Employment	(note b)	(note b)	2
4) Contribution from income of physical persons to FSP for Invalidity	(note b)	(note b)	1
5) Tax for added costs (e.g., VAT)	20	16.67 or 20	
6) Tax for profit from enterprise	30	(note c)	(note c)
7) Tax from value of volume in trade		3	
8) Tax from sale of combustible & lubricating materials	15	15	
9) Tax on purchases of vehicles & wheeled engineering	2	2	
10) Tax on entry of foreign vehicles & vehicle travel	Assessed	Assessed	Assessed
11) Tax on users of national motorways	0.05	0.03	0.03
12) Tax from bulk sale of combustible & lubricants	Assessed	Assessed	
13) Excise tax on qualifying products	7.5 to 65	7.5 to 65	
14) Tax on enterprise property	0.5	0.5	
15) Tax on ground for living space (AZM fixed)			5 to 250
16) Tax on ground for sowing (AZM per hectar)	300-165,000	300-165,000	
17) Tax on Royalties Assessed	3 to 26	3 to 26	
18) Payments on gain from a registered patent	Assessed	Assessed	
19) Customs tax on imports (varies with items)	0, 5, or 15	0, 5, or 15	
20) Customs tax on exports (as of 7/1999, exempt)	0	0	

Notes: a) Taxes levied on persons but deducted and paid through employers; b) Taxes levied on physical persons and non-exempt self-employed trade enterprises, paid through employer or owner; c) Taxes on merchandising trade proprietorships and individuals engaged in trade may be subject to enterprise tax; "assessed notation" indicates that tax inspectorate determines rates on a case-by-case basis; and not noted is "state tax for separate activities" which is unclear, but applies to certain transactions involving foreign firms and licenses, and rates are "variable." ***Sources:*** Azerbaijan Republic Fund for Social Protection, ***Budget and Finances Report,*** July 1999, and AZ-SA-EL Technology, ***Tax System of Azerbaijan***, October 1999.

Taxes are also levied on land for farming and livestock grazing, and the rates are fixed annually between 300 manats and 165,000 manats, depending on the nature of the land and the category of the business. For industry, services, and trade enterprises the rates represent minor payments, and they generally apply to allocations of public lands or restructured assets from state-owned enterprises. Private farms and individuals are not assessed these taxes. All individual households pay a very superficial tax (between 5 and 250 manats annually) on living space. The remaining tax on profits from patents is not fully articulated in the tax code. Apparently its original intent was to collect taxes on windfall profits from proprietary patents and various royalties, but patents are not defined in Azerbaijan the same as in the International Patent Convention. Assessment procedures and collections are, again, subject to question, and this study was unable to pursue a clearer understanding of the situation.

V. ASSISTANCE TO THE PRIVATE SECTOR

A. OVERVIEW OF FOREIGN ASSISTANCE

The fundamental pattern of foreign assistance to Azerbaijan is humanitarian, yet the majority of international funding is channeled toward infrastructure through the World Bank, EBRD, IFC, and IMF. With that said, component programs of the UN address both infrastructure and humanitarian needs, and all international organizations other than the U.S. pay significant attention to policy reforms and institutional capacity building activities. The introductory section of this report has made reference to the mainstream efforts by the international community, and appropriate attention has been given elsewhere to policies and regulations pertaining to private sector development. The purpose here is not to provide a comprehensive evaluation of these issues, hut to focus on component activities directed toward enterprise development in the private sector.

A matrix of PVO and NGO activities is provided in Table 22 with a summary of the primary types of assistance provided. The most noticeable point is that "almost everyone is trying to do everything." Most NGOs have their hands in a number of pies that do not always fall within their official mandates. Second, these activities are seldom orchestrated, and they are certainly not coordinated among the community of international organizations and NGOs. Third, many of the activities (such as micro-lending) are conducted in isolation from other forms of intervention (such as technical assistance) that are crucial for sustainability. And fourth, assistance may be broad in scope but the target population is very narrowly defined within a humanitarian mandate for refugees and IDPs. In effect, assistance is not provided to the general population, and there is little effort to provide development support m sectors with high-growth potential.

1. Micro-credit

Lack of money to pursue income generation activities or to underwrite private enterprise development is the most pressing issue. Consequently, two-thirds of the 40 NGOs have some form of micro-credit lending activity. These range from very small loans of $100 with no interest, to $2,000 loans carrying interest at 2.0% monthly. The term of loans can be very short, between 1 and 3 months, up to a year. Many of the smaller credits are for a term of 4 to *6* months, and they average slightly less than $250 for a period of six months at 1.0 percent interest per month. Very few larger credits exist, and they fall under the lending activities of Shore Bank. More than half of all credits are to agricultural recipients, and approximately 92 percent of these credits occur in the IDP and rural "vulnerable population" areas.

Most donor agencies have one, or very few, "loan officers" who evaluate projects, make the loans, administer them, and perform collection duties. Therefore, one individual may handle several dozen client projects in several different geographic areas. One would expect a high loan default rate, but this does not seem to be the case as the agencies report 90 percent repayment rates. With that said, there is evidence from the respondents that many small credits are written down (thereby becoming grants), and some are repaid with replacement credits. There is anecdotal evidence that where several donors operate at once, recipients "rotate" loans, getting one from one organization to pay another, and so on.

The critical question is whether these micro-credits are having any effect on employment or enterprise development. After briefings with virtually all organizations involved – and with more than 50 company interviews and four regional "community" conferences – the team has not discovered a meaningful result that can be cited for enterprise development. The programs obviously play a crucial role in providing subsistence support and immediate cash required for survival, but from an "enterprise development" perspective, it would be very difficult to conclude that micro-credits have led to any sustainable income-generation activities or new business formations. In the future, successful enterprises may surface, but they are likely to be micro-enterprises and adjunct to assistance efforts.

Table 22: **PVO & NGO ACTIVITIES IN PRIVATE ENTERPRISE DEVELOPMENT**

Organization	**T/A**	**Grants**	**Credit & Income Generation**			**Training**		**BSO**
			Micro-Cred	Grants	Seed/Stk	Bus.	VocTch	Dev
ACDI/VOCA	X	X				X		X
Adventist Development & Relief					X			
Academy for Ed. Development		X				X		
AZ Red Crescent			X	X				
Benevolence Intl. Foundation					X			
Children's Aid Direct			X		X	X		X
CARE International			X	X	X	X		
Danish Refugee Council	X		X				X	X
Diakonie Emergecy Aid		**X**	X		**X**		x	
Eurasia Foundation		X					X	X
FINCA			X					
Global SourceNet Azerbaijan			X		X		X	
GTZ	X				X	X		X
HAYAT (for WB/UNHCR)					X	X		X
Intl.Fed. of RC			X		X		X	
Intl. Organization for Migration	X		X	X		X		X
Intl. Research & Exchanges		X					X	
Intl. Rescue Committee		X	X	X		X		
In. for Social Action &Renewal						X		X
KOSIA-SMEDA	X					X		X
Mercy Corps Intl.	X	X	X	X	X		X	X
Norwegian Humanitarian Ent.		X						
Norwegian Refugee Council			X	X				
OXFAM			X	X	X		X	
Relief International			X			X		
Save the Children	X		X		X		X	X
UMCOR		X				X		
UMID-Human/Social Support							X	
UNDESA								X
UNDP	X	X	X				X	
World Hope International							X	
World Vision International			X			X		X

2. Technical Assistance

Technical assistance is separated from training activities and grant-related activities in the matrix on NGOs to distinguish hands-on intervention commonly associated with business development programs. Only five or six donor organizations can be characterized as providing this type of technical assistance, and perhaps no more than three NGOs offer TA together with micro-lending activities or development grants. If training is set aside momentarily, the result is that credits and other forms of support are being provided with very little intervention that could help start and sustain business and income-generation activities.

3. Grants

Utilization of direct grants is limited in Azerbaijan. Most are directed toward association building and BSO activities (such as those by the Eurasia Foundation and ISAR). Most grants are directed toward humanitarian populations and concerned with "communal" activities. In several instances, grants have been used in support of educational efforts, and for internships, resource training, and external travel by indigenous recipients. They appear to be linked to one or more specific (and primary) activities such as training or developing associations and local NGOs, but they do not appear to be part of a business development strategy. The exception, of course, is the expected knock-on effect of generating potentially self-sustaining national advocacy groups and business support organizations.

4. Income Generation

Income generation activities are heavily skewed toward humanitarian assistance. More specifically, they are "survival" tactics associated with micro-credits that sustain economically disadvantaged families, and some field training to assist the recipients. Training that is associated with income generation activities is largely confined to individuals and families in rural areas. However, IOM, the Danish and Norwegian Refugee Councils, and Save the Children have reached urban areas with skills training among handicraft workers and those with aspirations for trades such as carpentry and masonry.

The most common form of income generation assistance is to provide agrarian recipients with physical means of subsistence, such as seeds or livestock with which to sow crops or to propagate sheep herds. There are 13 donor activities associated with seed or livestock grants in addition to broader components under CARE and the Red Cross/Red Crescent programs for helping IDPs and refugees to plant and harvest. Also under the humanitarian umbrella, several successful greenhouse projects have emerged in villages. These are innovative programs with potential for helping small communities create a sustainable system of year-round produce. Indeed, these could result in commercial endeavors where off-season vegetables find their way to markets, but the combined size of the greenhouse projects will not have a significant mark on economic development as much as providing local communities with badly needed food for subsistence. Some micro-credits are associated with the greenhouse and seed-and-sow projects as "working capital" needed for hand tools, fertilizers, and harvesting. Livestock recipients also receive micro-credits for animal feed and veterinary support, and in several instances, hand shears and combs have been purchased for families with sheep in order to process wool.

Overall, these efforts are humanitarian, and even if they generate some income for the recipients, the income is likely to be no more than needed for subsistence in the near future. The programs simply do not provide a critical mass required for enterprise development, employment, or cash crops on a scale that will have economic impact. With that said, the greenhouse projects and the rural canning projects are promising; they are certainly successful at the level of activity for which they were intended. Two distinctions separate these types of projects from the large majority of other income generation activities. First, the contractors have provided "appropriate technology" and have intervened with technical assistance to ensure that recipients implement their activities, and second, there has been consistent follow-up and support.

Specifically, the recipients benefit from technology itself, but also from training, initial market planning, and hands-on management of their endeavors.

5. Training Activities

Training activities are broadly grouped in the matrix illustration as "business related," or as "vocational/technical." The type of training in each differs significantly, and for each donor activity, training can have many different meanings. These are described momentarily, but it is also important to distinguish donor-related training activities from programs by the Government of Azerbaijan, and "flow-through training support from IMF, EC-Tacis, and World Bank programs. There are significant major training and education components under each of these international organizations which involve public or quasi-government organizations, but these are beyond the scope of this report to evaluate in detail.

a) Training *to* Business

This category of training includes seminars, workshops, or courses that focus on improving participant business skills. These may include writing business plans, understanding marketing, business accounting, management, and actual techniques required for business endeavors (e.g., ACDI/VOCA's process canning systems). On a slightly different scale, business training can include formal seminars and courses, such as those provided to bankers on lending, enterprise training on international accounting standards, workshops on quality standards or international ISO mandates, export/import transaction training, and general business topics to a public audience. Several programs include **grants,** such as the Academy for Educational Development, which provide some external training through formal coursework, and the International Research Exchange organization that has scholarship grants for a few local recipients who study abroad. In fact, there is a wide range of training taking place in Azerbaijan, but it has been difficult to assess other than to identify whether or not a donor project has a training program in place. The general impression is that most training is limited to brief interventions by donor staff on site, or by local staff who have some expertise in the topic at hand. What is not taking place is an organized private sector training program under a coordinated business development mandate.

b) Vocational/Technical Training

This type of training provided through the international donor community has been largely concerned with introducing specific **skills** to individuals, either through hands-on field activities or short seminars and independent **workshops.** These are almost always adjunct to humanitarian intervention activities. In fact, it is difficult to call this type of training as "voc/tech" **as** it is understood elsewhere. Specifically, more than half of the training is individual – directed toward farmers and herders **to** improve their abilities to plant, fertilize, harvest, and grow farm-related products. In the case of cash crops (some fruits, apples, cotton), there has been an effort to "build community" efforts through group training for sowing, harvesting, and marketing. The greenhouse projects have had distinct programs of training for developing high-yield crops, waste management, and packaging. ACDVVOCA has been successful **with** its farmer-to-farmer component to "mentor" rural recipients in new methods of crop management. And the UNDP/UNHCR-funded programs that include sheep and grazing activities have included a fairly strong component for training participants.

Word Vision has been particularly successful in raising skill levels among participants in construction and trade occupations, rural farming, herding, and several dimensions of fundamental business skills such as accounting, product packaging, and service trades. These donor activities also target women, disabled, and disadvantaged. Relief International, the German Diakonie Emergency Fund, CARE, International Red Cross, OXFAM, and World Hope, all report that a majority ofparticipants are women, and two-thirds are rural. Save the Children has a very strong training component, but its is only peripherally related to business, and more specifically directed toward disadvantaged and women for health concerns.

Still, it addresses vocational needs that support the income-generating initiatives, such as managing budgets, nutrition, communal support for distribution of food and water, and a variety of child healthcare issues. Anecdotal responses indicate that all of these programs have some effect on localized income efforts, and they have had a significant effect on personal skills, often put to use for employment or one-off micro-enterprise efforts.

6. NGO & Association Development

Development efforts directed at associations, national NGOs, and business support organizations represent a rather confusing picture. The UNDP and its associated UNDESA office has spearheaded NGO/BSO development as a regional strategy coupled with democratic institution building. There are at least 14 donor organizations involved in such activities, and perhaps as many as 12 more projects involving some aspect of the GOA under UN, EC, or World Bank funding support. There are more than 250 associations and National NGOs registered at the moment, 14 of which concern women, and 127 that claim to be concerned with private enterprise development. The remainder has unique mandates (such as associations for TV broadcasters, or Democracy in Government advocacy groups). We have not vetted this list to determine their capabilities, but the team has visited the donor agencies most involved and 28 associations or BSOs, both in Baku and in the regions.

The consensus is that a majority of all legally registered associations have their foundations in government-connected groups that existed prior to independence. This includes the Azerbaijan Chamber of Commerce and Industry, which dates to 1929, and although claiming autonomy from government influence and supported now by membership fees, lists key members from state-owned enterprises, banks, unions, telecommunications, and other associations. The two leading advocacy associations for women are, in fact, chaired by one individual who is an executive staff in the President's office. Four of the seven "youth movement" associations declaring themselves independent and supportive of youth entrepreneurship are partially funded through the antimonopoly committee, which in turn have a large state budget and was chartered directly by the President through decree. The same pattern occurs as "associations" often seem to change names from Soviet-era unions or political units.

On the bright side, there are many new associations and business support organizations with promising growth and private sector members. These are profiled in the section on associations later in the report, but as a general statement, they provide an optimistic framework for future development, and they may be valuable conduits for foreign assistance.

B. BANKING AND FINANCIAL SUPPORT FOR THE PRIVATE SECTOR

In this section we review in turn institutions and programs providing finance to the business sector and support of the development of banking in Azerbaijan.

1. European Bank for Reconstruction and Development (EBRD)

EBRD's Financial Sector Development program has been funded with $20.0 million, to be used over several years in providing finance to business. Only a small part of this amount has been used up to now, so there is considerable further potential to contribute to the development of the banking sector. The funds can be used for credit and credit lines, for equity participation, convertible loans, etc. EBRD has initiated the program with four banks. **Two** of these banks already received loans: IBA, with $2.3 million, and Azerdemiryol Bank, with $1.5 million.

Two more banks, Arkobank and Azerigazbank, have been selected to take part and to sign credit contracts with EBRD. In all four banks EBRD is also providing consulting assistance. The signing of the contract with Arkobank is expected to happen this year, in the fourth case some problems have arisen so that it is not clear when or if there will be a contract signed.

The terms of the EBRD loans depend on the equity position of the bank and of the relevant target company. The amount of the credit is limited to 50% of the bank's registered capital, or a smaller amount according to. the EBRD's contract with the bank. The **$2.3** million is to be used for individual credits between $100,000 and $500,000, and the Azerdemiryol Bank's $1.5 million line is for credits **of** behveen $50,000 to $150,000. EBRD charges the banks LIBOR+5.5%, but the banks **will** charge their final borrowers a rate of 18% per annum, closer to local market rates, with a maturity of up to 5 years. This still-high cost of credit has disappointed some potential borrowers.

The overall EBRD program is mainly for qualified business borrowers, but **20%** can be used for the institutional development of the bank itself. Credits to businesses are intended to be primarily for capital expenditures, but some working capital lending is not precluded. The credit procedures foresee a double review of each credit: the bank originates and recommends the project, and the EBRD confirms the decision after making its own assessment, mainly in their Baku office, and partly at London headquarters. Credits disbursed to date include a refrigeration unit, a sports center, and a producer of motor oil, among others.

a) ***Constraints***

According to interviewees on the lending side of the EBRD program, the key problem is not to f i d money, but to find projects which can survive in this environment. Banks report a lack of applications for viable projects. EBRD is willing to see the program increase slowly, once the consulting work in the banks selected produces positive results. The consultants there are working to develop credit assessment and credit administration procedures and train the staff on the job. According to respondents, the banks are developing more reliable procedures and better results.

