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FDI in Azerbaijan: A Structural Analysis of the Business Environment

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Abstract:

Although Azerbaijan could be an attractive destination for international business endeavors, there are massive barriers in practice. The national economy of Azerbaijan is divided among several clientelistic networks, capturing state institutions in order to back their own business activities and keep out competitors. Opportunities are limited to areas in which international firms channel technology into the country that cannot be provided locally. However, even in such cases, Western enterprises still have to comply with the particularities, rules and norms of the local clientelistic system in order to be successful.

Great Potential

At first sight, Azerbaijan could be an attractive destination for doing business. The country is rich in natural resources. Oil and gas extraction produce high incomes—money that is available for investments and thus could boost business. Although the country currently suffers from low oil prices and a decline in oil production, it is economically still in a different position than its resource-poor post-Soviet counterparts. At the same time, Azerbaijan has proved to be a reliable business partner in the energy sector since the signing of the “Contract of the Century” in 1994. The country has, moreover, taken decisive reform steps, like the establishment of the State Oil Fund of Azerbaijan Republic (SOFAZ) in December 2000 and the implementation of the Extractive Industries Transparency Initiative (EITI) since 2003. In 2007/08, Azerbaijan even led the world as the top reformer in the World Bank’s Ease of Doing Business Index. Is Azerbaijan thus a reliable destination for Western business in general?

This contribution demonstrates that the picture is more complex. In fact, the aforementioned reform measures have been isolated steps, well-orchestrated by the otherwise corrupt and authoritarian elite. At the same time, Western investments remain rare outside the oil sector. As a locally well-connected Austrian businessman told the authors: “You often meet foreigners with high expectations, coming to explore business opportunities. They want to take part in the country’s ‘gold rush’. But this is an illusion. They always get disappointed very quickly.” The following sections highlight the reasons behind these issues. First, we take a look beneath the surface of formal institutions, revealing that the national economy of Azerbaijan is divided among several clientelistic networks, capturing state institutions to realize their particularistic business interests. Next we analyze the impact of this constellation on Western businesses, providing a basis for our conclusions.

Informality: The Merger of Politics and Business

In OECD countries, formal institutions dominate. They work in a legal-rational manner and are characterized by

predictability and impersonality. There is a differentiation between the private and the public sphere and thus a—more or less—clear boundary between politics and business. However, in many countries worldwide, formal and informal institutions collide and mix in hybrid ways. In this context, private actors seize public institutions to realize their particularistic interests of accumulating ever more power and private wealth. For this purpose, they systematically abuse, side-step, ignore, or even tailor formal institutions to fit their interests. Azerbaijan is a typical example.

The informal power system of Azerbaijan has often been characterized as a pyramid structure, of which the different levels are bonded by patron-client relationships. While the system unites different—to a certain degree rivalling—clientelistic networks, the president of the country is the central and final arbiter. As a leaked U.S. cable emphasizes, this system dominates the business sphere: Certain sectors of the national economy are controlled by a handful of well-connected families who, at the same time, control certain geographic areas. Conflicts are kept low by a central agreement to divide the spoils and not to interfere in each others’ sphere. As the cable further highlights, the families also collude, using government mechanisms, to keep out foreign competitors, and official entities, such as the State Border Services, State Customs and tax authorities, create barriers that only the best connected can clear. The results are enormous opportunity and wealth for a small handful of players.

In order to describe this system of elite networks, the term “clan” is often used. There are traditionally three clans that are said to have influence: The Nakhchivan clan, the Yeraz clan and the Kurdish clan. However, it is important to note that these groups are not linked to traditional roots, but rather emerged around high-ranked members of the local Soviet nomenklatura. At the same time, since the turn of the millennium, clan loyalties have increasingly lost out to commitments of mutual business interests. Patriarch Heydar Aliyev’s death in 2003 and the transfer of power to his son Ilham accelerated this development. In regards to the contemporary elite structure, the literature speaks of the “old guard”, the “oli-

garchs” and the ruling “family”. In times of economic crisis, a centralization of the informal system has recently taken place, since the president has strengthened his role.

