

T.C.
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AVRUPA TOPLULUĞU ENSTİTÜSÜ
AVRUPA BİRLİĞİ İKTİSADI ANABİLİM DALI

**THE EUROPEAN NEIGHBOURHOOD POLICY
FROM THE PERSPECTIVE OF AZERBAIJANI ECONOMY**
(Yüksek Lisans Tezi)

Süleyman OĞUZ

İSTANBUL - 2006

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ABSTRACT

The purpose of the thesis is to examine the potential effects of the European Neighbourhood Policy (ENP) on the Azerbaijani economy. In addition to the economic implications, the study also discusses the ENP's probable contribution to democracy and human rights developments in Azerbaijan. Likewise, the thesis provides an assessment of the ENP from the perspective of Nagorno-Karabakh conflict.

Based on a qualitative analysis, the ENP seems to have the potential to foster economic growth in Azerbaijan. The study identifies a number of ways through which this might happen, both directly through economic channels and indirectly, by providing support for proper structural and macroeconomic policies. The study also highlights a number of possible risks as supply-side specialisation and over-regulation .

On the other hand, the intended EU contribution to democracy and human rights of Azerbaijan seems questionable, given that historically it was neither effective nor consistent in its related policies. Moreover, by considering the fact that the ENP is underdeveloped as a conflict resolution tool, the perspectives for the Nagorno-Karabakh conflict are limited.

ÖZET

Tezin amacı Avrupa Komşuluk Politikası'nın Azerbaycan ekonomisi açısından muhtemel etkilerini incelemektir. Çalışmada, ekonomik beklentilerin yanısıra Komşuluk Politikası'nın Azerbaycandaki demokrasi ve insan hakları gelişimine olası katkıları da tartışılmış, benzer şekilde Dağlık-Karabağ problemi açısından Komşuluk Politikası'nın değerlendirmesi yapılmıştır.

Çalışmada kullanılan niteliksel çözümlenmeye dayanarak Komşuluk Politikası'nın Azerbaycandaki ekonomik büyümeye pozitif etki yapacağı sonucuna varılmaktadır. Öte yandan, Avrupa Birliği'nin tarihsel olarak Azerbaycan'a yönelik olan benzer politikalarının başarısızlığı ve tutarsızlığı düşünülürse, Komşuluk Politikası'nın demokrasi ve insan hakları gibi değerlerin gelişimine katkısının öngörülen düzeyde gerçekleşmesinin şüpheli olduğu ifade edilmektedir. Bundan başka, Komşuluk Politikası'nın bir anlaşmazlık çözme aracı olarak geliştirilmediği dikkate alınırca, Dağlık-Karabağ probleminin çözümü açısından bu Politika'nın katkısının sınırlı olacağı düşünülmektedir.

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LIST OF THE ABBREVIATIONS

AA	: Association Agreement
AP	: Action Plan
ARRA	: Agency for Rehabilitation and Reconstruction of Areas
CHF	: Swiss Franc
CIS	: Commonwealth of Independent States
CoE	: Council of Europe
CORDIS	: Community Research and Development Information Service
CPI	: Consumer Price Index
ECHO	: European Community Humanitarian Office
EEA	: European Economic Area
EFTA	: European Free Trade Area
EHA	: Exceptional Humanitarian Aid
EIDHR	: European Initiative for Democracy and Human Rights
EMP	: Euro-Mediterranean Policy
ENP	: European Neighbourhood Policy
ENPI	: European Neighborhood and Partnership Instrument
<i>Et al.</i>	: and others
<i>Etc.</i>	: and so on
EU	: European Union
EUSR	: EU Special Representative
EXAP	: Exceptional Assistance Programme
FEOGA	: Fondo Europeo de Orientacion y Garantia para la Agricultura (European Agriculture Guarantee and Guidance Fund, EAGGF)
FSP	: Food Security Program
FTA	: Free Trade Area
GAC	: General Affairs Council
GALILEO	: Global Navigation Satellite System
GDP	: Gross Domestic Product
GSP	: Generalized System of Preferences
<i>Ibid.</i>	: ibidem
IDPs	: Internally Displaced Persons
INOGATE	: Interstate Oil and Gas Transport to Europe
JPY	: Japanese Yen
KWD	: Kuwait Dinar
MEDA	: EU's financial instrument for the Euro-Mediterranean Partnership
MFN	: Most Favored Nation
MTP	: Managers' Training Programme
NIP	: National Indicative Programme

OSCE	: Organization for Security and Cooperation in Europe
PCA	: Partnership and Cooperation Agreement
REHAB	: Rehabilitation programme
SDR	: Special Drawing Right
SMEs	: Small and Medium Size Enterprises
SSR	: Soviet Socialist Republic
TACIS	: Technical Assistance to the Commonwealth of Independent States
TAIEX	: Technical Assistance and Information Exchange
TEMPUS	: Trans- European Mobility Scheme for University Studies
TRACECA	: Transport corridor Europe - Caucasus - Asia trade
UN	: United Nations
USA	: United States of America
USSR	: Union of the Soviet Socialist Republics
WNIS	: Western New Independent States
WTO	: World Trade Organization