EBRD has not yet taken an equity position in any private bank as this is still seen as too risky. One first step could be some involvement in the IBA after or in the context of a successful privatization, where it is considering acquiring up to 20% of IBA's equity. The EBRD is ready to participate in the new bank that is planned to be set up by Shore Bank supported by IFC.

b) ***Participation in the Caucasus Venture Capital Fund.***

The EBRD participates with $8 million in the equity of this fund, which **was** established this year and is planning to invest $100 million regionally. The first investment of **S2.3** million in the telecommunication sector has already been agreed.

2. The World Bank and the IFC

a) *The World Bank's Rural Credit Component*

This program will start its implementation phase in spring 2000, with the tender for an international agency to run the program. This agency will have to contribute 20% of the $11.5 million which is to be used for credits. The complete program cost is $15.5million. The main idea is to form 80 agricultural credit cooperatives that will lend money to their members. They intend to raise local funds and savings later on, so the program is an initial push for a system that will be self sufficient and sustainable. This system is based on an existing law of credit cooperatives in Azerbaijan. There also will be up to **200** lending groups composed of local farmers who will form solidarity groups. These groups will guarantee their members (maximum $900 per loan), based on the idea of social control. The responsible Azerbaijani institution is the Ministry of Finance.

In the first phase, 60 credits and 160 borrower groups are expected to be established with about $8 million allocated to loans. These credits and borrower groups are expected to become independent from subsidies and generate their funds from local savings and profits. There should be some 12,000 loans outstanding to 10,000 farmers, who will also receive training.

The program is based on the idea that rural credit facilities are not effective as an isolated intervention. They need to be supported by consulting components, by institution-building and by an appropriate legal framework. In its program paper the World Bank states: "Micro-credit schemes are efficient if they address the people who have some entrepreneurial spirit and ability and who can use the money to develop a business. So the credit should focus on the ones that already having a business or who have a promising idea and the personal skills to implement it."

b) World Bank Assistance to *Develop* the Legal *Environment*

The World Bank is assisting in the drafting of a new Civil Code together with the relevant procedure regulations as well as the institution development aspect that will be needed afterwards such as developing the courts. In this field the World Bank cooperates with the German Agency for Technical Cooperation *(GTZ).* GTZ is providing the expertise from Prof. Knieper from Bremen who has already drafted the Civil Code for the neighboring countries of Georgia and Armenia. These countries are interested in having the same legal environment, which would make economic cooperation easier. It is expected that the draft of the civil law and civil law procedures will be passed by the Azerbaijani parliament next spring, and could come into force one year later.

c) World Bank Public Sector Reform Project

This project is a key effort to modernize the country's administration system. It is a long term approach and will concern many public institutions. The IFC's credit line is a project already in place. Several banks have received credit lines to produce credits for SME's. These are the Azerdemiryol Bank and the Rabita Bank. IFC is assisted by Shorebank. This technical assistance component is sponsored by USAID. The selected local banks originate and assess the original loan applications, and make credit recommendations to Shorebank. Shorebank reviews the application and can veto the bank's recommendation. The idea is that Shorebank supervises and at the same time trains the local banks to assess and to administer IFC credits for SME's. Shorebank also actively monitors borrowers, via joint assessment and monitoring missions. In cases which look uncomplicated Shorebank and the local bank visit the project at least once every three months. Most are visited every month, hut more difficult projects are visited weekly. So far, 29 credits have been issued with an average of $47,000.

d) The Micro-Credit Bank *Initiative*

Seeing a need for wider lending, and excessive risk aversion in its onlending partners, Shorebank has undertaken an initiative directly to make small loans of $1,000 - $10,000. IFC is ready to contribute to a joint venture with Shorebank, and so would EBRD. The new Micro-Credit Bank would directly address the target group and issue credits without involving local banks for the assessment and the credit decision. In this case the risk would stay with the Shorebank. However, Shorebank is experiencing delays from the authorities in the granting of a lending license, reminiscent of the Kocbank experience (see below).

e) The Kocbank Project

IFC decided to participate in the establishing of a new bank in Azerbaijan together with the Turkey based private Kocbank. This bank will increase the lending capacities of the Azerbaijan credit system. The new bank, in which the joint venture partners have already invested substantially for offices and equipment, is still waiting for its banking license after one year, despite earlier assurances by the authorities on the basis of which the setup expenses were incurred. The outcome is uncertain, but some interviewees suspected that powerful local banks were blocking the license, fearing that a new international bank would attract away local deposits and business.

f) The Azeri Leasing Company

IFC is providing $300,000 (10% of capital) to assist the newly-started leasing company Azeri Leasing, with Garanti Bankasi of Turkey 50%), and IBA **(40%)** as joint venture partner. They have been exploring the situation in Azerbaijan for more than one year now. The company was established two months ago and moved to new premises. The company has a time frame of several years and does not depend on a quick profit. At the moment the tax legislation for leasing is not yet in place. Presently, leasing payments cannot be deducted from a company's expenses for income tax purposes. The target customers are in the construction industry, agriculture and food processing. Leasing is a new concept, and therefore the company will initially focus on assets that can be easily repossessed. These include vehicles, light machinery, and office equipment that can be easily sold or removed. The average time of the leases **will** be 2-3 **years.** The volume is expected to grow gradually up to $40 million at the end of 2001. The transactions should vary between $100,000 and $500,000per case. The expected market share is 35%-40%

3. KFW Credit Program

KFW will start a new SME credit line within the coming months. KFW **will** provide DM 10 million. could be extended up to DM 17 million. The program is based on a study by Luso Consult in 1998. The credits to the final beneficiaries will in the range of DM 10,000 – 100,000 ($5,000 to 55,000) and are planned to support small businesses. Start-ups will get a special attention. The program will be managed by an international accounting company that will assume the responsibilities of an APEX Unit to check the proposed banks, administer funds provided to selected banks, and control distribution of all portfolio assets.

This company will be established through a tender, and therefore must the successful bidder must assumme part of the risk for bad performance. It looks as if Azerigaz Bank and Azerdemiryol Bank **will** be selected for the program. Maturity of credits will be as long as 5 years, and the interest rate is proposed to be about 16%, but whether these terms can be implemented is debatable.

4. EU-TACIS

a) *Supportfor Rural Banking Project*

TACIS is already active in providing funds for rural projects. These funds were channeled via commercial banks. Now TACIS wants to extend the program and make it more efficient. The key idea is to form credit unions whereby farmers pool their resources and set up a credit-granting institution, supported through a TACIS program for Credit Unions. This program needs consulting and institution building support to be effective. It is not clear if this program is coordinated with the World Bank rural credit program.

In addition to support for new credit unions, TACIS will continue to channel credit through the commercial banks. To encourage cooperation with commercial banks, TACIS is behind the establishment of a new bank to serve as the umbrella organization for the program. It will provide the credit unions with funds and it will be the APEX unit, the second tier bank for the credits channeled via commercial banks to the final borrower. This bank will start as a state bank and is then planned to be privatized within two years.

b) *TACIS Bank Training Center*

TACIS is starting a bank training center within the coming weeks. The idea is to offer training courses for the staff of the banks in Azerbaijan to qualify them for their task as bankers in a market economy. Courses will be basic and advanced. The goal **is** to create a sustainable institution that is permanently available to guarantee a qualified platform for the banking business in Azerbaijan.

5. Micro-Credit Suppliers

There are several NGOs focusing on the micro-credit sector. They produce credits up to $1,500 **per** case and are linked to a humanitarian program (ARRA). Together with other program components which would provide shelter, the micro-credit component is intended to help generate income and create jobs, most importantly for IDP's.

a) Finca

Finca has been working since 1996 in Azerbaijan and has produced about 3.000 micro-loans with an average size of $126. At the moment there are still 600 credits in the portfolio. The credit period is 16 weeks and the interest rate 4% per month. The default rate lies according to Finca at just two percent. The loans are provided under the "village banking" model used in Asia and Latin America. The loan is given to a solidarity group which commits to repay the credit back even if the directly addressed project turns out to be not viable. The projects are mainly all trade operations. The money is used to buy vegetables or fruits from wholesalers to sell them in smaller portions to final users on bazaar markets.

There was no study conducted on the impact that this program has on business development in the target group. According to its experience, Finca reports that the businesses do generate income, which is used for living expenses of the borrower's household. In general there is no development in the sense of investing the profit and increasing business. Finca reports that up to 5% of its borrowers show entrepreneurial attitudes and skills. These people could be capable of creating a sustainable small business if they had access to a larger loan and consulting assistance.

Finca was approached by the authorities because of its status as an humanitarian organization and a lending institution at the same time. There are conflicting views, apparently regarding precedent, as to whether they should have the right to lend money without being a bank, while keeping the tax-free status of a humanitarian organization. At any rate it is questionable whether it makes sense to remain an organization that focuses on IDPs many years after these people have left their homes. These IDPs are not necessarily in a more difficult position than the local population, so that the preference given by the micro-credit scheme can be questioned.

b) ***World Vision***

The World Vision program is running projects in six areas. 80% of the beneficiaries are IDPs, 20% local population. The World Vision micro-credit scheme offers credits of up to $ 1,500 per case with an average of $450. The number of small businesses started is reported at about 4600. The normal credit period is 7 months. Thirty-five percent of loans are to repeat borrowers who have successfully repaid earlier loans. At the moment there are about 1100 outstanding loans with a total volume of about $344,000. During the lifetime of the program there have been some 23,000 beneficiaries employed and supported. The repayment rate has been 60%, and operational sustainability 70%. The program has different credit ceilings with different interest rates. For start-ups loans are between $100-$800 with an interest rate of 3% per month and a maturity of 3-6 months. For advanced projects loans are $100-$1000, with 3% per month interest and maturing in 3-12 months. For clients who have already successfully paid back one credit, loans are $100-1,500, the interest rate is 2.5% per month, and maturity is 3-12 months. There is a large variety of projects that were financed: 32% trade, 8% services (e.g. car repair, barber shop), 33% production (knitted and sewn apparel), 27% agriculture (e.g. livestock, cattle, poultry). According to World Vision, repayment performance has deteriorated in recent months, probably reflecting general economic stagnation.

Like Finca, World Vision is facing problems with the authorities concerning its legal status as an humanitarian organization and a non-banking lending organization. Registration will end up requiring taxes on the income of the employees as well as VAT. The authorities' concern is suggested by NBA statistics showing a large increase in 1999, to about 50 in registrations of non-banking lending organizations. It was not yet possible to get the names of these newly registered organizations.

World Vision made an attempt to support applicants who showed strong entrepreneurial skills with larger credits between $1,500 and $10,000. There were more than 20 applications out of which 4 were selected and approved. These four credits, among others for the establishment of a bakery and for a leather jacket production operation, proved viable and loans were repaid according to contract. **At** the **same** time these companies failed to get the necessary legal status and to be registered. This exposed them to possible actions by the authorities. World Vision decided to stop this type of program, but the attempt showed that there are possibilities to pick individual projects and help them to develop beyond the level of a pure subsistence activity to a small business that can create jobs.

c) Constraints to Programs

The micro-credit programs of Finca and World Vision could produce more benefits if there were a closer follow-up of the impact they have on the development of small businesses out of grass root activities. The example of World Vision's small (as opposed to micro-) loans of $1.500 to $10.000 showed that there is some potential among the micro-credit beneficiaries. The top **5%** or even 1% of capable entrepreneurs could develop their businesses beyond the level of family income generation. Five percent would represent 150 enterprises in Finca's case and many more in the case of World Vision, bridging the gap between micro-credits and true small business loans.

This **small** loan range of $5.000-$ 30.000 is difficult to find in the domestic banking system unless the borrower personally **knows** the banker, and even then banks simply may not have the money **to** lend. The director of the sole private bank in Mingechevir, in the presence of two qualified borrowers needeing money in this range and who he knew well, reported he simply had no money to lend. To get a credit of this size with a maturity of 2- 4 years for starting a new business or for growing an existing one is practically impossible.

6. GTZ and KfW

GTZ presently implements three types of projects and is assessing an additional component. The ***rural development project*** has two projects, one in the region of Zagatala next to the Georgian boarder **in** the northwest, and one near Guba. These project are based on the idea of integrated rural development and involve community intervention without a specific agenda. The ***civil code project*** provides legal advisory services to help draft laws and procedures. It also includes training for judges and lawyers in civil jurisprudence. Training activities consist of seminars and personal assistance. If the civil code **is** successfully passed by the Azerbaijani parliament next spring, there may be additional projects offered in training and institution-building **for** the judicial system. GTZ also provides ***technical assistance*** to selected companies restarting after privatization and restructuring, or for performance improvement. This is a pure consulting approach with no credit component. Credits may be forthcoming through the proposed KfW credit line.

C. TECHNICAL ASSISTANCE FOR PRIVATE SECTOR DEVELOPMENT

Technical assistance has been very limited throughout the donor community. The matrix prepared for this report has been liberal in checking off eight donor organizations identified with technical assistance for private sector development. UNDP clearly is responsible for umbrella funding of technical assistance for a variety of its sponsored programs, but these have not been specifically directed toward private enterprises. Instead, it has been a by-product of humanitarian aid to disadvantaged families and enclaves of refugees or IDPs. In that respect, the UNDP has accomplished much in terms of raising skill levels through direct support for its recipients, and helping many micro-businesses (farms, village craftsmen, carpenters, rug weavers, etc) re-establish a toehold on civil life through micro-credits, income-generation efforts, and non-monetary necessities. This has been accomplished through various "implementers," such as Hayat (which also works with UNHCR and WB projects) to send indigenous staff into the field to provide hands-on assistance.

Technical assistance has been a core component of the most successful USAID business development programs around the world. It is an integral part of CIDA and BESO projects by the Canadians and British, respectively, and a strategic component of ACDI/VOCA, Land O'Lakes, IESC, CDC, and others. Yet in Azerbaijan, there is an obvious lack of direct technical assistance. With few exceptions, such as those associated with USAID sponsorship, indirect flow-through efforts by the UNDP and sister UN agencies, tactical intervention under the umbrella of Mercy Corps International, and a limited program by the German programs under GTZ, there has been little direct support for enterprise development. In effect, there is no strategic business development program in Azerbaijan which, by definition, has a strategic technical assistance component.

The ACDWOCA projects come closest. These are concerned with food preservation and canning techniques, and they represent a step up above the seed/livestock activities. By providing several rural communities with the "means of production," the contractor has equipped the recipients with equipment and knowledge of techniques for canning foods. The scale of these endeavors is very small, and they include two primary test sites with self-contained canning units. The term "canning" is used here to refer to the steam or boiled-water bath type of rural preservation system using sterile "mason" jars with vacuum-sealed tops. This technique is useful for fruits, vegetables, and processed sauces (such as tomato paste and relishes), as opposed to "canning" of meats and fish requiring tinned containers and a production facility. Nevertheless, the ACDWOCA projects provide to their recipients a platform for enterprise that could grow into meaningful, if not limited, rural commercial activities.

The nearest any activity comes to technical assistance to industry is through the EC-Tacis instigated programs of KOSIA-SMEDA. This organization is, as the name implies, an "SME Development Agency," but is somewhat difficult to assess. It became an official development agency under a Tacis grant four years ago, and although now listed as a private commercial company, it still has funding from Tacis channeled through a fund under the State Committee on Antimonopoly Policy & Support for Entrepreneurship (referred to elsewhere simply as the "Antimonopoly Committee"). This linkage suggests that SMEDA has some residual (if not active) responsibilities to its parent state committee. With that said, it has a solid reputation of helping several dozen industrial companies with business plans, marketing, networking with foreign buyers, and intensive workshops or seminars on western business techniques ranging from ISO-9000 issues to ISA procedures.

The team made an attempt to study SMEDA's records, including reviews of more than 50 consulting reports, and interviewing selected clients. The consensus is that SMEDA has, indeed, assisted a number of businesses with successful results ranging from post-privatization repositioning to concluded contracts with European buyers for Azeri products. However, their successes should not be overemphasized as SMEDA is struggling to become a commercially autonomous company, and it has limited staff and resources. With its linkage to the Antimonopoly Committee, it cannot by a viable conduit for technical assistance or training to the private Azeri business community. This stems from an underpinning distrust of the Antimonopoly Committee (often bitter recriminations by individuals interviewed by this team) who generally believe the committee is a corrupt agency under the direct patronage of the President.

There appears to be no other evidence of direct technical assistance to industry, or any form of technology transfer, in the sense that USAID funds elsewhere in CEE countries. The high-growth sectors of construction and trade is not addressed by assistance, machining companies, equipment makers, and the agribusiness sectors are on their knees with no visible attention from any international donor. We have alluded to some exceptions, such as micro-credits that trickle into some trade and craft endeavors, the ACDWOCA efforts in small-scale canning that can be counted among potential agribusiness interests, and several of the more substantial loans placed through Shore Bank.

There may be some progress through the newly implemented CDC project if the project director's objectives are realized. CDC hopes to target subcontractors and suppliers who have potential to work within the oil sector, such as oil field machinery and equipment suppliers, construction contractors, and established companies with growth potential linked to future oil field and pipeline development. Our viewpoint of CDC's project objectives is that they are definitely on the right track, but perhaps overoptimistic. Over a two-year period, CDC expects to bring to Azerbaijan 100 volunteers for technical assistance, completing 200 interventions either by direct work plans or by piggybacking on the volunteer's ability to deal with two or more client organizations. This effort is coupled with a projected level of effort program of training seminars. The combined effort is rather awesome for two reasons. First, the ability of a contractor to recruit and host such a large number of volunteers in a relatively short period of time can be a logistics challenge. Second, the ability to identify such a large number of viable client companies, evaluate them, and develop appropriate work plans for volunteers suggests a pace of "two a week" every week, with post-intervention evaluation and impact documentation. We sincerely wish CDC good fortune, but also suggest that technical assistance may not meet expectations without excellent support and effective networking in Azerbaijan.