Within this overall constellation, the closest power circle around Ilham Aliyev is said to consist of seven groups, and even these groups are identified with key individuals. Two of them are first and foremost political actors, whereas two others are active in the business sphere and the final three unite political and economic power. Ramiz Mehdiyev, chief of the presidential administration and Ramil Usubov, minister of the interior, have major political influence. Concerning cadre policy and suppression, they are described as “the guys behind the doors”. They are part of the “old guard” and Mehdiyev is said to belong to the Nakhchivan network. These individuals obviously run their own businesses as well, although on a small scale. The other five players are all associated with big holdings. The exact structure of these holdings remains unclear, but the ruling family is said to have decisive influence in all of them, owning 70 to 80 percent of the shares. Kamaladdin Heydarov, minister of emergency situations, is connected to the GILAN Holding. Ziya Mammadov, minister of transportation, is related to ZQAN Holding. The national aviation company Jalal and the Silkway Holding are associated with Jahangir Askerov and his wife Zarifa Hamsayeva. The PASHA Holding is connected to the family of Mehriban Pashayeva, the First Lady.

Kamaladdin Heydarov is the most powerful oligarch in the country. As a member of the Nakhchivan network, his father was a close ally of Heydar Aliyev. Kamaladdin Heydarov gathered massive wealth as chairman of the State Customs Committee, as significant illicit payments were paid up the food chain. The Heydarov family is active in food processing, agriculture, construction business, real estate, chemicals, textiles, tourism, banking, and insurance. Ziya Mammadov is said to be the second biggest oligarch, active in passenger transport and cargo shipments, the construction business, insurance and banking. The Pashayev family, geographically rooted in Baku and the Absheron peninsula, are less rich than the others, but due to their political status, the single most powerful family in Azerbaijan. PASHA Holding is a conglomerate including Pasha Bank, Pasha Insurance, Pasha Construction, and Pasha Travel. The family furthermore owns a local TV station and a mobile phone provider. They are also active in the cosmetics industry.

Implications for International Enterprises

The major problem for Western enterprises in this market is the quasi-monopolistic character of most of the important industries. The economic influence of the inner power circle combined with their political influence hardly leaves room for competitors who act against

the ruling elite’s interests. Nevertheless, there are opportunities for foreign businesses in areas that require high technology, which local companies are not capable of delivering. Foreign firms might get project financing for such efforts, a point that is increasingly crucial.

With the international slump in oil prices and the consequent depreciation of the country’s Manat currency, the Azeri regime has been forced to address the diminishing resource inflow and must therefore seek additional foreign funding for its prestigious projects. Another endeavor that severely stressed the regime’s budget, with an officially stated expenditure of \$1.2bn was the “European Games” that took place in summer 2015. However, these figures raise serious skepticism as the real costs are probably much higher considering that the price tag for the new Olympic Stadium alone was \$600 million. The country’s declining macroeconomic performance has also been reflected in fluctuating GDP-growth rates (year-on-year) over the previous years with a low in 2011 of 0.11%, 2.2% in 2012, and a high in 2013 of 5.8% which was followed again by a decline to 2.8% in 2014. The sustainable drop in oil prices revealed—once again—the vulnerabilities of Azerbaijan’s economic model, i.e. the high dependence on oil revenues, the low diversification of the economy and the problematic business environment¹. In response to the latest macroeconomic developments of the country, the EBRD identified three key priority areas to reshape the economy: (i) Accelerating diversification of the economy, (ii) strengthening regulations for, and governance of, the financial sector, and (iii) a conservative budget for 2016 that reflects the country’s declining economic performance.²

Azerbaijan is eager to present itself internationally as a reliable partner offering a wide range of business opportunities. The European Games were just one recent example for this strategy as Sports Minister Azad Rahimov put it in a 2015 BBC interview, “After the European Games in Baku, people across the world will know that Azerbaijan is in Europe”³. In contrast, the reality for international firms initiating business activities in the country looks quite different and leaves frustrated those projects that do not take advantage of a “krysha”, i.e. a protector who guides the project through the informal networks which are crucial for successful operations. These informal decision-making platforms exist parallel to the formal institutions such as ministries, supervisory bodies and licensing offices, and are responsible for granting necessary permissions, licenses and clearance from tax authorities. The most difficult question for a foreign investor probably is