I. INTRODUCTION

Azerbaijan holds a critical geo-strategic space between the European and Asian cultures and is undoubtedly the leading actor in the South Caucasus. Its rich supplies of oil and gas, alongside its links to the major actors in the region and its vital geographical role as the bridge between Europe and Asia means that the future of the region is very much dependent on the political, cultural and economic advancement of Azerbaijan. Russia, Turkey, Iran and the USA are all clearly taking a keen interest in this country. However, despite of some EU member states' bilateral interests, the EU has been passive as a global actor in Azerbaijan, as well as in the Caucasus region.

Only after the 2004 enlargement, the EU focused on offering deeper and more meaningful dialogue between the EU and Azerbaijan. In addition, it focused for the first time on the Nagorno- Karabakh conflict, like other conflicts in the region. It was the result of the realisation that the European enlargement has inevitably impacted upon the political and geo-strategic map of the world and new map brings Azerbaijan into closer contact with the EU. It is further interested in the South Caucasus to ensure access to Caspian oil and gas, develop transport and communication corridors between Europe and Asia, and contain such threats as smuggling, trafficking and environmental issues.

Consequently, On May 14 2004, the European Commission issued a Strategy Paper that called for closer integration between the European Union and the South Caucasus. The process was completed in June 2004, when Azerbaijan (together with Armenia and Georgia)

was included in the European Neighbourhood Policy (ENP), which had been launched in March 2003.

For Azerbaijan, the offer to share in a “privileged relationship” came at a crucial time in its development. The rich energy supplies it possesses are daily enhanced through the rising price of oil and the increased threat to the safe delivery of the resources of the Middle East. Moreover, the importance of Azerbaijan likely to be increased by the soon to be completed Baku-Tbilisi-Ceyhan oil pipeline and the Baku-Erzurum gas line. Thus, at first glance, the ENP, which considers energy security and safety in the region as one of the priorities, may be thought beneficial from economical perspective.

The thesis aims to highlight the potential effects of the ENP on Azerbaijani economy. Given that the ENP is still at a relatively early stage of development, a quantitative analysis of its economic effects will be possible only later on. Nevertheless, a qualitative discussion of the key economic implications of the ENP can be carried out at the present time. Hence, the focus of the study is on some effects that are likely to be visible in Azerbaijani economy. In addition, the thesis will seek answers to questions as: What is the motivational factor directing EU towards launching ENP? and how Azerbaijan fits the interest in that context? Because of significance to Azerbaijan, the perspectives for Nagorno-Karabakh conflict will also be highlighted in this study.

The thesis is organised as follows: Section II introduces the ENP and looking for the rationale, development process, aims and principles as well as incentives of the policy. In Section III, the historical EU-Azerbaijan relations are investigated from different

perspectives. After describing Azerbaijan's ENP process and stressing some significant issues in Section IV, the thesis discusses the probable economical benefits and risks in the fifth section. Finally, the main findings and expectations are concluded in last section.

II. THE EUROPEAN NEIGHBOURHOOD POLICY

2.1. Rationale for the Policy

The historic enlargement of the Union in 2004 is the main source of motivation for the ENP. The effects of enlargement can be considered from various points of view. In a simple sense, the transformation of neighbours created new challenges and opportunities that the EU has to address. Although the EU had close relationships with the neighbours,¹ the new geopolitical environment needs to reframe its external relations.

Other impact of enlargement is hidden under the “success” of enlargement. The success of enlargement has strengthened the EU's claim that it has developed an unique capacity to promote the internal transformations of states, which is driven less by a realist calculus of military power than by the civilian tools of economic integration and moral persuasion.² It has also given greater credibility to the EU's ambitions to be treated as a global actor in international politics.

Enlargement has also made the EU a more powerful actor through the very fact of territorial expansion. As against the older tradition of the EU as an introspective “civilian

¹ The relations were arranged under the Euro-Mediterranean Policy (EMP) or Barcelona process with Southern Mediterranean countries and the Partnership and Cooperation Agreements (PCAs) with CIS countries.

² Roland Dannreuther, (2006), “Developing the Alternative to Enlargement: The European Neighbourhood Policy”, *European Foreign Affairs Review* 11: p. 183

³ *ibid*, p. 184

power”, the realization has grown that a territorially enlarged EU can no longer be a disinterested actor in relation to the countries on its periphery. At the same time, the EU has also realized that its ambitions to gain greater international status and prestige, and its desire to become a serious global power, are very much connected to the relative success or failure of its regional policies.³

Although the prospect of membership is continuing for some countries, (Turkey, Bulgaria, Croatia and Romania) the final borders of the Union was almostly shaped by the enlargement. As pointed out by Romano Prodi, the Union cannot go on enlarging forever.⁴ Considering the fact that EU’s most successful instrument of foreign policy to build cooperation,⁵ the prospect of membership, is not anymore sustainable⁶, EU had to establish new forms of cooperation within its new geographic proximities.