D. BUSINESS SUPPORT & ASSOCIATIONS IN THE PRIVATE SECTOR

Azerbaijan has experienced three distinct patterns of development for associations and business support organizations. Soon after independence in 1991, there was a burst of activity as existing unions and state groups were encouraged to "go private." At the same time, new private (non-government) associations were openly encouraged. Within a year, 1,118 organizations had been registered as self-sustaining associations, and all but 12 were counted as "private non-profit and non-governmental." How many actually were beyond government influence is impossible to say, but the UNDP's current registered list of associations (National NGOs) numbers **212,** with 27 additional municipal groups, and 5 regional associations (244 total), indicate some government linkage for 187.

If this profile is accurate, there are only 57 legitimately private non-profit, non-government associations or registered business support organizations in the country. What happened during the interim since 1991 was a second period of severe de-registration during 1994 and 1995. The explanation for this contraction, offered by the President of the Azerbaijan Chamber of Commerce & Industry, is that a politically expedient vetting occurred to remove "disruption influences." The explanation given by three different association spokesmen whose organizations have survived, is that government leaders found excuses to "void registrations of anyone who was not supporting the gangsters in power."

Apparently "re-registration" can still occur without due process as two private business associations (both past recipients of Eurasia Foundation grants) were found to have "irregularities," and subsequently not permitted to continue their license. These were Profile, a think tank and research group **that now** contracts as a group of individually registered consultants, and the Strategic Research Center for Development and International Collaboration (SIGMA), which was known to advocate for reforms and published critical work under Eurasia grants on lack of government support for SME development. The situation in 1999 represents the third pattern of association development. This is best explained as a more stable, but slow-growth period, when associations must still be careful of their activities and mandates, but **with** donor-sponsorship, their number is expanding again. Registration remains a problem, and 15 of the 17 new associations recorded between January and June 1999, were connected in some manner to government *or state-owned* organizations. The two exceptions concerned charities for children or disadvantaged youth (Veten, 1999).

1. **Profile of** Associations **in** Azerbaijan

International assistance plays a major role in non-governmental association building, and in the support required for commercial business support organizations. The Initiative for Social Action and Renewal (ISAR) is the primary activity specifically charged with developing BSOs and NGOs, and it has been instrumental in helping at least ***20*** new organizations to register since 1996. ISAR has also been the leading provider of training materials, networking contacts, direct intervention for association charters and activity plans, and "training of trainers" within the commercial BSO community. With that said, much of the agency's activity has focused on rural communities and humanitarian priorities, and in Baku, attention has been on social organizations more than on business groups.

Business associations have largely formed on their own accord, yet they have benefited from grants by the Eurasia Foundation, contracts under World Bank and UNHCR programs, and cooperative programs with several USAID funded activities. There are 20 associations with formal business development charters. Of the remaining 224 registered associations, 7 are concerned with media, *6* are professional associations (journalists, teachers, etc.), 15 have a youth-support mandate, 34 are social groups or unions, 2 are sporting associations, 5 are state-connected groups for disabled, 17 are cultural groups, 17 are health professionals, 33 are humanitarian or environment groups (many with donor support), 7 are listed as women's associations, and 8 are registered as having "economic" interests. The remainder are classified as having "civil or democratic" interests.

The table below lists the 12 most active associations with business development interests, but while they are registered as private, non-governmental, and non-profit judicial entities, there is room to question this conclusion. Officers or key members are often executives of state enterprises, and funding appears to slip through channels from government agencies or committees that have distinct government connections. A comparison of two powerful (and counterpoised) groups, illustrate the situation.

The ***Association of Entrepreneurs of Azerbaijan*** (AEA), originally chartered in 1993 under the auspices of the State Committee on Antimonopoly & Support for Entrepreneurship, was "de-registered" at the beginning of 1999. The **AEA** registered again in March 1999 after three months of delays and appeals, but now officially exists under the chairman, who is a member of parliament and Ambassador to Great Britain. Ironically, this group is considered to be the most aggressive opposition group to current government, and an association that is entirely private, self-supporting, and a strong advocate of free enterprise. The president and nine of its 11 founding member affiliates represent some of the strongest privately founded companies in Azerbaijan. It also has several unions, and the Association of Banks as member affiliates, but the 248 individual members are all private business owners.

In contrast, the ***Union of Small and Medium Enterprises of Azerbaijan,*** was established in April 1999 by 9 private companies, and currently has about 112 members who are private business owners. This group has recently added affiliated unions and 16 representatives of state-owned enterprises, but it is held out as a staunch advocate of free enterprise development. In the long term, this may prove to be true, but at the moment, a new president is also managing director of a large state-owned manufacturing company, the Union was a grant recipient from the Antimonopoly Committee, which is directly chartered by a decree of the President of Azerbaijan, and it has ex-officio board members appointed from three government ministries. The Antimonopoly Committee openly supports this group, and both the Union and this Committee scorn the AEA as subversive. The AEA strongly derides the Union as a puppet of the Committee, that both are corrupt, and together they pursue "political interests and interfere with private businesses" on behalf of their government benefactors.

The comparison of these two groups illustrates the difficulty of identifying the real purposes of associations, and clearly understanding whether an association has government connections that would 'complicate foreign assistance. The examples also demonstrate a requirement for "due diligence" to uncover association capabilities and whether they can earnestly provide business support, influence reforms, or deliver training, networking, and market access for members. These are common expectations for effective business organizations. Those listed in the table below have demonstrated these capabilities. They also have been evaluated by the Eurasia Foundation and the Veten International Fund for future development grants and cooperative assistance activities (Eurasia 1999, Veten 1999).

Table 23: **SELECTED ASSOCIATIONS WITH BUSINESS INTERESTS**

	rounded	Members Profile and Numbers	Type of Association	Remarks
1) Association of Entrepreneurs of Azerbaijan	1999	124 private and 24 state-affiliates	Private &	Active and autonomous
2) Union of Small and Medium Enterprises of Azerbaijan	1999	9 private, 92 state		Close political ties & funds
3) Association of Marketing Researchers, Baku	1999	4 private		Think tank
4) Association of Banks	1990	49 private banks, 4 state banks		Private and self-funded
5) Baku Coucil for Entrepreneur!			Eclectic	Has several foreign affils
6) Association of Brokers			Unclear	Questionable if active
7) Union of Insurance Societies				Active and autonomous
8) Association of Freight Forwarders of Azerbaijan				Beginning to be active
9) Center for Development of Entrepreneur Activities				Inactive, had political ties
10) Union of Managers	1993	12 private, 31 state		Appears to be olc SOE group
11) Union of Farmers (fmly Congress of Farmers)	1994	500 private farmers, 11700 from old congr		Autonomous and aggressive
12) Union of Free Manufacturers	1996	54 private	Industry	Advocacy group, in limbo

Source: Veten International Fund, ***Background Paper on Business Associations in Azerbaijan***, under Eurasia grant, Baku, 1999

2. Business Association Effectiveness

The studies cited earlier in this section coupled with team briefings with the leading business associations and several commercial BSOs, indicate a general lack of business acumen among the association officers, and rather poor performance on their stated operational mandates. The leading associations have performed well in terms of providing members with opportunities to attend local seminars, join together for better social cohesion, and assist with fundamental business plans or techniques **of** doing business. The vast majority of associations do not have officers with knowledge or experience related to private enterprise development, and few have any sense of western management techniques, international accounting standards, international quality standards, marketing, business strategy, or familiarity with business skills such as competitive advertising, inventory management, product innovation, retail merchandising, or wholesaling. These were the primary areas questioned in the research studies.

With that said, the AEA had several years experience with seminars, members with foreign interest that could participate constructively in training workshops, and the association had helped form four other business support groups. Several other associations appeared to be weak on many of the management issues, and generally not able to provide effective training or business networking, yet they have narrowly defined interests which they could address rather well. These include the Association of Banks, with 49 private bank members and the major SOEs, yet the association was instrumental is pushing through legislative measures with Tacis support for reforms. The members are active in training, linking with foreign bank associates, and working with universities, such as Western and Khazar, on curriculum design in banking and finance. The private association, officially known as the Union of Insurance Societies, has been active in developing new insurance businesses, writing standards for insurance rates and adjustments, and sponsoring seminars, publications, and organizational development. It has also won grants from USAID-funded Eurasia competitions. Others in the table have had more or less similar experiences, but less visible results. The Union of SMEs described earlier, has not yet demonstrated viable activities, but it has prepared an extensive proposal for a business incubator based on cooperative plans by an Italian group, and has established an export data bank on manufactured products in Azerbaijan.

The 1999 survey of associations and business support organizations by Veten included 500 candidate groups in all regions of the country. The conclusion was that few could realistically influence reforms or advocate for legislation, and consequently, they generally have little credibility with a majority of private business owners and managers. With the exception of those noted in this report, most do not attract participation from members other than at social functions, and the organizational activities of association officers is not very transparent. In effect, they are often suspect as perpetuating their own interests, and many of the registered associations either do not have effective connections in the business community, but are more closely connected to specific political constituents. All 20 groups on the previous table have had some foreign experience, including joint meetings abroad, participation at foreign trade fairs, or foreign business investments. However, research has revealed no other business-related association to have more than "tourist" experience abroad, if any. Consequently, there is little evidence to suggest that associations can provide a conduit to international market opportunities or to provide members with useful trade information.

None of the registered associations have rural branches to date, but the AEA has a grant to establish six regional offices, and to promote regional business development. During the first half of 1999, there were no applications for commercial or non-governmental business associations outside the Baku area. However, there were four new state-affiliated registrations concerned with a teacher's group, a farmers union, an affiliate of the Farm Progress Centers Program (Tacis supported), and a municipal committee listed as association supported through the UNDP-sponsored SME project. There do not seem to be associations or BSOs with interests in high-potential service industries (retail or wholesale trades), construction, transport enterprises, dairy, or agribusiness. Normally, these industrial groups are very influential, and they are usually the leading organizations to establish foreign markets, forge linkages with foreign suppliers, and provide members with crucial industry information.

3. Opportunities for Assistance

There are at least 13 PVO or *NGO* activities related to association development or support for BSOs. This figure could be expanded slightly to include "community participation" associations and assistance to vulnerable groups among IDPs, disabled, and rural farm groups. However, those that can realistically be credited with business-related assistance are perhaps six activities, plus KOSIA-SMEDA (as a quasi-contractor under Tacis) and the UN operations. As noted earlier, ISAR and the Eurasia Foundation are prominent for their business association activities, and ACDWOCA is focused on rural farm groups with marketing support. Agencies from other international donors tend to have specific interest groups with whom they work. This is a rather sparse effort, and there are ample opportunities for **work** with all types **of** associations and business groups.

Specifically, industry enterprises in high-potential sectors lack focal advocacy groups or methods of generating cohesive systems of market networks, business linkages, or information services. The American Chamber of Commerce provides an excellent model on which to build local associations, even if they are not official "chambers," but those who would create these organizations need the business development experience and connections to experts or volunteers who would provide more than a social dimension **to the** support **groups.** This theme is pursued in more detail under the report's recommendations, but the **point** is that association building requires a dedicated business programming approach, not superficial training exercises and hackneyed recommendations, such as "how to write a business plan." Genuine intervention **by** seasoned volunteers or professionals who can build and help sustain organizations is required.

VI. OPPORTUNITIES AND CONSTRAINTS FOR AZERI BUSINESS

This chapter, based on the preceding factual survey, presents the major findings and conclusions that form an assessment of the Azerbaijan private sector. First, we provide our assessment of the key opportunities open to Azeri business, by reviewing the country's comparative and competitive advantages and the specific industries and product groupings where business viability seems most feasible. Then, we summarize constraints to private sector development, as a prelude to the final chapter of the report, where recommendations are presented for potential programmatic assistance by USALD to Azerbaijan.

A. COMPARATIVE & COMPETITIVE ADVANTAGES

Comparative advantage is the 'traditional definition of the particular ***potential*** relative economic strengths of one nation over others in natural resources, human resources, and location. These advantages, if properly exploited, generate trade and investment to that country's benefit. **A** competitive advantage is a comparative advantage that is in fact being exploited. It is realized, ***operative*** relative market power through technology, proprietary industries, financial resources, intellectual property, or management acumen. Azerbaijan has several important comparative advantages, but few competitive advantages, and therein lies the key to development.

1. Comparative and Competitive Advantages

a) Location

From a regional / geographic perspective relative to its neighbors, Azerbaijan is positioned to be the pivotal player in the Caspian region. It has the potential as an entrepot for transit from Turkey the Gulf States to the southern CIS republics, Georgia, and Russia, a transshipment point between the Caspian and South Asian states to the Mediterranean, and, of course, the core Caspian oil and petroleum source for routes into Europe via the Balkans. To some degree, these location/distribution opportunities are being systematically pursued through the oil and gas pipeline projects and the "new silk road" initiative, but they require pervasive long-term commitments that suggest huge domestic development programs and major BOT (build-operate-transfer) foreign investments.

b) Oil and Gas

The most obvious comparative advantage is in ***oil & gas reserves,*** including recent discoveries of major natural gas pockets along the shallow areas of the Caspian coast south of the Absheron ridge. This presents a dilemma to Azerbaijan as well as a tremendous opportunity. On one hand, the gas pockets were a disappointment as drillers were searching for crude oil. Finding gas rather than oil meant that major oil companies had to downgrade their estimates of oil reserves substantially (by nearly a third). Soon after this news in September 1999, Conoco Oil withdrew from negotiations for oil lease and drilling rights, and Texaco announced that it would reconsider its commitment to the Caspian Basin fields. In response to these news stories, the Government of Azerbaijan admitted that gas could not be effectively extracted with existing technology, and that reduced oil production could mean that the break-even volume for the existing and proposed pipelines would not be met until 2004 or later.

The problem with gas is that Azerbaijan has no gas extraction, storage, or delivery capabilities, and LPG tanker requirements for draft depth and docking cannot be met by the country's ports. Gas requires huge infrastructure investments, and no one is currently addressing these. ***On*** the other hand, if **gas** could be tapped, the revenues could more than offset the disappointments in crude oil deposits, More to the point, gas can be found in the shallows and plateaus adjacent to the main coastline, thus easily reached. Gas pipelines do not exist, yet these are relatively inexpensive to build compared to oil pipelines according to industry studies by Exxon and BP. Whether or not these opportunities are being explored is a question beyond this report. Nevertheless, there is a major opportunity to "bail out" the domestic economy in 5-10 years with proper investment and management of the resources.

Oil is an anchor industry, but it is one-dimensional. Gas would provide a second dimension on two fronts. First, as an export resource vitally needed in Europe and CIS republics, and second, **as** a crucial power source for domestic industry. Gas-fed thermal electric power generators are 22 percent more efficient than oil-fed or coal generating stations, and domestic-gas infrastructure for heating and industry utilization could reduce domestic demand for electricity by 30 percent within five years of being brought on line. Consequently, the nation's excess demand on electricity could be substantially alleviated through investments in gas-fed systems.

Oil and gas, as anchors, create pervasive business opportunities for drilling, extracting, and distribution equipment, construction, transportation and distribution services, refining, port development, and many associated business and personal services. This is not surprising, yet it has not appeared strongly in studies about Azerbaijan's industry potential. What one hears is "oil will save the country in due course," but based on a Shell Oil study of social and economic impact of its subsidiary operations in 1997, the direct economic benefits of oil production generates approximately $4.20 in "associated" activities for every $1.00 from oil revenues. This occurs through subcontracting, construction, equipment, oil field maintenance, distribution, storage, financial services to the companies, and a broad range of local senices. The estimate admittedly could be somewhat upward biased from this source, but the basic point that oil can generate a major income multiplier through associated business is certainly valid. The question is whether the Azerbaijan government is positioning the country to promote these activities, and whether Azeri business has the management and capital resources to exploit this business potential. In both cases, the answers are not encouraging. By failing to privatize major state-owned oil-related equipment producers, government policy is holding back potential growth there, and the Azeri private business sector clearly does not have the financial resources to go beyond small service operations.

c) Agriculture

Agriculture has always been **an** important comparative advantage for Azerbaijan, and certainly has the potential to become a strong regional competitive advantage. The country has a diverse climate and arable land for high-value-added produce. **As** reviewed above, the country grew and exported very large volumes of fruits, vegetables, nuts, and money crops (wheat, cotton, tobacco, and silk), prior to its independence. It currently still produces domestic staples in abundance, so that despite massive human displacement, ravaged lands, and a legacy of agricultural mismanagement from the Soviet era, few people (if any) are starving. Indeed, fruits, grapes, tomatoes, and many other crops rot in their bins, or are fed to livestock, when these commodities once had commercial value for domestic and export markets. Meanwhile, the production of cash crops has declined dramatically due to land fragmentation, unorganized marketing, and equipment deterioration. Even wheat production – both a staple and a cash crop – is now inadequate to serve the economy's needs. In processed foods, Azerbaijan used to supply huge quantities of canned tomatoes and jarred fruit and vegetable products. These industries now operate at very **low** levels.