1 BEEPS V Survey. <<http://ebrd-beeps.com/countries/azerbaijan/>>

2 EBRD Transition Report 2015–16. <<http://2015.tr.ebrd.com/en/countries/#>>

3 BBC Report on the European Games in Azerbaijan 2015 <<http://www.bbc.com/news/world-europe-32977924>>

to determine the quality of the protector/broker. Is the contact person trustful and well established in the inner circle? When Western enterprises want to implement substantial business projects, they need direct personal access to high level power circles. However, given the economic crisis and the centralization of the informal power system, the freedom of an individual oligarch for taking a business decision on his own has recently decreased. Given this situation, an Austrian enterprise informed the authors that new projects are currently on hold.

Stability of the Informal Power System

The stability of the informal power system is another crucial factor for evaluating both future business opportunities and the safety of investments already made. Although the inner circle of Azerbaijan's ruling elite is a black box which can hardly be analyzed from within, conflicts are currently kept low. However, the coalition can only survive as long as there are enough resources to be distributed among its members to meet their demands. Exactly this pie might be under increasing pressure from diminishing oil revenues which reduce the pieces of the pie to be allocated among the members. To raise the regime's legitimacy before the November 2015 elections, the president demanded from one of his close clients, Jahangir Ashkarov of Azerbaijan's AZAL airline, to adjust ticket prices to international market levels. Also, for symbolic reasons, the fight against corruption was again high on the official political agenda to positively stimulate the electorate who suffers from reduced public spending and the devaluated Manat.

The coalition which characterizes the ruling elite is certainly not a coalition of equal partners. Instead, it can best be described and analyzed as a patronage regime with Ilham Aliyev on the top as illustrated in the second section of this analysis. The patron-client relationship typically works through the exchange of security and wealth provided by the patron for absolute loyalty and reliability provided by the client. The quality of the contact is substantially determined by one's position in this patron-client system. The further the client is distanced from the center, i.e. the patron, the weaker his/her power

to influence decisions for their business. Additionally, the quality of a client is largely indicated by the duration of the friendship, political loyalty and absence of scandals. On the other hand, factors that might endanger the quality of such patron-client relationships are political ambitions of the client, which might question the absolute power of the patron, or a public scandal, which would weaken the patron's legitimacy, potentially leading him to dismiss the client. It might also happen that the client serves as a scapegoat for the patron if something goes wrong. If a client falls from favor with the patron, the client's business partners are immediately out of the game as well. But also, if the client needs to decide between loyalty to his business partners or his patron, he/she will typically decide for the patron.

Property rights, legal disputes, and other matters can hardly be fought through formal institutions in Azerbaijan. Decisions always depend on personal linkages and relationships. All parties involved need to be willing to comply with the rules of the informal system; otherwise one can quickly fall from disgrace and is forced to leave the country immediately. This happened to an Austrian company that refused to stick to the informal rules and guarantee kick-back payments. In a matter of days, they had to close their offices, secure their files and charter a plane back to Vienna.

Conclusion

Behind Azerbaijan's facades, reality shows a regime that is based on a patron-client relationship among the ruling elites, which captures the state for their private gains. The collusion of public power and business interests for private gains, which are represented through omnipresent holding companies that control and protect their markets with backing from official authorities. Such a closed system leaves only a little room for international business interests, who want to participate in the prospering economic scene. However, while opportunities are ample, success stories are only written by those firms that channel technology into the country which cannot be provided locally. However, in order to be successful in this case, Western enterprises still have to comply with the particularities, rules and norms of the local clientelistic system.

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Recommended Reading:

- Leaked US Cable: <https://wikileaks.org/plusd/cables/10BAKU54_a.html>
- Farid Guliyev (2012): Political Elites, in: *Challenges of the Caspian Resource Boom. Domestic Elites and Policy-Making*, Andreas Heinrich and Heiko Pleines, eds., Houndmills: Palgrave Macmillan, pp. 117–130.