While enlargement is a proximate motivation for the ENP, the policy's roots are set down in the “European Security Strategy”, which points out that:

“It is in the European interest that countries on our borders are well-governed. Neighbours who are engaged in violent conflict, weak states where organized crime flourishes, dysfunctional societies or exploding population growth on its borders all pose problems for Europe The reunification of Europe and the

⁴ Romano Prodi (2002), “*A Wider Europe - A Proximity Policy as the key to stability*”, Speech at the Sixth ECSCA-World Conference, Jean Monnet Project : Brussels
[http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/02/619&format=HTML&aged=0&language=EN&guiLanguage=en_\(12/04/2006\)](http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/02/619&format=HTML&aged=0&language=EN&guiLanguage=en_(12/04/2006))

⁵ Marise Cremona (2004), “*The European Neighbourhood Policy: Legal and Institutional Issues*”, CDDRL Working Papers Number 25 , Stanford Institute for International Studies : Stanford
http://iis-db.stanford.edu/pubs/20738/Cremona-ENP_and_the_Rule_of_Law.pdf, (10/01/2006)

⁶ Rosa Rossi, (2004), “*The European Neighbourhood Policy in Perspective*”, in Fulvio Attina and Rosa Rossi eds., “*European Neighbourhood Policy: Political, Economic and Social Issues*”, Catania: The Jean Monnet Centre “Euro med” , p. 8

integration of acceding states will increase our security but they also bring Europe closer to troubled areas".⁷

In addition to enlargement connected security problems, there are global threats as terrorism, the proliferation of Weapons of Mass Destruction, regional conflicts, state failure and organized crime. Whether the neighbourhood oriented or not security and strategic considerations were, therefore, a critical factor in the development of a new neighbourhood policy. The EU has two options: export stability and security to its near neighbours, or risk importing instability from them.⁸

2.2 Development of the Policy

The idea behind the European Neighbourhood Policy (to have a single framework of relations for all the Eastern and Southern neighbours) was officially launched by the EU in 2003. However, the ideas underlying the ENP were initiated in early 2002 and gradually emerged as a result of a debate that involved a number of political actors.⁹

The General Affairs Council (GAC) held on 15 April 2002 may be considered as first attempt towards this policy. It welcomed the intention of the Commission and the High Representative, Mr. Javier Solana, to prepare contributions during the second half of 2002 on

⁷ Council of the European Union (2003), "*European Security Strategy: A Secure Europe in a Better World*", EU Brussels, p.7

⁸ William Wallace (2003), "*Looking After the Neighbourhood: Responsibilities for the EU-25*", Notre Europe Policy Papers N°4: Paris, pp.18-19. <http://www.notreeurope.asso.fr/fichiers/Policypaper4.pdf>, (01/02/2006)

⁹ In 2002, a British initiative aimed at countries such as Belarus, Moldova, Russia and Ukraine. Later that year, in December, and after an intense lobbying of southern EU member states, the Mediterranean countries were included.

the possibilities for strengthening those relations, taking into account the state of relations between the EU and the various countries involved, as well as their level of political and economic development.¹⁰ Joint letter, mailed on 7 August 2002 by EU Commissioner Chris Patten and Solana, proposed the General Framework for the relations with the new neighbours: the geographical coverage; the method and the principles; the measures (the areas of action); and the instruments.¹¹ In September, the GAC initial outline presented to foreign ministers at an informal meeting, but did not meet a general lack of interest.¹²

Two of the important steps towards the policy were realized in December 2002. The first was speech of Romano Prodi on 5-6 December. At an academic conference, the Commission President talked for the first time about the need to create a “ring of friends” around a Union enlarged to 25 members in order to guarantee stability in the region. In the words of the Prodi, it was necessary “to share everything but the institutions”, with neighbouring countries.¹³ Other was The Copenhagen European Council held on 12-13 December. The Copenhagen European Council declared the will to promote stability and prosperity within and beyond the new borders of the Union.¹⁴

On 24 February 2003, The General Affairs and External Relations Council discussed the "Wider Europe - New Neighbourhood" initiative as part of a reflection on the enlarged Union and its neighbours initiated by the Council in September 2002.