Summarizing, despite its natural comparative advantages in agriculture, Azerbaijan has lost its competitive advantages. Many Comparative advantages, however, are permanent, and can be pursued again with proper strategic and marketing management, and with capital resources. Cash crops and food processing can viably expand. Agribusiness enterprises represent a major sector for both domestic import substitution capabilities and export market development. Specific agriculture sector product opportunities are summarized below in the "high-potential business opportunities" section.

d) Other Manufacturing

Industrial potential is also discussed separately for high-growth potential, but as a general statement, it is important to note that Azerbaijan previously has had competitive strength in a number of durable products. Ceramics, construction materials, oil field equipment, auto parts, tires, chemical fertilizers, electric motors, electric cable, and small appliances have all been productive lines for years prior to 1990. Most of these are now defunct or in a state of decay after the country lost proprietary Soviet markets. Azerbaijan industry was part of the integrated Soviet system of "concentrated enclaves" with dedicated segments of production, and, consequently, domestic industries often filled only one notch in a complicated value chain. After independence, industry was adrift with neither access to upstream resources or to downstream markets, and without the marketing skills to direct efforts toward other markets. Therefore, large dedicated factories may have had enormous capacity, but became isolated in a dependent system. Nevertheless, the country has industry assets and a demonstrated capability that could be constructively positioned in regional commerce.

e) Human Resource ***Skills*** and ***Cost*** Advantages

Azerbaijan may have a temporary advantage in comparative labor costs that could be leveraged as an incremental development tool. Specifically, the extremely low wage structure coupled with high unemployment suggests opportunities for foreign direct investment in offshore manufacturing, co-production, and regional distribution facilities. Similar wage-based advantages were leveraged by each of the Asian "tigers," (Singapore, Hong Kong, Taiwan, and South Korea), and more recently by Malaysia, Thailand, and Indonesia. Although those nations have suffered setbacks from political instability and a variety of social or financial discontinuities, they have, in fact, rapidly developed from marginally low-income countries to middle and high income countries with substantial institutional capabilities for rapid growth in the next century. Azerbaijan may have a unique opportunity to do the same within the South Asia and Caucasus Regions, not merely because of the very low wage base and ample labor, but because the level of education and industrial skills in the labor force are high relative to many of its neighbors.

2. Competitive Disadvantages

While the country has several distinct comparative advantages, and potential to nurture those advantages, unfortunately it has some important competitive disadvantages. These make it difficult to exploit its comparative advantages for other than the most obvious immediate gains – as in pumping crude oil. This is the fundamental "germ" behind the so-called "Dutch Disease". A country that does not create a competitive advantage subsequently depletes its resources and becomes a victim of circumstances beyond its control (such as world oil prices in an oil-dominated economy). We can summarize the main categories of competitive disadvantages that compromise Azerbaijan's prospects.

Political instability is perceived to be considerably higher than in fact it is, because of the drawn-out failure to settle the NK crisis, raising the country risk profile for Azerbaijan in the minds of potential foreign strategic business partners and investors. When this is coupled with an extremely high level of corruption, unpredictable government administration, a capricious system of civil and commercial law enforcement, and a general "rule of man" versus "rule of law," the country is seriously crippled in its aspirations to attract foreign investment outside of the most obvious natural resources.

The slow pace of privatization coupled with a stagnant effort to transform its industry leaves Azerbaijan drifting further behind in a technological wake. Industrial assets and technology that may have been viable ten years ago are rapidly depreciating due to the failure to privatize and shift resources into commercial hands, Even after privatization, many medium-sized companies will be domestically owned, and concerted assistance efforts will probably be necessary to help companies adopt technology, inspire innovation, and advance intellectual property. Presently, the ***decaying technology profile*** of .Azerbaijan is become a liability when, not long ago, it could have been considered an asset.

Azerbaijan does not have the ***financial strength*** or the ***institutional capability*** to become a commercial center within the region, yet given Azerbaijan's unique geographical location in the Caspian Region, it could vie for commercial leadership. The point is emphasized by examples of smaller and more isolated economies with virtually no natural resources, yet they have built their entire success on financial intermediation and commerce. Singapore and Hong Hong, specifically, created extremely strong institutional and banking systems to service regional trade, shipping, and foreign investments. These were economies with few opportunities other than "commercial proximity" to other larger countries. Azerbaijan, a crossroads location, is not unlike these territories, but also has natural resources on which to build the foundations of a regional commerce center.

The final disadvantage common to most transition economies is a pervasive lack of ***management acumen.*** Because its reforms have lagged behind, Azerbaijan has made less progress in this area than many other transition economies. Marketing skills are opportunistic rather than strategic. Financial management is at an elementary stage, with crude *or* nonexistent managerial accounting. Total quality management concepts are rare, so of course their valuable operational process advantages have not appeared. Management skills in other transition economies have gone hand-in-hand with real transition of the enabling environment. Privatization and the accompanying emergence of competent banking, active securities markets, and reform of commercial law and tax administration force improved management, because without it businesses are unable to access finance, and poorly managed companies quickly lose markets to better-managed ones. Improvement ofmanagement does not come naturally, but while not rocket science it must be learned from experts. In most transition economies, the most important sources **of such** learning have been two: USAID-funded management improvement projects working broadly, and strategic mergers with foreign business working case-by-case.

More generally, Azerbaijan does not demonstrate a sense of cohesion on which to build commerce: but more importantly, the social chaos that occurs on a daily basis suggests a nation that is not being managed. One of Japan's unique strengths has been its managerial capabilities that fostered a generation of highly competitive process engineering innovations. The Japanese are **not** necessarily "innovative," but they created a disciplined society of extremely well-managed organizations. Despite recent cycles of social and political problems (events that plague every nation periodically), the fundamentals of Japanese industry remain strong. Ironically, this was a nation of few resources and no distinct competencies, yet the cohesion of its organizations coupled with well-articulated management systems directed toward strategic trade revolutionized society. In Azerbaijan, we observe people seeming to move in conflicting directions, individual indifference toward one another, and a prevailing win-lose mentality that festers in social and business organizations. There is no parade, and no one is setting a cadence for economic growth.

Management acumen extends to education capabilities, fundamental business processes, marketing talent, motivation to achieve, confidence in and commitment to systems and leaders, and ultimately the ability of a people to build self-esteem. These are more than academic concepts **or** philosophical pronouncements. To the contrary, they constitute the ***psyche of a nation,*** and consequently, the underpinning strength of its institutions and organizations, however so small. At this moment in its history, Azerbaijan has serious competitive disadvantages within the make-up of this managerial psyche.

Under present conditions, there are few ***proprietary industries*** or ***distinct competitive advantages*** remaining in the country. There certainly is potential for developing distinct advantages, either through industry or agribusiness niches, or through keystone sectors that complement oil resource development, but this potential is latent and cannot be realistically exploited until the constraints to private sector development identified in this report are addressed. From a competitive perspective, Azerbaijan cannot presently attract investment *or* penetrate markets outside the oil and gas production sector. Existing and new industries with new technology, and a determined long-term commitment to building markets, will be required to reverse import/export deficits, and ultimately build an industrial platform for the country.

This rather negative portrait of Azerbaijan's competitive advantages is balanced by its ongoing comparative advantages, even though they are presently latent, and by the many viable potential business areas surveyed above and summarized in the immediately following section. This "good news-bad news" assessment is consistent with the highly polarized individual attitudes toward the country's potential observed by the team in its many individual and group interviews. At one extreme, discouraged youth, scientists, educators, and those with sufficient resources have one foot out the door. Indeed, many have already left the country, sensing few internal opportunities or perplexed by a corrupt system where otherwise ethical human beings have no choice but to exploit others to survive. At the other extreme, there are enthusiastic individuals found among young entrepreneurs, inspired persons who have formed associations intent on advocating change, and a few public officials who distance themselves from government perversion and believe that they can make a difference with the right kinds of help.

Hopeful signs emerge in the response of individuals interviewed during this study, many of them recipients of foreign assistance, who want to be part of a growing society, and to contribute to a nation that they see has potential for economic prosperity. Farmers, growers, small business owners, associations of entrepreneurs and their members, and several relatively young government ministers and state committee officials demonstrated the insight that they could make a difference, and that a change in national psyche would be possible. Indeed, this may be the first requirement to gain the momentum needed for a constructive economic transition.

B. HIGH-POTENTIAL BUSINESS OPPORTUNITIES

The relative potential of business growth was presented in an earlier chapter segment under the "Economic Environment" (Section III, B). In that analysis, a number of viable opportunities for Azeri private business were identified, but a sense of priority is needed.

A focal priority list would include the following: (1) agribusiness, including food processing, meat and fish canning, and intermediate distribution of agricultural products; **(2)** light manufacturing, including fabricated electronics, tools, wire & cable, small appliances, and extruded plastics, which Azeri industry has previously demonstrated expertise; **(3)** construction materials, in particular those with high value-added market potential such as doors, windows, fixtures, glass, lighting, and wood accessories; (4) textiles and leather goods, including high value-added finished clothing, coats, household furnishings, and commercial textile products; (5) trade and merchandising services, excluding retail stores and shops, hut including wholesale distribution, transport services, and trade expediting; and (6) professional business services, including business consulting, information systems networking, Internet, and business communications that are distinct from association and BSO interests.

Clearly, there are many other opportunities that might present themselves if economic conditions change. For example, if oil pipeline plans change, there could be a rapid reorientation in trade and services that would include very strong demand for transport, rail access and support activities, enhanced equipment supply, and very active heavy construction and steel fabrication businesses. Political priorities could also suddenly change regional patterns of trade, or prolonged requirements for military support. These issues are beyond this report, but Table 24 below summarizes opportunities as they exist today with pressing demand for agriculture, strong industry profiles, and construction.

Table 24: BUSINESS OI)RTUNITIES BY SECTOR	
Business Sector	Business Opportunities
I. Agriculture and Food Products	• Wheat growing • Cotton growing • Apples, citrus, and other orchard crops • Livestock feed • Livestock breeding and fattening • Silkfanning • Tobacco growing • Meatpacking • Fish farming and processed fish
II. The Oil Sector	• Oil and gas production • Oilfield equipment manufacturing • Oilfield services
III. Other Manufacturing	• Silkfabric • Cottonfabric • Cottonyarn • Cotton knitwear • Light manufacturing of metal and electrical products • Certain major appliances manufacturing • Paint and plastics • Furniture
IV. Construction	• Cement, sand, gravel • Window glass • Bricks and blocks • Doors and windows, parquet • Roofing materials • Ceramic tiles • Architecture • Construction contracting and services
V. Services	• Large retail outlets • Large wholesale distributors • Legal and accounting services • Printing and graphic arts • Office support services

C. CONSTRAINTS TO PRIVATE SECTOR DEVELOPMENT

Azerbaijan faces a number of constraints that will inhibit private sector development, but they can all be overcome in time, with effective western input and reform-minded national leadership. The points that follow can all be traced to the factual findings above. They summarize the preceding research, interviews of government officials and donor representatives, and a survey of companies and business representatives. puit in context by the team's experience in other transition and developing economies.

1. Corruption

Human frailties surface in every society and at every level as individuals, each finding his or her own position of comfort on the long continuum between sainthood and outright evil, find ways to exploit weaknesses in systems or to purposely circumvent the law for personal gain. In Azerbaijan, corruption is absolutely pervasive, but one must assume that the nation's population is not more inherently corrupt than people elsewhere. To the contrary, most people are caught up in a system that is unable to accommodate their economic needs, and a society that is unable to enforce lawful behavior. Even when laws exist that would prevent exploitation, inability or unwillingness to enforce laws pressures otherwise ethical and honest individuals toward alternative behavior, simply for survival.

There are two primary reasons for corruption. First, a confusing array of excessive taxes that can be capriciously levied by **tax** inspectors and assessors creates a pattern of payoffs (or outright extortion) that is generally less costly to the victim than complying with the official assessment. Second, the extremely low wage levels in public services forces individual employees to use their position power (however slight) to extract payments from businesses for every conceivable transaction. This ranges from small "tips" to police officers to avoid traffic tickets that would carry higher penalties than the tips, to substantial payments by job applicants to secure positions, to monthly payoffs to superiors to remain employed when jobs are scarce, to additional charges to secure expeditious attention to normal business registrations or licensing. These payments "trickle up" as supervisors are in a similar cash-flow trap and must supplement their formal income by extracting a percentage of payoffs from their subordinates. This operates much like a commission system in a sales organization where a pyramid of "overrides" filter upward. It is clearly organized and formal, though of course not documentary, and it occurs throughout most government ministries.

It would be impossible to describe all types of corruption taking place, but several practices are particularly troublesome for private enterprises. Company registrations cannot be easily secured without side money to the registration clerks. These is a common form of grease money in other countries, but in Azerbaijan, it has become an accepted way of doing business. Furthermore, there is a nonmonetary aspect to company registration that reflects a political bias of those in power and a system of reciprocal favors. Specifically, associations or social groups that legally have the right to register are often barred from doing so by a cadre of registrars who owe their positions to high-ranking political appointees, and consequently, they can arbitrarily block company or association registration according to politically motivated decisions. Therefore, individuals or associations that could challenge government or prove to be a threat to those in power are barred from legal formation. If they subsequently meet or try to carry on activities, they can quickly come under prosecution. This system of reciprocal favors extends to court rulings, appeals, and arbitration. Of course, we have only anecdotal information on these issues, but heard about such incidents from enough separate sources for them to be credible, including several government ministers who offered examples of improprieties (always in other ministries or agencies). Tax extortion is a complaint of virtually every business person interviewed, but these legitimate business owners and managers openly admitted to hiding employment and "cooking their books" to minimize turnover and profits, thus avoiding a majority of the employment levies and a significant portion of their taxes on profits, VAT, and gross turnover.

One important effect of these system of improprieties is to perpetuate a cash-and-carry economy that further erodes the ability of a banking system to transact business through credit, debit cards, or checking accounts. Meanwhile, the banking system does not provide secure accounts. Any tax official or designated agent of the Minister of Finance or the Minister of Labor can access any personal or business account on demand. At the same time, no bank can release funds from domestic accounts without clearance from an authorized representative of the Tax Department. In effect, an Azeri citizen cannot withdraw his or her funds without making a formal application and being approved for the transaction. Nevertheless, we are advised that a majority of transactions go through unabated – by a system of "prepaid donations" to those in decision-making roles within the banking or tax system. This constitutes an extra "cost of doing business" within the banking system, and consequently, many people hold their funds in cash **or** actually participate in a black market banking system.

The country has passed a rather long list of laws, and it has pending a new civil code with substantial commercial procedures. These are directed at improving "due process" and "enforcement of civil rights," according to the Minster of Economy, but he also pointed out that the President had issued several decrees in the past year aimed squarely at reducing tax extortion. One of those decrees placed quotas on **tax** inspectorate districts in an effort to reduce skimming by tax collectors who may have properly collected taxes from payees, but then "cooked their books" to reduce the amount they remitted to the budget office. The fundamental problem is that insufficient laws exist, and those that exist cannot be adequately enforced. The head of the State Securities Committee explained the problem in two parts. First, laws are written to permit discretion by senior officials who still largely "govern" in parallel to the law (rule by man), and second, those who are expected to enforce laws are themselves party to the questionable payments or behavior, and they cannot prosecute subordinates with risking prosecution themselves. The core issue was still net income and the "naked truth" that each person must take something from someone else to survive.

Reinforcing this view, the team found the official monthly salaries for the Chief Registrar **of** the Securities Committee, which was equivalent to $160 a month, and for the Senior Registry Officer of the Judicial Registry Office, which was equivalent to **$47** a month. The Registrar faces an effective 78% tax rate, with a take-home income of $35.20, and he is a very senior official. The Registry Officer is a mid-level career government employ under the Ministry of Justice, with an approximate tax rate of 64%, netting him $16.92 take home monthly. When these were discussed with three different Ministers, they answered with hypothetical questions such as: "Well, what would you do to feed your family in such a situation? I know **of** no improper behavior by these men, but I would understand their temptations." One business owner who offers company registration services to private companies and to foreign clients put prices on transactions: $200 for registering Azeri enterprises, $1,000 for foreign enterprises, and $2,000 to expedite a registration in less than six months. The same individual priced jobs at embassies, describing an informal system in which local nationals with influence over hiring require some $300 from an applicant for a driver post, and $500 for a more substantial post. Of course, there is no way to confirm such allegations, but similar recriminations came to every team member's attention, in Baku, in regional cities, and in villages. It was reinforced by Americans in residence here, at PriceWaterhouseCoopers, and by government ministries.

Another example was offered by a senior local official who characterized the Ministry of Education as the most corrupt branch of government. He conceded that training contracts for reeducation and technical training **were** all subject to "bid in the hallways," so that his department could not determine what institution would be an official "work center" or how much instructors or the school would be paid for their contracts. Asked about rumors of students "buying" grades, he denied the point adamantly, yet said that parents **are** accustomed to "buying their children into good schools" and "purchasing diplomas once they are in university."

Customs bottlenecks create an enormous opportunities for corruption. A member of the American Chamber of Commerce tracked several shipments of imports that he had made recently. In all insiances, he "prepays" the official 15% customs duty (i.e., fully complies with the law), but by prepaying, his goods come through without invoices. He assumes that customs moves the shipment and does not record it, thus pocketing the entire 15%. Meanwhile, he is never invoiced for VAT or excise taxes as the imported goods "do not exist." In one instance, he did not prepay the customs as his agent failed to get to the **port** as scheduled, and the entire shipment was "delayed" for six weeks – then released with only half of invoiced contents, and fully billed for the shipment, plus a surcharge for "storage" that doubled the invoice cost. His conclusion was that you do business within the corrupt system or pull up stakes and leave.