¹⁰ Esra Hatipoğlu (2005), “Yeni Komşuluk Politikası'nin Avrupa Birliği (AB)-Rusya İlişkilerine Etkisi”, *Akademik Arştırmalar Dergisi 2004-2005*, no 23, p.p. 95-96

¹¹ C. Patten & J. Solana (2002), “*Joint letter on Wider Europe.*”
[http://europa.eu.int/comm/world/enp/pdf/_0130163334_001_en.pdf_2002_\(3/03/2006\)](http://europa.eu.int/comm/world/enp/pdf/_0130163334_001_en.pdf_2002_(3/03/2006))

¹² Esra Hatipoğlu, *ibid* p 96

¹³ Romano Prodi (2002), *ibid*

¹³ Esra Hatipoğlu, *ibid* p 96

¹⁴ Council of the European Union(2002), “*The Presidency Conclusions, Copenhagen*”, 12–13 December 2002, Brussels, p.7 http://Ue.Eu.Int/Uedocs/Cms_Data/Docs/Pressdata/En/Ec/73842.Pdf., (02/04/2006)

The launch of the policy was realized on 11 March 2003, when the Commission proposed a communication on the “*Wider Europe Neighbourhood: A New Framework for Relations with our Eastern and Southern Neighbours*”. The Communication outlined the basic principles of the European Neighbourhood Policy. It also offered new perspectives of political and economic integration to create a security, prosperity, sustainable development and good neighbourhood area for the countries that cannot be accepted, for the time being, as members of the EU.¹⁵ The communication was welcomed by the General Affairs and External Relations Council on 16 June 2003 and by the Brussels European Council of 16-17 October.

In July 2003, the Commission developed a strategy for financing the ENP in two phases: 1) foreseen the coordination of existing financial instruments during the period 2004-2006 to respond to the objectives of the ENP; 2) proposed the creation of a new financial instrument (Neighbourhood Instrument) for the following period.¹⁶ This Communication, like the 11 March Communication, was supported by the European Parliament. In its *Report on the “Wider Europe” Communication*, the Parliament suggested extending ENP to the three Southern Caucasus countries: Armenia, Georgia, and Azerbaijan.¹⁷

¹⁵ The partner countries initially included in the policy were 14: Russia, plus ten Southern Mediterranean countries (Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, Palestinian Authority, Syria, Tunisia) and three Western Newly Independent States (WNIS-Ukraine, Moldova, Belarus).

¹⁶ Commission of the European Communities, (2003), “*Paving the way for a New Neighbourhood Instrument*”, Communication from the Commission, COM(2003)393 final, Brussels, 1 July 2003.p 4

¹⁷ European Parliament(2003), Report on “Wider Europe-Neighbourhood: A New Framework for Relations with our Eastern and Southern Neighbours”, Final A5-0378/2003, 5 November 2003, <http://www.europarl.europa.eu/omk/sipade3?PUBREF=-//EP//NONSGML+REPORT+A5-2003-0378+0+DOC+PDF+V0//EN&L=EN&LEVEL=1&NAV=S&LSTDOC=Y> (25/09/2006)

Another important development that shape the policy, was the adoption of the “European Security Strategy“ which was created to frame ,together with the ENP, the new European diplomacy.¹⁸

On May 12th 2004 the Commission presented another Communication called “Strategy Paper” and delivered seven Country Reports. In the Strategy Paper it is mentioned the possibility to extend the policy to the Southern Caucasus states.¹⁹

The General Affairs and External Relations Council of 14 June 2004 determined the inclusion in ENP of Caucasus Countries and clarified the acceptance conditions for Belarus and Libya. It also established that Russia would enjoy a special partnership with the EU in the context of the four common spaces determined at St. Petersburg in May 2003. This final conclusion was approved by European Council of 17-18 June 2004.²⁰

2.3. Aims and Principles

In May 2004, the European Commission published its “Strategy Paper on European Neighbourhood Policy”. In this document, the Commission laid down the principles and objectives that would govern all future ENP. According to the ENP Strategy Paper;

¹⁸ It presented by Javier Solana at the Thessaloniki European Council in June 2003 and adopted by the European Council in December 2003

¹⁹ Commission of the European Communities, (2004),”*European Neighbourhood Policy Strategy Paper*”, Communication from the Commission, COM(2004) 373 final, Brussels, 12 May 2004, p 4

²⁰ Council of the European Union(2004), *The Presidency Conclusions*, Brussels , 17–18 June 2004, p. 14,web <http://www.consilium.europa.eu/uedocs/cmsUpload/81742.pdf> (25/09/2006)

“The objective of the ENP is to share the benefits of the EU’s 2004 enlargement with neighbouring countries in strengthening stability, security and well-being for all concerned. It is designed to prevent the emergence of new dividing lines between the enlarged EU and its neighbours and to offer them the chance to participate in various EU activities, through greater political, security, economic and cultural co-operation”²¹

Of course, the objectives “to share the benefits of the EU’s enlargement in 2004” with its immediate vicinity in order to “prevent the emergence of new dividing lines in Europe”, are the objectives of the ENP. What European Union aims by the policy is different. As mentioned before, the main purpose of EU was to maintain security after “big bang” enlargement, which brings the EU closer to the troubled areas. Other objectives may be listed as: to protect or even increase global prestige, strengthening links with energy suppliers,²² limiting future membership of the EU,²³ establishing a “buffer” zone,²⁴ protecting from immigration ...etc.

The European Neighbourhood Policy rests upon several key principles. First at all, it is crucial to point that, the neighbourhood policy does not radically replace the previous agreements. (PCAs and Association Agreements) Rather than, it is designed to reinforce the earlier policies and built on the existing institutional framework of the PCAs and Association Agreements. These agreements form the contractual basis for further EU neighbour country relations. In addition, it excludes the perspective of future membership.

²¹ COM(2004) 373,p. 3

²² David Hall,(2006), “*EU Neighbourhood Policy: Implications for Public Services and Trade Unions*”, A Report Commissioned by the EPSU, London: University of Greenwich, p.5
<http://www.psir.org/reports/2006-01-EU-ENP.doc> (31/06/2006)

²³ David Hall,(2006) *ibid* p. 5

²⁴ Andreas Marchetti (2006), “*The European Neighbourhood Policy: Foreign Policy at the EU’s Periphery*”, Discussion Paper, Bonn: Center for European Integration Studies, p 17
http://www.zei.de/download/zei_dp/dp_c158Marchetti.pdf (31/06/2006)

Another principle, as the Commission stated, the ENP constitutes a case for “*joint ownership*” of the institutions and the process in general, and the cooperation is based on the “*shared values and common interests*”²⁵.

Implementation of the policy also requires the definition of some *objectives and priorities in key domains*. It is important to identify first set of issues that have to be addressed. By doing so, they serve as basis for later preparation of Action Plans which are specific to respective country.

The ENP relies on a benchmarking approach. This *periodical evaluation* principle cause another principle too: determination *of certain reference economic and political criteria*, in order to allow for a clear and transparent evaluation of each country’s progress in meeting the requirements derived from the Action Plans.

A *step-by-step* or *progressive* approach towards EU neighbouring countries is also required in order to introduce a gradual engagement for each state, depending on its willingness to progress with economic and political reform.

Two principles of the neighbourhood policy are especially important: *differentiation* and *conditionality*. The *differentiation* between partner countries is at the basis of the neighbourhood policy. In this case, EU's treatment of each of its neighbours would vary in accordance with each neighbour's particular needs, objectives, economic development and rate of progress. *Conditionality* is used widely in accession process too. This concept would

²⁵ COM(2004) 373 final, p.8

mean that the EU states what it has to offer to partners and under which conditions the EU is willing to deliver²⁶. The conditionality, or more precise, *positive conditionality*²⁷ feature of ENP, if implemented, is believed to make the policy more successful related to earlier agreements.

2.4. Instruments of the Policy

As it was mentioned before, the EU's relations with the neighbouring countries included by the ENP are governed by previous Partnership and Co-operation Agreements and Association Agreements. On their basis and in order with the principles of the European Neighbourhood Policy Strategy Paper, the process continues as: draft of Country Reports, bilateral agreement on Action Plans, implementation of the Action Plans and monitoring. So, Country Reports, Action Plans, monitoring and financial instruments for funding the policy, may be considered as the main tools of ENP.

2.4.1. Country Reports

The Country Reports assess the current state of relations as well as the political, social, economic and institutional developments and identify a first set of issues that will have to be

²⁶ Andreas Marchetti (2005), "*Barcelona, Neighbourhood and Beyond*", Research presented at ARI Movement's 7th International Security Conference: "Democratization and Security in the Wider Middle East", Istanbul, 23/24 June 2005 http://www.uni-bonn.de/~uzswac/marchetti-barcelona_neighbourhood.pdf (21/02/2006)

²⁷ Rafaella A. Del Sarto and Tobias Schumache (2005), "From EMP to ENP: What's at Stake with the European Neighbourhood Policy towards the Southern Mediterranean?", *European Foreign Affairs Review* 10: p.22

addressed. These documents will provide the space for future assessments of achievements of each of the EU's partner countries. They also serve as a basis for further Action Plans.²⁸

2.4.2. Action Plans

ENP Action Plans are the primary instrument of the Neighbourhood Policy. They are negotiated on a bilateral basis with each partner country based on both the country's' and the EU's interests and capacity of each country to undertake different reform measures towards the joint objective achievement. The areas of activity include *“political dialogue and reform, trade and measures preparing partners for gradually obtaining a stake in the EU's Internal Market, justice and home affairs, energy, transport, information society, environment and research and innovation, social policy and people-to-people contacts.”*²⁹

The Action Plans will define the way ahead over the next three to five years. The next step could consist in offering a new privileged partnership in the form of *European Neighbourhood Agreements*, to replace the present generation of bilateral agreements, when Action Plan priorities are met.³⁰

²⁸ Country reports were published in May, 2004, on the first seven of the ENP countries (Moldova, Ukraine Israel, Jordan, Morocco, Palestinian Authority and Tunisia); a further five country reports were published in March, 2005 (Georgia, Azerbaijan, Armenia ,Egypt and Lebanon)

²⁹ COM(2004) 373 final, p.3

³⁰ Esra Hatipoğlu (2004), “Daha Geniş Avrupa: Avrupa Birliği (AB)'nin Komşu Ülkeler Politikasının Analizi”, *Akademik Arştırmalar Dergisi*, volume 12, no.1-2, p.228.