Conuption, as we define it from an American viewpoint, is unacceptable, and virtually everyone who becomes involved is, by definition, conupt. This is an untenable position in the context **of** Azerbaijan. The pervasive nature of payments and favors may constitute an acceptable fact of doing business here, and most of those involved probably have no remorse, but instead, assume that payments to hospitals, schools, teachers, tax collectors, or even garbage collectors are "just normal." Clearly, the business owners and managers interviewed do not consider themselves corrupt, and most do not consider their "recipients" as corrupt – tax and government officers are exceptions. They simply rankle with cynicism about a system that cannot progress toward a transparent environment where doing business, handling transactions with banks or tax authorities, and providing for employees cannot be legitimate. Those individuals that are purposely corrupt are considered idiosyncratic, yet bred by the legacy of the Soviet era, which was viewed as equally corrupt as Azerbaijan is today.

It is frustrating to observe that payoffs typically are not particularly excessive – in other words, the actual total cost of a routine registration, license, etc. is probably reasonable. That is, the base official fees for services are far below their true cost, and the payoff essentially brings them up to a fair value for money. If the system were organized so that the total fee went to the service-providing agency, then it could in turn raise its pay rates to normal levels, and the incentive for corruption would be reduced.

2. Burdensome and Incoherent Taxes and Arbitrary Collection Procedures

Individual and business taxes are high and unsustainable in the long run. This has been one of the themes behind corruption, and has fostered cynicism and circumvention of the system, as alluded to frequently above. **A** strong need exists for substantially lower taxes that are fairly collected and enforced, which would reduce the informal sector and probably increase the government's net revenue. Whether analysis would prove this viable is beside the point, however, as the existing system penalizes legitimate businesses.

This becomes a serious constraint on formal assistance programs that must work with registered enterprises and private sector entrepreneurs who are openly accountable. Therefore, good prospects for assistance may prefer not to work with international donors or to participate in business development initiatives if they become transparent to tax authorities. This may also be a deterrent to successful capital market initiatives and to business credit activities that would require financial accountability. However, this is a constraint not a roadblock as many new businesses are registering and attempting to work within the system as demonstrated by the official statistics on private enterprise and SME trends described earlier.

Basic tax rates on income and business profits are not out of line with many European nations or the United States. Certainly reforms are needed in terms of contributions to the Social Fund and a variety of other funds that complicate tax administration while adding to the total tax burden, but fundamental income levies are not exceptional. The crucial problem rests on methods of tax collection and control over a series of 20 or more different types of taxes.

In addition, the government's approach to enforcement is misdirected by imposing heavy and capricious penalties on taxpayers. Specifically, a business can be penalized up to 100 percent of any understated income claimed as taxable, and a business enterprise accountant responsible for filing tax statements can be personally fined under a criminal liability for up to 30 times the person's base monthly salary. These two penalties can be imposed without due process, but simply at will by the tax inspectorate. Consequently, the penalty system does not discourage improper accounting. To the contrary, it encourages greater tax evasion through hidden books, and it provides more opportunities for extortion by tax collectors.

The problem of capriciousness and payoff demands in the tax process seemed greater to those we interviewed than the level of taxes itself. Consequently, many business managers felt that a donor-backed loan, beyond the finance itself, would have the substantial additional benefit of providing a prophylactic effect against arbitrary intrusion by financial police. Once a donor is involved who is closely tracking a borrower's cash flow, cash allocations, and performance against plan, the borrowing business has a shield against improper payments. Most businesses felt that they would come out ahead: that this protection from improper payments would offset the potential increase in legitimate tax liabilities that would come from the transparency in financial statements required by donor loan programs.

3. Insufficient Business Finance

The supply of loanable funds to business is entirely inadequate, as evidenced by the exorbitant cost of bank credit. Banks supply only some 10% of the business sector's financing needs, and securities markets that could separately intermediate domestic savings do not exist. The limited amount of household sector savings that does fails to find its way into the banking system for intermediation. These funds, which probably amount to several hundred million dollars, will never be deposited without a smalldeposit insurance system, as is taken for granted in western countries. Because banks are essentially lending equity-like finance, rather than deposits, lending rates must be very high and amounts available to lend are very **low.** Private sector expansion simply cannot proceed without significantly greater business finance. Existing donor programs are of course helpful but concentrate on very small *or* very large loans, with little in between, where so much of the real business potential lies. Alternative means for addressing business finance limitations, especially through leasing, are rare and could be encouraged as a means of leveraging business finance and managing its risk.

Assistance in business finance cannot occur in isolation. Although a new collateral law has been enacted, it must be implemented. Business assets in practice still cannot be easily hypothecated **for** credits, land registration has not been sufficiently reliable to leverage real property for expansion *or* working capital, and judicial foreclosure procedures are extremely difficult.

4. Weak Management Capabilities

Essential general management skills, especially in strategic planning, customer focus and marketing, financial management, and total quality management are simply not known in many companies. Such skills can be learned through professional training of present managers and direct company intervention, but no such training *or* intervention exists at present. Such intervention can be highly effective if it is an integral part of a business finance program. We observed no effective local management consulting businesses.

This problem is aggravated by the prevailing psyche "entitlement" inherited from a command economy, coupled with hierarchical authority based on affiliations rather than leadership capabilities or merit. This theme has surfaced several times in relation both to public governance and to how business is conducted in banks, services, and trade. It is a pervasive limitation to building a competitive economy with vibrant private enterprises.

There is a general lack of management education, business school courses, human resource training, and leadership programs at all levels. This is not something that can be changed quickly by simply "importing" expertise, but it does represent an opportunity to intervene through educational systems that can provide a different framework for management development in the younger generation. The older adult generation currently in control of organizations and government is unlikely *to* accept more than marginal changes in behavior *or* business ethics required for earnest organizational development and industry restructuring. Many of these managers will have to be replaced in order for their businesses to re-emerge.

5. Weak Purchasing Power

As long as wages remain low, taxes burdensome, and a large part ***of*** the population near poverty, effective demand (ability to meet living requirements and have excess for discretionary spending) **will** act as a brake on economic growth. The crucial requirement for any sector expansion is spending power with ample savings for consumer-related investment options, such as new housing or equity positions. This constraint needs no further explanation as it is the prevailing dilemma in every developing country.

Specifically, the question is how to jump-start demand with stagnant or low incomes, when to shift programs from income support (helping to "pull" demand up), and how to manage the risk of assisting capable businesses. When this is successful, private enterprises provide jobs and there is a general income expansion, but when those prospects are limited by purchasing power, there is a sense of stalemate.

6. Delayed Privatization of Major Enterprises

Privatization is not just prolonged, but stuck. The two preceding constraints – shortage of business finance and insufficient management skill – are naturally addressed to some extent by privatization. Private businesses attract foreign strategic and financial partners, who bring with them the much needed investment that is cannot be provided by low domestic savings, and the immediate application of talented management in acquired enterprises.

The continuing burden of supporting ineffective state enterprises, and providing a safety net for enterprise managers and remaining employees is a huge drain on government resources as well as a serious constraint on private enterprise development. This occurs for several reasons. First, the financial requirements alone distort public expenditures that could be productively used elsewhere. Second, there are many "component operations" of the manufacturing and collective farm industry that can still be revived, or entire plants that can be restructured as competitive enterprises. And third, there are vast resources idled that could be put to alternative use in production, agribusiness, or public service – such as being renovated for educational facilities. Privatization would create dislocations and unemployment, but restructuring programs in other transition economies have shown that safety nets can be provided economically, funds from privatization can be used to offset many of the costs, and substitution does occur to absorb many of the unemployed who have marketable skills. The longer privatization remains mired in rhetoric and selfishness, however, the higher those dislocation costs will be as skills deteriorate and assets depreciate.

7. Underdeveloped Infrastructure

There are obvious major limitations to power, water, waste disposal, ports, air transport, cargo, and ground transportation. These require "big bang" programs and long term efforts. However, many of these problems are being addressed. It will take a long time to reach the rural areas and to have effects on private enterprise development. The SME sector, and all trade, service, and agribusiness enterprises crucially need domestic and export transport, improved local and intercity roads, an affordable system of commercial vehicles, intermediate systems for food processing and distribution granaries, and an efficient value chain that runs from raw materials or produce to end markets.

One viewpoint is that the lack of this commercial and physical infrastructure is a pervasive constraint on enterprise development, which is certainly true, but these shortcomings in the value chain also provide many opportunities for new industries and enterprise growth. That part of the physical infrastructure requiring huge capital investments can only be addressed by government and international organizations, but the systems of support services, subcontractors, distributors, and intermediate processors are distinct opportunities for private businesses.

8. Inappropriate Technology and Intellectual Property

The country severely lacks appropriate technology and a knowledge base for sustained growth in most productive industries. At the same time, there is tremendous physical technology sitting idle in oil field machinery, electronics, plastics, quarrying, and defunct state-owned factories. Ironically, many aspiring entrepreneurs and smaller business owners require productive capacity while the SOE facilities, sometimes with excellent machinery, are idle. Consequently, there is ample opportunity for innovative reallocations of SOE assets, perhaps through co-manufacturing or leasing agreements that could recapture idled assets while offsetting capital expansion requirements of new enterprises. Technology transfer programs, such as a

USAID project in Poland, currently seek ways to utilize available assets in productive enterprises. and once there is a paradigm shift in how one thinks about underwriting assets, the entire concept of capital requirements changes.

Nevertheless, there is a great need for new process techniques, improved quality performance, and significant innovations. There is little evidence of design technology in Azerbaijan, and there seem to be more constraints than incentives for creative product development. Patents are taxed heavily (and once again, capriciously determined as levies against patent or copyright registrations are judgmental assessments by tax authorities). Profits from patents or intellectual property rights are taxed above the normal business assessment, which inhibits innovations while providing little legal protection for those **who** register patents, copyrights, or trademarks. This is all part of a larger issue of ineffective reforms, but a particular limitation on technological developments. The printing industry, for example, remains under state control so that private publishing is severely constrained, and subsequently, textbooks, manuals, cultural materials, and entertainment media other than licensed newspapers and popular music videos or CDs, is subject to cumbersome bureaucratic regulations and registrations.

9. Weakened Systems of Training & Education

The adult generation is literate and educated, but with little access to or knowledge of **business** or technology as described above. The public education system is in trouble with deteriorating facilities, depleted budgets, underpaid teachers, and overburdened schools in both urban and rural *areas.* The govemment mandated in 1997 that students purchase their own textbooks, which are determined by the Ministry of Education and provided through official state publishers. Most textbooks in state systems and often the only texts available to private universities, are remnants of Soviet materials with minor editing and few revisions. Research materials are largely in the Russian language and sourced from Russian libraries or journals. The exception is select courses and materials presented through private extension programs at Western University and donor-supported institutes. **As** described earlier, most students do not have text materials or access to modem education techniques.

Vocational and technical education occurs in a system of state programs for reeducation, but enrollments and funding support have declined significantly. Donor-related activities provide some voc/tech opportunities, but these are associated largely with minimal skills in agriculture and crafts. Consequently. there is a generation of underskilled young workers entering the labor market, and older workers are not skilled in trades required in high-growth sectors such as construction and agribusiness. Nevertheless, private training schools have expanded into an "economic subsector" that is **in** itself a **high-growth** area for business development, and these organizations provide courses on computer programming, data systems, and communications vital to an expanding IT service industry. Lack **of** skilled individuals will remain a constraint and a challenge for business development.

10. Inadequate Legal-Regulatory Environment

Capacity building is sadly lacking, but understandable in the face of conuption and an aging generation that neither understands nor wants to adopt a free market economy. Civil and commercial codes are critically needed, but laws by themselves will not change behavior. Any immediate efforts to make significant impact on enterprise development will be thwarted by an entrenched bureaucracy and ineffective enforcement of the best-intentioned reforms. With that said, an enabling environment must evolve to ensure sustained business development and to attract foreign investment. Even if efforts are frustrating, international donors have tremendous leverage to press for reforms.

In the near term, business development assistance must work within a constrained system further disabled by an entrenched bureaucracy. The biggest legal-regulatory problem in business finance, the ability to perfect security, can be addressed by direct means – court-approved letter agreements – on a case-by-case basis. With respect to financial and accounting transparency, these would be addressed within the scope of the program, as we have noted above.

11. Preoccupation with Micro-credit

Several donors and implementing NGO institutions recognize that micro-credit programs are have more in common with subsistence income generation programs than with business development. It is difficult to coordinate these efforts with technical assistance and meaningful long-term intervention. Still, there is a continuing preoccupation with small loans that do little more than repeat a pattern of survival consumption by recipients. As discussed elsewhere in this report, micro-credits have had no marked effect on enterprise development. There surely are exceptions to this conclusion, but they are not frequent, and if examples would surface, they would be associated with more than the disbursement of credit, such as entrepreneurial zeal, unusual self-determination, or good luck. More likely, the micro-loans perpetuate expectations for assistance that border on grants, and in fact, may hamper self-determined efforts to seek alternative methods of work or enterprise. From a humanitarian viewpoint, there is no argument that micro-loans may provide the last resort for many individuals who would otherwise be unable to meet basic human needs. And from an institutional viewpoint, "credit" programs that purport to develop small business may be more appealing in fundraising efforts than "giveaway" programs, even though the need and effect is pretty much the same. Strictly from a business development viewpoint, these programs are costly, labor-intensive, and largely ineffective. They do not provide a capital base for sourcing assets, are too small to be considered working capital, and cannot underwrite employment.

VII. PROGRAMATIC RECOMMENDATIONS

A. CONCEPTUAL FRAMEWORK FOR ASSISTANCE

a) *Overall Status of Present Donor Programs*

The international donor community has funded a broad range of programs, and among the agency projects, there is a very wide scope of activities, Unfortunately, these are not coordinated, and there is no cohesive approach to assistance in Azerbaijan. This does not mean that existing assistance activity is not worthwhile, nor is it a criticism of those involved who are capable and committed. Furthermore, there are a few well-designed and substantive programs that though limited in resources to a greater or lesser degree, do directly promote to private sector business development. The balance of the assistance activities is a fragmented range of thinly-spread "safety net" efforts, that contribute very little to real economic progress.

This general criticism of assistance does not include major structural adjustment projects, infrastructure, and policy reform programs, but there is a certain element of uncoordination in these activities as well. Indeed, there seems to be a presumption that "big bang" international funding can occur in isolation, without intense management intervention. In fact, the two are complementary and suggest a pressing need for comprehensive or at least orchestrated assistance strategies. An effective private sector assistance program that conserves donor resources and achieves sustainable results will rest heavily on the ability of donor organizations to coordinate their efforts, converge on key issues, and allocate major responsibilities.

The major conclusion that emerges from our comprehensive survey of the present donor assistant effort is the following: ***There presently is no program with an effective business development profile in Azerbaijan.*** That is, neither any single program, nor the combination of programs – even if coordinated – adequately addresses the minimum set of interrelated requirements of effective business development. We believe that it is essential that this be rectified if Azerbaijan is to progress, and in Section B of this chapter we provide an outline of these minimum comprehensive needs. In the final section of this chapter and of the report, we provide a variety of design suggestions for addressing the program outline that may be helpful to USAID strategists.

Before turning to these specific recommendations, we would like to review in broad terms the requirements for sustainable development in Azerbaijan, from which our focused "minimum effective" business development program is derived.

b) *Requirements for Sustainable Development*

A sustainable strategy will address broad objectives common among USAID's worldwide development mandate. These include foreign assistance programs that promote: (I) full and unbridled participation by a nation's entire citizenry in political, social, and economic activities with democratic institutional processes; (2) a legal-regulatory environment with "rule of law" that protects human rights and both individual and commercial due process; (3) equal opportunities for the economically and socially disadvantaged populace with respect to education, health, and employment that are required for a dignified standard of living; (4) systems of indigenous associations and business institutions that can sustain support required for private enterprise growth while fulfilling advocacy roles in the economic, political, and social development of the nation; and (5) sustainable private sector growth through the encouragement of entrepreneurship and development of capable management, the expansion and channeling of financial resources to viable businesses through fair and transparent banking and securities markets; and the transfer of appropriate technology and technical operations assistance.

Together with strategic objectives of assistance, these requirements constitute a major commitment of human and financial resources, and even under ideal circumstances, a mission is unlikely to achieve all that is needed. Nevertheless, this is the framework for a viable program in any transition economy, and requirements for sustainable private sector development in Azerbaijan are summarized in the following points:

1. Corruption may not be resolved, but the debilitating systems that foster corruption must be improved through concerted attention by government, and perhaps with more intense pressure from major international donors and political constituencies.
2. The tax system requires reforms in the nature of tax, level of taxation, and "generally accepted accounting practices" that provide consistent and equitable tax treatment under the law.
3. Transparency and access to information must be nurtured, particularly with regard to tax procedures that are incoherent, enterprise registrations, judicial rights, public budget allocations, and legislative initiatives.
4. Intellectual property rights must be firmly established with regulatory enforcement of internationally accepted guidelines for copyrights, trademarks, and patents to encourage invention and innovation.
5. Legal and regulatory reforms are essential, specifically for private sector development, with respect to banking, commerce, civil actions, enterprise registrations, real property titles, and status of associations an non-governmental organizations.
6. Enforcement of equitable and just laws, such as a credible system of tax collection, assessments for public services, fines and penalties, police and public safety, adjudication of commercial conflicts, and fundamental human rights to "due process" are essential to reduce the shadow economy and subsequently nurture trust in the country's legislative and judicial institutions.
7. The deterioration of the nation's education system must be reversed through a sustainable commitment to ensure universal education at primary and secondary levels with quality teaching materials, well-paid educators, adequate facilities, and support programs. These may include school bussing to reach rural populations or urban areas without adequate transport, safe physical facilities, water, and waste management, well-equipped libraries, computer centers, and both cultural and recreational opportunities.
8. Business management and scientific educational opportunities must improve substantially at tertiary institutions and through post-graduate educational programs. It is not enough to introduce isolated BBA or MBA courses, or to make incremental improvements in one or two university curricula. It is necessary to establish a foundation of balanced educational initiatives that offer choices to students, and that integrates the priorities of business, technology, and science with fine arts and liberal studies.
9. Vocational and technical training has begun to evolve toward the private sector through grass-roots demand for marketable skills, for which students and working adults are willing to pay. Meanwhile, public voc/tech and re-education efforts are mired in bureaucracy that to deliver marketable skills or to enhance job mobility required to alleviate employment problems. This entire sector of education requires restructuring and programs based on future demands for a skilled populace.
10. Economic policies, monetary controls, and fiscal accountability must demonstrate credibility and stability to sustain domestic growth as well as to reduce the perceived risk profile of Azerbaijan among potential foreign investors.
11. Capital market development must ensue together with a viable equities market, private control over company registrations, public offerings, auctions of financial instruments, and autonomous regulation of this industry that cannot be convoluted by government interference.

12. Privatization must be strategically restructured and put on a sound footing to move systematically toward pervasive devolution or revival of industry and banking, to include appropriate safety net programs for the eventual dislocations.
13. Post-privatization programs must be established for capital asset funding, reorganization, access to credit for transition operating capital, employment, management development, market development, technology transfer, international quality standards, international accounting standards, and trade.
14. Bank systems and regulations must be substantially reformed for lending, supervision, credit management, transactional accounting systems, security of personal and commercial accounts, and an effective savings system that generates intermediation of the nation's wealth.
15. Consumer credit must have an opportunity to evolve within a private (and internationally accepted) banking system so that purchasing power can grow, transactions can be facilitated (in time, through electronic banking, credit, and debit cards), and both the capital base for banks and liquidity of funds for customers expands appropriately.
16. Institutional development must occur with specific requirements for a deposit guarantee facility that is beyond reproach, and support for bank credit transactions through domestic or donor-assisted credit guarantee facilities.
17. Infrastructure development must occur with a broad-base objective of nationwide systems that support all economic sectors, nor merely oil interests or proprietary trade partners. Specifically, power generation, port facilities, air cargo, regional air and rail transport, road systems, water and waste facilities, and intercity linkage must be established to support domestic commerce as well as international trade and regional transshipment objectives.
18. Effective associations and business support organizations must evolve apart from government, and be sustainable without assistance, to ensure advocacy for human rights and public accountability, to provide a conduit for commercial information, linkage to global markets, technologies, and resources, and to support private enterprise through training and development initiatives.
19. Institutionalized programs for the economically, physically, and socially disadvantaged must be established to address income and life-style disparities, not through welfare or humanitarian efforts that can often disenfranchise recipients, but through initiatives that provide the means of productive enterprise, marketable skills, and opportunities for self-advancement.
20. **A** national psyche of self-determination must replace an ingrained legacy of entitlements. This will be the consolidation of long-term efforts to create a national mentality of free enterprise and a paradigm shift toward a multifaceted economy where government is socially responsive to personal and commercial interests. Because this psyche is unlikely to change with the embedded values of the adult population currently in executive positions of government and commerce, programs that focus on youth, young adults, and entrepreneurially minded individuals will achieve the greatest results in cultural convergence toward these objectives.

B. RECOMENDATION FOR A BUSINESS DEVELOPMENT PROGRAM

The preceding "top twenty" list of development priorities cannot possibly be fully addressed by any one donor. Comprehensive coverage would require the entire donor community to act in unison, along with a radically reform-oriented Government of Azerbaijan. This is not realistic. It is very difficult **for** donors to act in unison, and in many instances the government is the problem, or simply fails to recognize the priorities of reform. Nevertheless, USAID has strategic and operational advantages that have proven to be effective in many testing environments, and it can influence many of these changes and provide a vehicle for sustainable private sector development. In the following recommended program, we outline those areas that we think must be addressed for a business development program to be effective in Azerbaijan.

The following table provides a summary of our assessment of the business development program need.

Table 25: **PROFILE OF BUSINESS DEVELOPMENT PROGRAM NEEDS**

Functional Assistance Area	Elements
I. Business Finance	• Credits to medium-sized businesses in amounts of $50,000 - $500,000, total lending $25 million per year.
	• Technical assistance to banks for improved credit process administration and know-how.
	• Venture capital equity finance.
	• Support for leasing companies as efficient complement to lending program.
	• Support for securities markets development.
	• Deposit insurance, for the mobilization of household savings.
II. General Business Management Performance Improvement	• Direct in-company intervention for business strategy and planning, marketing management, financial management.
	• Due diligence for business finance loan underwriting, and monitoring / performance improvement to ensure loan repayment.
	• Group professional training in management performance improvement.
III. Operations and Technical Management Assistance	• Direct in-company application of specific industry expertise for equipment purchase, technology transfer, and work process / productivity improvement.
	• Group training in operations management.
IV. Business Environment	• Privatization technical assistance
	• Tax reform
	• Business associations development
	• Legal and regulatory reform
	• Accounting reform
	• Assistance in establishing external business marketing and finance connections

The primary focus of the Azerbaijan business development program need, we believe, is on the " M in SME. We are not suggesting that support of smaller businesses is entirely adequate, but there are a number of existing programs in this area with a record of activity, and some programs which started out as true micro-lending are moving up to small-scale enterprise lending. Medium-sized businesses, which in the Azeri context means annual revenues of at least $250,000 and as much as $10 million and employment of 15 to 300, have received much less assistance attention, yet they are the most dependent upon outside financing for revitalization or expansion, the most in need of management performance improvement, and they are essential for sizeable job growth. Outside of the limited EBRD program at the IBA, there is no credit support facility targeted on this key segment, and the only technical assistance program for management performance improvement is the Citizens Democracy Corps (CDC) program currently starting up.

We do not suggest that all of these areas must be covered by a USAID program, because some are being met in some degree by other donor programs, and others may be difficult to address anyway for as long as the 907 restrictions are in place. Presently, there is at least a some of donor support in bank training, venture capital, leasing, securities markets development, group management training, privatization technical assistance, business associations development, and tax, legal / regulatory, and accounting reform. Of these, we would focus on four – direct in-bank training, privatization technical assistance, securities markets development, and tax reform – as priorities for USAID support, where possible. Furthermore, in hvo critical areas – business finance and management performance improvement – the existing level **of** assistance is completely inadequate, and USAID assistance is essential. Deposit insurance is needed, but this is for a future phase when the banks are stronger.

There are many design options that could be used in a program to address the above needs. In the following final section we provide a variety of design suggestions. These are not comprehensive. bur are meant to provide some ideas that could be helpful to USAID's strategy designers.

C. SUGGESTIONS FOR PROGRAM DESIGN ELEMENTS

USAID as been particularly effective with private sector development through a broad range of financial and consulting intervention at the "retail" level for assisting individual businesses. These programs have employed both paid resident teams with a high national:expat professional ratio, and industry experts from private volunteer organizations (PVO's). The target of these operations has been small and medium-sized firms, but too often this costly assistance has been focused on micro- and small businesses, rather than medium-sized and larger enterprises. We envision a program in which insompany intervention is focused on medium-sized enterprises, where financial underwriting and consulting are combined in the same operation, and the targeted number of new company entrants into the program is 25-50 per year.

1. Business Finance **and** Techical Assistance **for** Business Management

Although micro-credits may be appropriate for minimal support of individual initiatives and legitimate "micro-enterprises," they would not fit into a business development project. Consequently, a formal credit program is envisioned whereby funds could be directly provided through loans of sufficient size and with logical repayment terms that provide a platform for growth of small and medium-sized enterprises. Ideally, these would be between $50,000 to $500,000, thereby targeting high-potential enterprises requiring significant capital underwriting for sustained growth. This component would constitute a business finance activity that would provide as many credits as possible, but not at the expense of spreading coverage thinly or under-financing recipient projects. The point is to provide financial support that is sufficient for a critical mass required for enterprise growth.

Targeted companies would of course be in those areas identified above as high-potential business opportunities.

The resident contractor would form a Business Development Program (BDP) team, staffed by capable expat and local professionals. Direct business finance and in-company management consulting would focus on medium-sized operations. For "wholesale" assistance, restricted to management performance improvement, effective training and information programs leveraging indigenous associations and business support organizations is recommended. The proposed component of business development for Azerbaijan could comprise the following activities:

Pre-intervention Evaluation. The BDP team would make preliminary evaluations of the candidate companies' business strategies, growth opportunities and needs. This assessment would be the basis for financial support under a credit or grant component, and resident team and volunteer assistance in management performance improvement. It could also result in a referral to a BSO affiliated with the development project.

Business Finance. A fallacy of some business finance programs is that they make loans and walk away. We recommend a program where finance and consulting are fully integrated.

We envision a program that uses agent banks as loan originators and who carry a portion of the credit risk. A funding concept that could work effectively, and have a number of ancillary benefits, is a "loan-backed CD". The agent banks would originate and recommend loans to the BDP. The BDP team would perform due diligence on the recommended borrower and, if it approves the underwriting of the loan, purchase a special CD in the principal amount of the loan, which is secured by the loan and whose repayment terms are directly aligned with those of the loan. The interest rate on the CD would be several percentage points below the loan rate. Borrower repayments of interest and principal on the loan would first go toward servicing the counterpart CD. In the event of default, after pass-through by the bank of amounts recovered through liquidation of collateral, the BDP would write off 80-90% of the balance due on the CD.

This method should allow the BDP to avoid the need to register as a bank. It provides the BDP with the necessary control over exposure, because funding is on a case-by-case basis after BDP underwriting due diligence. It also helps train banks in funding operations and of course credit process management. Finally, in an SBA-like manner, it has the benefit in terms of credit carefulness of giving the banks some credit risk, while avoiding losses so serious that thin bank capital margins would be threatened.

General Management Performance Improvement. The resident Business Development Program team would be responsible for providing extensive in-company management performance improvement programs to all borrowers. Its attitude would be similar to that of an active closely-held investment portfolio management company. It would remain in a close monitoring role with borrowers throughout the life of their loans. Its primary responsibilities would be the full range of business restructuring and performance improvement work, in strategy, marketing and sales management, financial management and managerial accounting, and total quality management. It would also be responsible for identifying needs best addressed by PVO industry experts, and developing scopes of work and referrals for these organizations.

Volunteer Assistance to Enterprises. A portion of the development budget would be directed toward short-term volunteer assistance (several weeks to several months) for direct "retail" advice to a candidate enterprise, especially where specific industry technical expertise is needed. This would require participation by the enterprise to partially underwrite the costs of assistance, thus generating a vested interest in the volunteer's work, and accountability for results. Each intervention would conform to a work plan and address specific contractual needs negotiated by USAID's contractor and the recipient.

Volunteer Assistance to Associations & BSOs. A significant component activity would require volunteer assistance as the mainstay of association development, or ''wholesale'' intervention, that builds capacity for future enterprise assistance by indigenous organizations. These would include local or regional chambers of commerce, commercial (or non-governmental, nonprofit) business support organizations, trade groups, professional or industry associations, market or economic research enterprises, or academic-based educational affiliates. Eventually, the sustainability of these groups and organizations would determine the successful graduation of USAID from Azerbaijan, but during the project's life, they would also become active referrals for services by "retail" candidates. They would also become the conduits for training, conferences, and, when possible, technical assistance in support of the volunteers. Consequently, the interaction of resident project staff, contract volunteers, and the indigenous personnel would not only assist individual enterprises, but systematically develop the capabilities of the associations and BSOs.

2. Other Financial Support

Cooperative Loans or Referrals. In the spirit of multi-donor cooperation, a component activity of business finance should generate a portfolio of alternative credit courses. Therefore, when candidate clients apply for assistance or direct loans, they should be assessed for their credit-worthiness and for successfully securing commercial credit. This could involve any one of many other donors with credit lines for specific purposes (such as farm credit) to which the client would be referred, or through a combination of USAID direct loans and commercial credit, provide a package of funding. The effect would be to increase agency leverage of existing funds, but also to reinforce applications and required due diligence for cooperative donors or commercial lenders.

Credits in Support of BSOs. Credits are not usually provided to associations and NGOs as they lack income-generating capacity to repay loans. However, a business development project based solely on grants and "no-cost-no-accountability" assistance violates the spirit of association building whereby USAID would want to generate autonomous self-sustaining organizations. An alternative approach is to allocate a portion of funding to finance NGOs and BSOs with a mandate to generate income. Indeed. it may occur that USAID ends up paying them for services, thus "repaying" one's own loans, but that would provide nvo important benefits. First, the NGO/BSO affiliates would have initial working capital or capital assets, creating full accountability for performance. Second, the affiliates would be motivated to bid for, and work diligently at, agency projects to protect the credits and earnings. Grants provide neither of these dimensions. Eventually, USAID would not face "weaning away" its BSO networks because, by definition, they will have faced the responsibilities of business from the outset.

3. Grants and Management Development

Grant programs for business development would be directed toward association-building activities where organizations do not have repayment capabilities, toward business or market research that would serve a broad range of clientele, and toward education and training associated with capacity building and enterprise development. In addition, grants would be employed to address the special needs of women, youth programs, and special disadvantaged groups as determined by the mission. Grants would not replace loans when clients are credit worthy, but they would be considered as leveraging tools that benefit special interest groups or a wide base of client interests. Recommended activities include:

Grants to Associations. Monetary grants, similar to those structured under the Eurasia Foundation, are ideal for community-based associations, think tanks, support for local chambers of commerce, professional organizations, or industry advocacy groups. These would be noncompetitive grants based on project assessments for association initiatives, and they would always be coupled with project consulting, either through volunteer assistance, project staff assistance, or cooperative support with other associations or BSOs affiliated with the agency project.

Grants to Disadvantaeed Persons and Women. Grant activity would be distinguished as business development, not humanitarian assistance, and therefore be directed toward target groups (candidate associations in rural areas, for example), physically handicapped persons capable of pursuing a self-sustaining enterprise, and women who have the potential for managing an enterprise, pursuing women-oriented associations, or benefiting from training assistance that would prepare them for ownership roles.

Competitive Grants for Research. Monetary grants for business, management, or marketing research, industry studies, economic studies, and other projects would be awarded on a competitive application by candidates from BSOs, think tanks, private businesses, or qualified academic institutes. These would provide assistance to the recipients, but more important, provide a growing base of information resources for business development. These can be leveraged among associations or for public use: provide industry information for market access, or underscore educational materials used in project training, volunteer assistance, and colleagues in other donor agencies.

Grants for Education and Training. A significant aspect of the grant program would be to support seminars, workshops, and formal educational exchange programs that address two mandates. First, education for management development, particularly for owners and managers of SMEs, women, and disadvantaged persons. This would be ideally delivered through BSOs and association members, but also by volunteers who may present programs in adjunct to their primary assignments, or they may develop in-house programs of management development and training for client firms. Second, the grants would bring to Azerbaijan selected educators capable of supplementing existing programs, or alternatively, underwrite select Azeri grantees to work in residence in the United States with cooperative corporations or associations under a twinning or mentoring program. Indeed, USAID may be able to find matching grants from US industry or associations that would further expend these capabilities.

Grants for Trade Fairs, Marketing, and Linkage. Grants can be effectively used to sponsor local trade fairs, delegations to foreign trade fairs, development of marketing programs, and linkage with foreign associations or potential foreign investors. Ideally, the project would have the ability to network with American companies or access trade data bases (either privately developed or sponsored by USAID's Washington-based Trade & Investment Network). *An* innovative contractor would also be able to structure grants in such a way to connect with individual U.S. state-sponsored business development initiatives were there are aggressive programs for business exchange and technology transfer.

2. Support for Capital Markets and Venture Capital

There are no capital markets in Azerbaijan, at least none in the official sense of an operating securities exchange, equity instruments, or enabling legislation that would permit "corporate" investments common in developed countries. However, the State Securities Committee (de facto SEC), has the capabilities to facilitate a private stock exchange, and to provide a system for equity registrations, listings, IPOs, bond markets, and various forms of financial instrumentation. Section 907 of the Foreign Assistance Act prevents USAID from becoming involved with the SSC, but that does not preclude assistance to a private judicially constituted stock exchange. The framework for this may exist in a registered private holding company, the Baku Stock Exchange. The BSE is not operational, has no assets, and is "owned" entirely by several private companies. Consequently, there is an opportunity for USAID to support a capital markets initiative' if it can remain insulated from SSC involvement. Ideally, 907 restrictions would be removed, and USAID could proactively pursue a project with the SSC, which appears to have the capability and the predisposition to establish both an exchange and an autonomous regulatory agency.

We have noted the beginning of venture capital activity outside the oil sector, but this is hardly enough for needed seed capital, much less mezzanine capital required for public listings or IPOs. This gap in resources presents an opportunity for assistance. In this instance, an enterprise equity fund along lines familiar to AID could be useful here.