Table 2.1

ENP partners, their past contractual links with the EU, and current ENP situation

Country	Contractual Basis			Country Report	Action Plan	
	Type	Agreed	In force		Agreed	In force
Algeria	AA	12/2001		Under development		
Armenia	PCA	04/1996	07/1999	03/2005	Under development	
Azerbaijan	PCA	04/1996	07/1999	03/2005	Under development	
Belarus	PCA	03/1995				
Egypt	AA	06/2001	06/2004	03/2005	Under development	
Georgia	PCA	04/1996	07/1999	03/2005	Under development	
Israel	AA	11/1995	06/2000	05/2004	12/2004	03/2005
Jordan	AA	11/1997	05/2002	05/2004	12/2004	06/2005
Lebanon	AA	06/2002	03/2003 (interim)	03/2005	Under development	
Libya	–	–	–	–	–	–
Moldova	PCA	11/1994	07/1998	05/2004	12/2004	02/2005
Morocco	AA	02/1996	03/2000	05/2004	12/2004	07/2005
Palestinian Authority	AA (interim)	02/1997 (interim)	07/1997 (interim)	05/2004	12/2004	05/2005
Syria	AA	10/2004				
Tunisia	AA	07/1995	03/1998	05/2004	12/2004	07/2005
Ukraine	PCA	06/1994	03/1998	05/2004	12/2004	02/2005

Source: http://ec.europa.eu/world/enp/faq_en.htm (21/11/2005)

2.4.3. Monitoring Reports

The Monitoring Reports are analysis papers of the bilateral relations, political, institutional, economic and social situation of the partner country and of its progress in the priority domains established through Action Plans.

2.4.4, ENP Financial Instrument

Currently, the EU's assistance to the countries, covered by the European Neighbourhood Policy, is channeled through various geographical programmes including TACIS (for Eastern neighbours and Russia) and MEDA (for southern Mediterranean neighbours), as well as thematic programmes such as EIDHR (European Initiative for Democracy and Human Rights). For the current budgetary period (2000-2006), the funds available were approximately €5.3 billion for MEDA and €3.1 billion for TACIS, as well as approximately €2 billion in European Investment Bank lending for MEDA beneficiary countries and €500 million for TACIS beneficiary countries.³¹

From 2007, within the financial perspectives for 2007-2013, the Commission will replace the TACIS and the MEDA with a new "European Neighborhood and Partnership Instrument (ENPI), which will be applicable to all of the EU's external borders. The objectives of the ENPI are: *to promote the sustainable development in the border regions; the cooperation in the field of environment, public security, conflict and organized crime prevention; border management; promotion of cross-border cooperation at the local level and "people-to-people contacts.*³² The ENPI will be more flexible than its predecessors and will focus in particular on supporting the implementation of the Action Plans. In comparison to these former instruments, the ENPI goes beyond sustainable development or fighting poverty and offers progressive participation in the EU's internal market. It also asks for a

³¹ "The Policy: Funding" , http://ec.europa.eu/world/enp/funding_en.htm.(18/12/2005)

³² COM(2003)393 final, p.4-6

budget of €12 billion for 2007-2013,³³ as compared to approximately €8.4 billion for 2000-2006 under respective predecessor programmes.

2.5. ENP Proposed Incentives

As it mentioned before, the ENP is based on the “positive conditionality” principle, which means additional benefits for good performance. The core of positive conditionality, of course, is the existence of incentives. Without the membership perspective, the EU had to offer substantial incentives to motivate neighbouring countries towards successful implementation of reforms. Therefore the EU proposed following incentives³⁴:

- extension of the Internal Market and regulatory structures
- preferential trading relations and market opening
- perspectives for lawful migration and movement of persons
- intensified cooperation to prevent and combat common security threats
- greater EU political involvement in conflict prevention and crisis management
- greater efforts to promote human rights, further cultural cooperation and enhanced mutual understanding
- integration into transport, energy and telecommunication networks and the European Research Area
- new instruments for investment promotion and protection
- support for integration into the global trading system
- enhanced assistance, better tailored to needs

³³ The Commission proposed a budget of nearly 15 billion euros for ENPI, but this figure was reduced to just under 12 billion euros as a result of the compromise over the budget at the December 2005 European Council.