4. Technology Transfer Centers

A business development program can at least in part take the form of a Technology Transfer Center. USAID has such a program in Poland. Specifically, a donor-assisted TTC would take the model of US-based Manufacturing Technology Centers (MTCs) created in 53 locations and nine states under a Department of Commerce program several years ago. These centers provide a comprehensive approach to introducing physical technology and intellectual capacity to client organizations through a consortium of education, industry, and donor projects. A typical project would have a business center (perhaps a business incubator), linkage to a host university which provides business and science faculty, and access to research laboratories, and a host industry (or industry association) that provides access to limited production facilities. An individual with an idea can then design, test, and build a prototype, engage in limited production, and benefit from expert advice from both academics and industry specialists. Every good idea (product, service, innovation, process, etc.), therefore has a network behind it to help develop business and marketing plans, provide access to capital, and a channel for production or marketing.

It is beyond the scope of this report to attempt a "design initiative," but the concept of TTCs is a viable alternative, and it could be an added component for business development. In any event, technology transfer in some form is important to Azerbaijan, and USAID could investigate comparable projects in its other missions.

5. Alternatives to Cash – Innovative Approaches to Capital

Credit and equity investments are required for hvo fundamental purposes uses: operating capital and underwriting assets. We offer two viewpoints on these issues where alternative financing can occur, or enterprises can learn new skills to avoid the formalities of bank loans or equity investments. There is one rule that underscores this presentation: ***Gaining access to productive assets is the requirement for success, not owning them.***

Operating Capital. There is no easy way to secure operating capital other than through cash infusions, and in the absence of adequate business finance, these are generally obtained **from** personal savings, selling personal assets, leveraging everything that can be used for collateral, or finding "angels" among family and friends. Of course, there are black market options and other risky ways to acquire money, but some legitimate choices exist for an on-going business. Entrepreneurs tend to sniff out these options.

For example, inventory and accounts receivables can be factored, but no factoring options currently exist in Azerbaijan. Perhaps that is another opportunity for intervention. Suppliers who want to establish new markets will provide trade credit. This is typically a form of extended payment plans, or terms for payables that allow several months before collection. **An** experienced businessperson will learn how to negotiate favorable terms, and often get 3-to-6 months leeway before paying the trade credit. In a cash-and-carry environment such as Azerbaijan, this is not an option, yet there is no reason why purchasing companies cannot pursue this option. The result (even if only short-term relief) is an addition to working capital by reducing cash that might be required for inventory, tools, or services. Perhaps this too is an opportunity for educating local business leaders in negotiation and purchasing skills. A twist on this theme is securing inventory for performance (a form of countertrade), that **works** well when a company is engaged in some form of product conversion or has exportable products.

Leasing. Although leasing is not considered a source of finance, it reduces requirements **for** operating capital ***or*** investments in assets. Many companies are stuck in a "buy and hold" mode of thinking, and they find themselves caught in cycles of **purchasingdepreciating-rebuying** assets that may not be fully utilized yet depreciate rapidly. So-called "minimalists" seek to avoid this trap by identifying **all** possible assets (and in particular, depreciating assets such as cars, vans, computers, furniture, etc.) then leasing or renting them. Monthly cash **flow** out may be higher than purchasing, but not necessarily if the cost of capital is high, and there is a minimum front-end investment. More important, the businessperson has access **to** required assets without overspending. Leasing can extend to virtually any asset, and there are lessons to be learned from experiences of developing economies that passed leasing legislation and encouraged leasing through tax incentives. Singapore built its entire airline industry on leases of aircraft from airlines with excess capacity during its early transition era when the country had no investment credit rating nor purchasing power. The principal is the same for a comer store as for a major corporation – find out how to control assets without investment. This provides huge opportunities for innovative assistance to locate assets for client companies, but also to help establish a viable leasing industry in Azerbaijan.

Obtainine Capital Assets. Leasing is a form of capital asset management, but gaining access to productive assets suggests a much more complicated scenario, and competent consultants will be able to draw on experiences of successful entrepreneurs to find alternatives to capital financing. We mention several for their potential in Azerbaijan.

Countertrade is an option in any situation where there are disparities between imports and exports, creating opportunities for exchanges of one resource for another. An example is where a fabric producer in one Asian country required thread produced in another country. The thread supply provided the thread in example for the economic equivalent in finished women's garments, which were in turn sold at a profit. The thread supplier profited twice, once from providing thread for goods at a profitable margin, and Once for selling a value-added garment. Meanwhile, the fabric company avoided a cash outlay for thread, and also profited from the implicit mark-up on the value of goods traded.

A second option is to finance equipment or other assets through one's products. A case in point is when a manufacturer in Poland could not afford to purchase extruding machines for making plastic surgical tubing. His customer in Germany agreed to invest in equipment and place that equipment in the Polish factory in exchange for allocations of products each month. The product value was offset against the cost of the machinery so that in three years, the Polish entrepreneur owned the equipment, yet he benefited from paying in performance, not a cash purchase.

A third option is to engage in co-manufacturing or subcontracting. This may be particularly interesting in Azerbaijan where massive state enterprises stand idle, often with good equipment and capable workers. In almost every country, there are entrepreneurs and smaller businesses that cannot grow without capital equipment or the means of production. Meanwhile, that equipment often exists in plants that are underutilized or waiting privatization. By contracting the idle equipment, often at very low costs, the entrepreneurial venture achieves production objectives and the idled capacity is put to a profitable use. Similar options occur in nearly any business. For example, virtually all Japanese retail department stores now sublease or provide boutique contracts to brand-name and specialty retailers who may rent no more than a small counter space for an item such as perfume. The retailer achieves maximum space utilization without variable costs of employment or inventory, yet shares in sales under participative contracts. The boutique avoids the overhead costs of facilities and fixtures, yet gains the needed retail exposure, often in a very high-quality and high-traffic environment.

The critical success factor in these examples – and in many like them – is business acumen required to think creatively about managing assets effectively and being able to generate "win-win" situations for all parties. It is an area of assistance virtually ignored, and requires very little investment to deliver. Essentially, a donor must find those few creative consultants capable of organizing a project that trains recipients in creative thinking, negotiating, contracting, and asset management. Then the project must have the marketing acumen to identify opportunities and bring the parties together, help them cost out their interests, place value on one another's deliverables, and do the deal.

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STATISTICAL APPENDIX

TABLE A1 -- EMPLOYMENT AND HUMAN CAPITAL IN AZERBAIJAN	1995	1996	1997	1998	1999 est
Total Resident Labor Force (thousands)	4,036	4,060	4,101	4,135	4,172
Less those in full-time education (thousands)	232	216	215	215	213
Effective Resident Labor Force (thousands)	3,804	3,844	3,887	3,920	3,959
Percent of Total Population (%)	53.1%	53.4%	54.0%	54.4%	54.9%
Total Registered Employment (thousands)	2,837	2,895	2,902	2,914	2,940
Registered Unemployment (thousands)"	28	32	38	42	43
Percent Registered Unemployed (%)	1.0%	1.1%	1.3%	1.4%	1.5%
Official Active Population (thousands)	2,866	2,927	2,941	2,956	2,983
Total Active Adults Unemployed (thousands)	967	948	984	1,006	1,008
Percent of Active Adults Unemployed (%)	33.7%	32.4%	33.5%	34.0%	33.8%
Total Informal Employment (thousand)[b]	444	417	441	454	(no est)
Percent Employed Informally (%)	15.5%	14.2%	15.0%	15.4%	(no est)
Distribution of Official Employment:					
Public Sector (% of active labor market)	57.2	51.5	46.4	42.1	41.0
Women in Public Sector (% of sector)"	45.2	46.4	46.9	48.6	49.1
Cooperatives (% of active labor market)	12.0	13.2	8.5	10.6	9.5
Private Sector (% of active labor market)	18.5	21.0	***26.6***	29.4	31.8
Unemployed Registered (% of active labor)	12.2	14.3	18.5	17.8	17.7
Employment by Major Sector:					
Agriculture (ex. Food Proc, % of total)[d]	30.8	31.8	29.0	28.7	29.0
Industry (in. Food Proc, % of total)	12.4	9.8	8.3	8.2	8.0
Construction & Transport (% of total)	6.5	5.7	5.3	5.3	6.0
Trade & Services (non-gov., % of total)	18.5	21.6	25.7	27.3	28.0
Other (in. public services, % of total)	31.8	31.1	31.7	30.4	29.0

Sources: European Commission, TACIS & Minstry of Economy, ***Azerbaijan Economic Trends,*** Quarterly Issue, January-March, 1999; State Committee of Statistics **of** Azerbaijan Republic, ***Statistical yearbook 1999*** .
Notes; [a] -- Official data on employment and unemployment tracks adult population aged 16 to 60 who have registered for employment or for benefits; [b] -- Informal employment and unemployment has been estimated by EC-Tacis; [c] -- Female employment is not tracked except in public sector govement services; [d] -- the agriculture sector excludes food processing and distribution, which are captured in industry sector data.

TABLE A2 -- DECO ... r & OFFICIAL VACANCIES	1991	(%)	1995	(%)	1996	(%)	1997	(%)	1998	(%)
lumber of **Unemployed** Seeking Jobs:	**11,321**		**66,867**		**77,904**		**79,844**		**81,016**	
Males registered for work	3,969	35.1%	28,314	42.35	31,935	41.0%	32,1 17	40.2%	31,988	39.5%
Females registered for work	7,352	64.9%	38,553	57.75	45,969	59.0%	47,727	59.8%	49,028	60.5%
lumber Receiving Unemployment **Pay:**	**3,969**		**2,981**		**2,266**		**2,745**		**3,714**	
Males qualified for payments	1,452	36.6%	1,162	39.00,	1,171	51.7%	1,488	54.2%	1,887	50.8%
Females qualified for paymeiits	2,517	63.4%	1,819	61.00,	1,095	48.3%	1,257	45.8%	1,827	49.2%
'ercent Registered Unemployed **by** Age:										
Under 18 (but eligible)	7.5%		1.3%		2.3%		2.8%		3.6%	
18 through 29	30.4%		48.6%		41.1%		47.6%		49.3%	
30 through 54	8.0%		2.9%		4.0%		4.2%		4.1%	
55 or older (but eligible)	54.1%		47.2%		52.6%		45.4%		43.0%	
lumber of **Vacancies** by **Sector:**	**18,584**		**10,742**		**9,459**		**10,478**		**11,760**	
Industry (including rood processing)	7,221	38.9%	2,899	27.0%	2,186	23.1%	311	3.0%	122	1.0%
Agriculture (ex. food processing)	710	3.8%	442	4.1%	290	3.1%	187	1.8%	**43**	0.4%
Transport & Communications	915	4.9%	769	7.2%	463	4.9%	599	5.7%	1,067	9.1%
Construction	4,140	22.3%	2,303	21.4%	245	2.6%	812	7.7%	2,106	17.9%
Trade Services (private)	574	3.1%	250	2.3%	102	1.1%	199	1.9%	255	2.2%
Housing and Utilities (public)	1,511	8.1%	917	8.5%	1,100	11.6%	1,099	10.5%	914	7.8%
Healthcare & Social Security (public)	0	0.0%	1,473	13.7%	2,020	21.4%	2,121	20.2%	1,920	16.3%
Educetion, Culture, Scieiicc	0	0.0%	581	5.4%	2,295	24.3%	3,877	37.0%	3,916	33.3%
Other (all resident registrations)	3,513	18.9%	1,108	10.3%	758	8.0%	1,273	12.1%	1,417	12.0%
;hortfall (Vacancies versus Job Seekers)	**7,263**		**-56,125**		**-68,445**		**-69,366**		**-69,256**	
'ercent Placed by **Work Centers:**	**6.1%**		**3.0%**		**5.7%**		**7.9%**		**4.4%**	

'ources : State Statistics Committee of Azerbaijan Re ... olic, ***Statistical Yearbook 1999*** ; Departm

TABLE A3 -- WAGES & SELECTED DIFFERENTIALS IN AZERBAIJAN

	1995 (base)				(est)	Diff'l to Avg
Nominal Monthly Wages (AZM)	**62,467**	**89,370**	**141,643**	**168,419**	**187,060**	
Monthly Wage (in current US$)	14	21	36	44	47	--
Percent Change on Year **(%)**	**n/a**	43.1%	58.5%	18.9%	11.1%	--
Sector Wage Averages:						
Agriculture (ex. Food Processing)	51,244	46,413	44,311	38,009	29,650	-84.1%
% Change	n/a	-9.4%	-4.5%	-14.2%	-22.0%	
Industry (In. Food Processing)	153,187	156,722	162,731	154,202	148,250	-20.7%
% Change	n/a	2.3%	3.8%	-5.2%	-3.9%	
Construction	153,198	179,940	180,847	224,109	257,600	37.7%
% Change	n/a	17.5%	0.5%	23.9%	14.9%	
Trade Services	113,921	132,069	145,101	178,882	201,500	7.7%
% Change	n/a	15.9%	9.9%	23.3%	12.6%	
Government Administration	94,318	86,671	75,617	94,299	100,500	-46.3%
% Change	n/a	-8.1%	-12.8%	24.7%	6.6%	
Healthcare & Social Security	72,119	70,246	72,201	81,004	96,500	-48.4%
% Change	n/a	-2.6%	2.8%	12.2%	19.1%	
Education (teachers, non-admin.)	70,546	68,919	68,114	76,004	78,822	-57.9%
% Change	n/a	-2.3%	-1.2%	11.6%	3.7%	

Sources: European Commission, TACIS Minstry of Economy, ***Azerbaijan Economic Trends,*** Quarterly Issue, January-March 1999; State Statistics Committee, ***Statistical Yearbook*** 1999.

TABLE A4 -- PROFILE OF ENTERPRI

Classification[a]	Total Enterprises 1995	Total Enterprises 1998	Total Enterprises % chg	State-Owned 1995	State-Owned 1998	State-Owned % chg
Total **Juridicial** Enterprises	46,792	53,234	14%	27,945	13,945	-50%
Sector						
Fostcry, Hunting, Fishing	12,871	10,416	-19%	2,774	874	-689
Industry, Energy, Utilities	8,002	4,498	-44%	6,416	1,429	-789
Trade, Hotels, Restaurants	15,906	20,094	26%	11,017	2,500	-779
Construction Trades	3,744	5,180	38%	3,129	2,741	-129
Financial Intermediation	299	742	148%	291	351	219
Transport Services	711	1,045	47%	510	413	-199
Postal & Communications	82	246	200%	75	173	1319
Real Estate & Rental	1,668	1,771	6%	1,388	611	-569
Education, Training	214	583	172%	163	461	1839
Health & Social Scrvices	477	1,242	160%	470	757	619
Otlicr Personal Scrvices	2,818	4,573	62%	1,712	831	-519
Physical Person **Business**	35,919	56,596	58%	**0**	**0**	
Sector						
Rural economy	213	519	144%			
Industry	1,132	1,367	21%			
Construction	877	965	10%			
Trade and service	31,298	46,234	48%			
Transport	2,206	5,505	150%			
Financial Intermediation	5	22	340%			
Audit and Accounting	188	1,984	955%			

Classification[a]	Private-Owned 1995	Private-Owned 1998	Private-Owned % chg	Foreign-Owned 1995	Foreign-Owned 1998	Foreign-Owned % chg	Mixed-Property 1995	Mixed-Property 1998	Mixed-Property % chg
Total **Juridicial** Enterprises	17,982	36,825	105%	410	1,596	289%	457	868	90%
Sector									
Fostcry, Hunting, Fishing	10,078	9,515	-6%	9	11	22%	10	16	60%
Industry, Energy, Utilities	1,374	2,714	98%	16	130	713%	196	255	30%
Trade, Hotels, Restaurants	4,501	16,558	268%	313	648	107%	75	88	17%
Construction Trades	494	2,202	346%	18	149	728%	103	388	277%
Financial Intermediation	4	355	8775%	0	15	n/a	4	21	425%
Transport Services	164	498	204%	9	87	867%	28	47	68%
Postal & Communications	2	43	2050%	3	12	300%	2	18	800%
Real Estate & Rental	252	727	188%	22	407	1750%	6	27	350%
Education, Training	47	103	119%	4	17	325%	0	2	n/a
Health & Social Scrvices	8	432	5300%	0	50	n/a	1	3	200%
Otlicr Personal Scrvices	1,058	3,678	248%	16	31	94%	32	33	3%
Physical Person **Business**	**34,520**	**53,127**	54%	**1,399**	**3,469**	**148%**	**0**	0	
Sector									
Rural economy	213	519	144%	n/a	0	-			
Industry	1,132	1,325	17%	n/a	42	-			
Construction	877	907	3%	n/a	58	-			
Trade and service	30,011	43,373	45%	1,287	2,861	122%			
Transport	2,094	5,139	145%	112	366	227%			
Financial Intermediation	5	13	160%	n/a	9	-			
Audit and Accounting	188	1,851	885%	n/a	133	-			

Notes : [a] -- Definitions used here and categories of business reflect Ministry of Justice syntax: "Juridicial" refers to registered enterprises as "legal entities," and "Physical Person" refers to a personally registered "proprietorship." By definition, there are no "physical" businesses in government or "mixed property." Privatization and new laws on foreign company registration generated several odd percentage changes.

Sources: State Statistics Committee survey for the Ministry of Justice and Ministry of Labor, ***Summaries Industry of Azerbaijan***, 1996 and 1998.