³⁴ Commission of the European Communities (2003), “*Wider Europe-Neighbourhood: A Framework for Relations with our Eastern and Southern Neighbours*”, Communication from the Commission, COM (2003)104 final, Brussels, 11 March 2003.

- new sources of finance

Without neglecting the importance of other aspects, for the general purpose of the study, some areas are discussed detailed in following sections.

2.5.1. Conflict Resolution

A key objective of the EU is to have a stable, secure, prosperous and democratic neighbourhood. As it stated earlier, “...neighbours who are engaged in violent conflicts...pose problems for the Europe.”³⁵ In this context, the EU may not be disinterested towards the conflicts in its periphery³⁶. Hence, the ENP has been developed with conflict resolution as one of its objectives.

The main documents of the neighbourhood policy mention about the requirements of more active role of EU in conflict settlement³⁷ and consider the ENP to reinforce stability and security and contribute to efforts at conflict resolution.³⁸ However, while explicitly stated in all of the documents, conflict resolution is not the central objective of the ENP.³⁹

³⁵ European Council , “*European Security Strategy: A Secure Europe in a Better World*”, Brussels, 12 December 2003, p. 7

³⁶ The concerned conflicts are: Western Sahara, Israel-Palestine, Abkhasia, South Osetia, Nagorno-Karabakh and Transnistria conflicts.

³⁷ COM(2003)104 final,p.12

³⁸ COM(2004) 373 final, p.4

³⁹ Nicu Popescu,(2005), “*The EU in Moldova-Settling Conflicts in the Neighbourhood*” , Chaillot Occasional Papers 60,Paris:European Union Institute for Security Studies, p.9,

Although contributing to conflict resolution in its neighbourhood is significant to the achievement of EU objectives, the conflict resolution dimension of ENP is underdeveloped.⁴⁰ Rather than direct involvement in conflict resolution, EU prefers contributing indirectly to conflict prevention⁴¹ and stabilization by promoting standards and values such as the rule of law, prosperity, democracy and respect to human rights.

This avoidance of responsibility approach can be explained by the controversial aspects of a more active EU policy in crisis resolution⁴². The contradiction may be caused by either different interests of other global actors as US and Russia or simply, from the idea to satisfy both conflicting parties such as in Nagorno-Karabakh conflict. Moreover, ENP is a Commission-driven policy, and crisis management is prerogative of the Council, which is the main EU institutional actor in foreign and security policy issues.⁴³ Through the Commission, so far the security dimension of ENP has been mainly focused on conflict prevention and post-conflict rehabilitation.⁴⁴

Nevertheless, it is believed that ENP would lead to greater involvement of the EU in crisis resolution.⁴⁵ The ENP Action Plans agreed in 2005, all set conflict resolutions as their priorities. Action Plans under negotiation, are also consider the conflict resolutions as key

⁴⁰ Jean F. Crombois,(n.a) “*The European Neighbourhood Policy and Conflict Resolution in the Mediterranean and in Black Sea*”,
http://www.cceisaconf.ut.ee/orb.aw/class=file/action=preview/id=164442/crombois_new.doc. (20/03/2006)

⁴¹ For detailed information about Conflict Prevention role of ENP, see Fraser Cameron (2006), “*The European Neighbourhood Policy as a conflict prevention tool*”, European Policy Center (EPC) Issue Paper No.47, Brussels
http://www.conflictprevention.net/library/documents/thematic_issues/prevention_tool__epc_issue_paper_47.pdf

⁴² Jean F. Crombois ,ibid

⁴³ Georgi Kamov (2006), “*EU’s Role in Conflict Resolution: the Case of the Eastern Enlargement and the Neighbourhood Policy Areas*”, Master Thesis, Institut Européen des Hautes Etudes Internationales (IEHEI), Nice, France, <http://www.iehei.org/bibliotheque/memoires/2006/KAMOV.pdf>. (25/07/2006)

⁴⁴ Nicu Popescu, ibid, p.10

⁴⁵ Roberto Aliboni (2005), “The Geopolitical Implications of the European Neighbourhood Policy”, *European Foreign Affairs Review* 10: p. 5

objectives. However, the EU actions towards conflicts are different⁴⁶ and are yet unsatisfactory. Despite the Moldova plan in which a viable solution to the Transdnistria conflict is defined as a key priority and seven steps are elaborated, the other Action Plans, also the APs under negotiation, do not go beyond the enhances support for current UN and OSCE negotiation efforts and formats.⁴⁷

2.5.2. Contribution to “Common Values”

Although the only stated incentive related to “common values” was “greater efforts to promote human rights,”⁴⁸ promotion of other “shared values” as democracy and rule of law can be considered in the same way. Hence, in the policy the “shared values” appears in two ways: as a condition for cooperation on other areas, and as an incentive that requires specific cooperation as other dimensions.