TABLE A5 -- GDP COMPOSITION and TRENDS, STANDARD BREAKDOWN

Origin of GDP by Sector (% of GDP)	1995 Base	1996	% Chg Yr	1997	% Chg Yr	1998	% Chg Yr	1999 (est)	% Chg Yr	% Chg 1995-99
Agriculture (excludes food processing)	**24.8**	**21.4**	-13.7%	**20.0**	-6.5%	**19.2**	-4.0%	**19.0**	-1.0%	**-23.4%**
Crops as percent of agriculture	58.6	58.5	-0.2%	59.0	**0.9%**	59.1	0.2%	59.0	-0.2%	**0.7%**
Livestock as percent of agriculture	41.4	41.5	0.2%	41.0	-1.2%	40.9	-0.2%	41.0	0.2%	**-1.0%**
Industry (including oil & manufacturing)	**19.4**	**20.6**	6.2%	**24.3**	18.0%	**26.1**	7.4%	**25.8**	-1.1%	**33.0%**
Oil and fuel as percent of industry	46.2	52.4	13.4%	53.6	2.3%	50.1	-6.5%	52.0	3.8%	**12.6%**
Manufacturing as percent of industry	19.8	16.6	-16.2%	8.4	-49.4%	9.6	14.3%	9.7	1.0%	**-51.0%**
Food processing as percent of industry	6.6	7.4	12.1%	3.2	-56.8%	4.3	34.4%	5.4	25.6%	**-18.2%**
Construction (including public works)	**10.7**	**13.1**	22.4%	**13.8**	5.3%	**14.0**	1.4%	**14.4**	**2.9%**	**34.6%**
Transport & Communications	**8.7**	**8.8**	1.1%	**11.9**	35.2%	**12.8**	7.6%	**13.0**	1.6%	**49.4%**
Trade Services (nongovernmental)	**4.7**	**4.8**	2.1%	**5.5**	14.6%	**7.7**	40.0%	**8.2**	6.5%	**74.5%**
Others (plus electricity & public services)	**31.7**	**31.3**	-1.3%	**24.5**	-21.7%	**20.2**	-17.6%	**19.6**	-3.0%	**-38.2%**

Sources: European Commission, TACIS & Minstry of Economy, ***Azerbaijan Economic Trends***, Quarterly Issue, January-March 1999; World Bank, ***Report Number 10586-AZ***, August 16, 1999; Economist Intelligence Unit, ***Country Report Azerbaijan 3rd Quarter 1999***, September 1999; and UNDP, ***Azerbaijan Human Development Report 1998***, March 1999.

TABLE A6 - AGRICULTURAL and FOOD PRODUCTS - Commercial Production and Imports

Item	Unit	1990 Commercial Production	1998 Commercial Production	Change '90-'98	Domestic Market	Implied Imports	Reported Imports
Meat & Poultry	tons	86.800	14,300	-84%	85,800	71,500	43,948
Fish	tons	66,800	12.400	-81%	57,200	44,800	
Dairy Prods	ions	208,200	224,600	8%	228,800	4,200	6.399
Vcg Oil Prods	tons	59,800	8,300	-86%	39,600	3 1,300	7,028
Fresh Fruits & Vegs	tons	800,000	600,000	-25%	572.000	-28,000	35,232
Proc Fruits & Vegs	units	709,600,000	85,600,000	-88%	208,000,000	122,400,000	23,370
Salt	tons	99,300	5,500	-94%	26,400	20,900	
Bread & Macaroni	tons	423,100	401,600	-5%	594,000	192,400	71,114
Alcholholic Bvgs	liters	251,000,000	4,900,000	-98%	114,400,000	109,500,000	
Soap	tons	43,000	710	-98%	33,000	32,290	
Cigarettes	cartons	32,500,000	1,000.000	-97%	24,000,000	23,000,000	
Tea	tons	30,700	900	-97%	26,400	25,500	2,409
Tobacco	tons	48,700	4,600	-91%	13,200	8,600	
US$ Millions		**2,960**	**892**		**1,956**	**1,064**	**126**

TABLE A7 - ESTIMATES of HOUSEHOLD CONSUMPTION and MARKET SIZE								
	Assumptions for Household Consmptn				Implied	Implied	Tot Mkt	Annual
Item	Prch Amt	Meas	Price $	Times/ Year	Spending HH/Mo $	Tot Mkt Value $ MM	Volume 000 or Tons	Consmptn / Capita
Tea	1	kil	3.00	12	3.00	72	26400	3
Eggs	16	ea	0.10	52	6.93	166.4	1664000	208
Meat	0.75	kilo	4.00	52	13.00	312	85800	9.75
Poultry	0.6	kilo	2.00	52	5.20	124.8	68640	7.8
Fish	0.5	kilo	1.50	52	3.25	78	57200	6.5
Dairy	2	liter	0.50	52	4.33	104	228800	26
Bread & Pasta	0.75	kilo	0.25	360	5.63	135	594000	67.5
Fresh Fruit&Veg	5	kilo	0.25	52	5.42	130	572000	65
Proc Fruit&Veg, Juice	2	units	0.75	52	6.50	156	208000	26
Veg Oils	1.5	liter	1.00	12	1.50	36	39600	4.5
Salt	I	kilo	0.50	12	0.50	12	26400	3
Alchoholic Bvgs	1	liter	3.00	52	13.00	312	114400	13
Soap	1.25	kilo	0.75	12	0.94	22.5	33000	3.75
Cigarettes	1	ctn	12.00	12	12.00	288	24000	3
Other Consumables	5	kilo	1.00	12	5.00		--	--
Total					**$86.20**	**$2,069**		

Source: Evaluation Team estimates

TABLE A8 - OTHER MANUFACTURED PRODUCTS - Domestic Production and Value						
Item	**Unit**	**Price**	**1990 Volume**	**1990 $MM**	**1998 Volume**	**1998 $MM**
Textiles rind Apparel						
Carpet (industrial)	m2 000	14000	2,243	31	34	0
Silk Fabric	m2 000	I2000	33,500	402	5	0
Footwear	pair	10	15,207,000	152	327,000	3
Cotton Fabric	m2 000	3000	101,600	305	6,900	21
Wool Fabric	m2 000	15000	10,700	161	100	2
Apparel	pcs	12	18,899,000	227	265,000	3
Socks	pair	3	37.800.000	113	1,700,000	5
Knitwear	pcs	3	36,700,000	110	1,400	0
Subtotal Textiles & Apparel				***1,501***		***34***
Fabricated Metal Products, Machines						
Electric Motors & Ventilators	units	75	732,400	55	10,200	I
Electric Cable	tons	4000	32,700	131	400	2
Refrigerators, Stoves, Air Conditioners	units	125	684,000	86	14,100	2
Cast & Formed Metal Products	tons	800	155,000	I24	5,800	5
Bicycles	units	35	130,000	5	0	0
Kitchen Utensils, Pots & Pans	units	5	23,560,000	118	5,526,000	28
Subtotal Metal Producs				***518***		***36***
Other Manufactured Products						
Window Glass	m2 000	2000	5,320	11	637	I
Paints and Plastics	tons	200	68,400	14	18,300	4
Tires	pcs	30	1, 123,000	34	300	0
Detergent	tons	250	81,500	20	600	0
Cardboard	m2 000	500	1 1,609	G	750	0
Subtotal Other				*84*		***5***
Total All Products				**2103**		**76**

Source: State Statistics Committee, ***Azerbaijan Industry***, 1999

TABLE A9 -- INFORMATION ON THE BANKING SYSTEM *$ million, end of year (unless otherwise specified)*					
	1995	**1996**	**1997**	**1998**	***% Chg*** *95-98*
Number of Banks	180	136	99	79	
Of which Foreign-Owned	11	13	13	12	
Capital	**25.2**	**59.7**	**103.8**	**153.9**	***511***
State Banks	5.6	9.7	9.6	35.9	*541*
Private Banks	19.6	50.0	94.2	117.9	*502*
% of Total	*78%*	*84%*	*91%*	*77%*	
Of which Foreign Capital	*5.4*	*7.1*	*13.6*	*17.6*	*226*
% of Total	*21%*	*12%*	*13%*	*11%*	
Loan Assets	**248.0**	**321.6**	**390.5**	**437.7**	*77*
State Banks	198.6	269.8	275.6	266.6	*34*
% of Total	*80%*	*84%*	*71%*	*61%*	
Private Banks	49.3	51.8	114.8	171.1	*247*
% of Total	*20%*	*16%*	*29%*	*39%*	
Savings Deposits	**19.1**	**26.8**	**39.7**	**48.2**	***152***
State Banks	14.8	13.9	22.4	27.3	*84*
% of Total	*77%*	*52%*	*56%*	*57%*	
Private Banks	4.3	12.9	11.2	11.2	*159*
% of Total	*23%*	*48%*	*28%*	*23%*	
Of which Foreign-Owned Banks	4.1	2.7	8.6	7.5	*84*
% of Total	*21%*	*10%*	*22%*	*16%*	
Profitability	**29.3**	**16.6**	**18.5**	**11.4**	***-61***
State Banks	22.5	11.0	56.0	6.5	*-71*
Private Banks	6.8	5.6	28.0	4.8	*-29*
Of which Foreign-Owned Banks	*0.5*	*-0.2*	*7.0*	*3.0*	

Source: National Bank of Azerbaijan, 1999

TABLE A10 – BANKS IN AZERBAIJAN
Apr-1999, $ 000 (unless otherwise indicated)

Bank Type	Loans	rank	Deposits & Oth Liabs	rank	Capital	rank	Staff	Branches
State-Owned Banks								
Prominvest Bank	33,316	3	18,091	4	2,788	2	809	32
International Bank of Az	111,078	I	54,517	2	2,667	3	544	27
Agropromet Bank	96,404	2	66,800	1	2,091	8	612	62
Sber Bank	10,797	6	11,196	5	28,887	1	1,592	56
Private Banks								
Adjemi Bank	1,335		0		1,407		12	I
Akadem Bank	2,247		848		1,381			
Arko Bank	11,033	5	7,152	6	1,860	11		
Amrakh Bank	1,626		85		1,741		20	
Anar Bank	1,682		43		1,769			
Ata Bank	2,315		254		1,871		2-1	
Atlant Bank	781		39		1,358			
Alra Bank	2,347		1,118		1,401		24	
Azad Bank	2,031		893		1,215			
Azal Bank	2,653		1,521	15	1,452		140	6
Azerdemiryol Bank	8,039	8	5,471	7	2,485	4	215	I2
Azerigaz Bank	3,842	9	3.228	9	1,535		37	
Azernagliyat Bank	2,817	15	1,300		1,419		72	6
Azerko Bank	3,067	11	1,490		1,395		37	
Azinvest Bank	1,049		9		1,404		51	4
Azershara Bank	1,368		0		1,419			
Azsharg Bank	2,598		1,176		1,627			
Bako Bank	521		7		1,358		20	
Bakcity Bank	1,205		4		1,370			
Bank of Baku	1,366		97		1,366			
Birlik Bank	1,705		201		1,372		22	
Borchachi Bank	1,295		0		1,467			
Deka Bank	1,456		63		1,392		12	
Debyut Bank	2,203		1,41I		2,043	9	53	I
Denizbiznes Bank	1,574		295		1,378		26	I
Elin Bbank	1,526		210		1,403		40	I
Elvid Bank	1,339		0		1,453			
Ganal Bank	1,197		12		1,370			
Gandja Bank	1,340		0		1,395		41	1
Gunay Bank	1,613		555		1,367		31	I
Ilkan Bank	2,267		119		2,118	7		
Ilk Bank	1,354		2		1,372		20	
Impero Bank	2,003		757		1,216			

TABLE A10 -- BANKS IN AZERBAIJAN
Apr-1999, $ 000 (unless otherwise indicated)

Bank Type	Loans	rank	Deposits & 0th Liabs	rank	Capital	rank	Staff	Branches
Jabbarli Bank	2,060		248		1.362			
Kaspian Bank	976		10		1,368		40	1
Kapital Bank	286		0		1,383		17	
Kontinent Bank	1,558		31		1,637	14	18	
M Bank	2,012		61		1,861		32	1
Manat Bank	1,655		344		1,578		22	
MEC Ver Bank	1,375		372		1,360		15	
Mugan Bank	1,620		21		1,685	13	33	
Para Bank	1,247		129		1,470		64	7
Poct Bank	10,073	7	2,411	11	1,378		69	1
Promtekh Bank	1,660		87		1,406			
Rabita Bank	2,891	13	1,369		1,378		77	3
Respublika Bank	1,395		3,092	10	1,931	10	64	3
Ruzu- Bank	1,939		1		2,287	5		
Saltan Bank	862		12		1,360		15	
Shukur Bank	1,093		0		1,419			
Tehnika Bank	1,273		730		1,405		15	
Ticaret Sanaye Bank	23		23		1,370		25	
Trust Bank	2,237		1,354		1,434		23	
Turan Bank	1,857		617		1,426		32	4
Ulfat Bank	1,750		6		1,360		22	2
Ulpar Bank	2,841	14	1,348		1,532		8	
Viza Bank	1,436		1		1,382		10	
Zemin Bank	1,697		550		1,552		31	
Foreign-Owned Banks								
Azerturk Bank	654		1,011		1,485		35	
Bay-Bank	2,301		1,033		1,450		24	
HSBC	19,267	4	19,054	3	1,443		60	
Ci Bank	412		2,309	12	1,434			
Gafgaz Inkishaf Bank	1,327		2		1,603	14	63	2
Is Bankasi Azerbaijan	1,118		29		1,369		27	
Milli Iran Bank	120		1,640	14	1,383			
Most Bank Azerbaijan	3,480	10	4,008	8	2,146	6	62	1
Royal Bank of Baku	932		19		1,789	12	25	
United credit Bank	1.985		805		1.449		42	
Universal Bank	2,973	12	1,958	13	1,395		32	2
Totals	**406,773**		**223,948**		**139,885**		**5,456**	**238**

ource: National Bank of Azerbaijan, 1999

TABLE A11 -- INTERNATIONAL BA K OF AZERBAIJAN

Balance Sheet Data, 12/31, $ 000

	1997	Shr	1998	Shr	Change
Assets					
Cash and short-term funds	24,923	9%	51,139	160,	-57%
Loans and advances to banks	26,728	10%	61,156	180,	-59%
Loans and advances to customers	164,929	59%	119,224	51%	-8%
Fixed assets	21,626	10%	22,051	60,	25%
Other assets	36,228	13%	31,113	90,	16%
Total assets	280,434	100%	354,889	1000,	-21%
Liabilities					
Deposits from banks *	84,819	30%	133,482	380,	-56%
Customer accounts	94,315	34%	116,593	33%	-19%
Other borrower funds	65,580	23%	74,119	21%	-12%
Other liabilities	23,620	8%	25.325	70,	-7%
Total liabilities	268,334	96%	350,178	990,	-23%
Shareholder's equity					
Paid in capital	2,948	1%	2,929	1%	1%
Retained earnings	1,851	1%	-3,521	-19	
Other equity	7,296	3%	5,303	Is,	38%
Total shareholder's' equity	12,100	4%	4,710	1%	157%
Total liabilities and shareholder equity	280,434	100%	354,889	100%	-21%
Note:					
Loans with Government Guarantee			127,868		
Short-Term			51,904		
Long-Term			15,963		
Without Government Guarantee			51,356		
Loan Loss Provision			17,945		

Source: International Bank of Azerbaijan

TABLE A12 - COMPARISON of STRUCTURE of ASSETS & LIABILITIES, Four Private Banks *Showing Share in Each Major Category and Change from Dec-97 to Dec-98*												
	Arko Bank			**Azerdemiryol Bank**			**Promtekh Bank**			**Rabita Bank**		
	$ 000	Shr	Chg	$ 000	Shr	Chg	$ 000	Shr	Chg	$ 000	Shr	Chg
Assets												
Cash & Short-term Funds	829	5%	-12%	2,113	17%	-37%	150	10%	154%	1,812	31%	-62%
Loans & Advances to Banks	0	0%		140	1%	-30%	219	15%	-59%	367	6%	-25%
Loans & Advances to Customers	11,702	73%	109%	5,869	48%	80%	1,025	69%	-11%	2,482	43%	-27%
Fixed Assets	2,696	17%	-8%	3,466	28%	-3%	8	0%	-66%	764	13%	150%
Other Assets	898	6%	74%	595	5%	121%	92	6%	-21%	342	6%	46%
Total Assets	**16,125**	**100%**	**60%**	**12,183**	**100%**	**14%**	**1,494**	**100%**	**-21%**	**5,767**	**100%**	**-37%**
Liabilities												
Deposits from Banks	8,812	55%	162%	2,111	17%	33%	0			165	3%	-52%
Customer Accounts	1,480	9%	-8%	5,872	48%	18%	389	26%	-38%	3,208	56%	-59%
Other Borrowed Funds	50	0%		119	1%	-80%				683	12%	
Other Liabilities	626	4%	-38%	314	3%	-49%	42	3%	-29%	137	2%	407%
Total Liabilities	**10,968**	**68%**	**83%**	**8,416**	**69%**	**8%**	**431**	**29%**	**-51%**	**4,193**	**73%**	**-49%**
Shareholder Equity												
Paid-in Capital	2,029	13%	13%	2,571	21%	11%	1,179	79%	12%	1,522	26%	42%
Retained Earnings	3,080	19%	37%	1,067	9%	148%	-117	-8%	-98%	35	1%	17%
Other Equity	48	0%	0%	129	1%	0%						
Total Shareholder Equity	**5,157**	**32%**	**26%**	**3,767**	**31%**	**31%**	**1,062**	**71%**	**7%**	1,557	27%	41%
Total Liabs & Shrholdr Equity	**16,125**	**100%**	**60%**	**12,183**	**100%**	**14%**	**1,494**	**100%**	**-21%**	**5,750**	**100%**	**-38%**

Source: National Bank of Azerbaijan, 1999