On the one hand, “privileged partnership with neighbours”, which is offered by the ENP, was thought to “build on mutual commitment to common values”. In addition, the Strategy Paper stipulates that differentiation, which requires taking account of an individual country’s needs and capacities, as well as its existing relations with and interest in the EU, should “be based on a clear commitment to shared values” and that the “level of ambition of

⁴⁶ Nicu Popescu, *ibid*, p.10

⁴⁷ International Crisis Group (2006), “*Conflict Resolution in the South Caucasus: The EU’s Role*”, Europe Report N°173 :Brussels, p.8

⁴⁸ COM(2003)104 final, Brussels,p.12

the EU's relationships with its neighbours will take into account the extent to which these values are effectively shared."⁴⁹

On the other hand, the Strategy Paper sets that "the Action Plans will contain a number of priorities intended to strengthen commitment to these values."⁵⁰ Indeed, the Action Plans, realized so far, established several actions to strengthen democracy, rule of law, human rights and fundamental freedoms. Of course, the actions are not uniform since we may distinguish three main groups of neighbour countries: those towards which the EU should promote the transition towards democracy (Palestinian Authority and Tunisia), those towards which the Union should encourage democratic consolidation (Ukraine, Moldova, Morocco and Jordan) and those towards which the EU should support the growing of democratic quality (only Israel).⁵¹

According to the official documents, it is possible to affirm that the EU wishes to realize a strategy of promotion of "common values". However, more uncertain issue is whether it will be effective or not. Studies related to the issue are not optimistic about the effect of the ENP on democracy and human rights.

Schimmelfennig, based on his and others' previous studies, argues that, whereas the promotion of democracy and human rights through political conditionality as intended in the ENP program documents has had a long tradition in EU external governance, the prospects for its success in ENP are bad. He sums up the reasons as: lack of the major external

⁴⁹ COM(2004) 373 final, p.13

⁵⁰ *ibid*, p.13

⁵¹ Elena Baracani (2004), "*The EU and Democracy Promotion: A Strategy of Democratization in the Framework of Neighbourhood Policy ?*", in Fulvio Attina and Rosa Rossi eds., "European Neighbourhood Policy: Political, Economic and Social Issues", Catania: The Jean Monnet Centre "Euro med", p.54

incentives, in the absence of membership perspective for ENP countries; inconsistency of political conditionality due to conflicting goals; authoritarian and autocratic regimes in ENP, which means high domestic adaptation costs.⁵²

Kelley too mentions about the inconsistency of political conditionality under ENP, and points the requirement of significant adjustments in the absence of the membership incentives. Moreover, she considers the challenges to the ENP as: significantly lower starting points for the ENP countries in terms of common values; credibility problem, connected to previous ineffective efforts and poorly implemented political conditionality.⁵³

2.5.3. Economic Propositions

On the economic field, the ENP offerings to neighbourhood countries are: enhanced preferential trade relations, a stake in the EU internal market, the progressive participation in a number of EU policies and programmes (such as research and education), and increased sectoral cooperation (energy, transport, telecommunication, environment...etc), as well as increased financial and technical assistance.

⁵² Frank Schimmelfennig (2005), “*European Neighborhood Policy: Political Conditionality and its Impact on Democracy in Non-Candidate Neighboring Countries*”, Paper prepared for the EUSA Ninth Biennial International Conference, Austin, March 31-April 2 2005, http://aei.pitt.edu/3302/02/European_Neighborhood_Policy.doc (30/03/2005)

⁵³ Judith Kelley (2006), “New Wine in Old Wineskins: Policy Adaptation in the European Neighborhood Policy”, *Journal of Common Market Studies (JCMS)*, Volume 44. Number 1, pp 50-51

The preferential trade relations are not new instrument of the EU foreign policy. The South Mediterranean Countries already have preferential trade policy with the EU and the Barcelona agreement provides for the completion of a free trade area (FTA) by 2010. By contrast, the WNIS do not benefit such preferential trade policy. Hence, enhanced trade preferences, which could lead in the medium run to FTAs in some cases, is particularly relevant for the EU eastern neighbours. However, Mediterranean countries are also set to benefit from improved market access to the EU if trade in agriculture is included in existing FTAs and accompanied with the reduction of EU agricultural export subsidies. In addition, the liberalization of trade in services has the potential to yield considerable economic benefits for all neighbouring countries.

The potential of “a stake in the EU Internal Market” for the neighbouring countries is the most novel⁵⁴ and considerable aspect of the ENP. The term “stake” has not been clearly defined in any official text, but is understood to refer to a substantial reduction of tariff and non-tariff barriers across many dimensions of the Internal Market.⁵⁵ This prospect is potentially far-reaching, since it is subject to progress in legislative and regulatory convergence towards the *acquis communautaire*.

The basic principle of the Internal Market is that, goods, services capital and persons move freely without controls at the borders because all participating countries of the market have the same system and the similar rules. However, the EU seems like cautious about the

⁵⁴ The possibility for non-EU members to participate in the EU internal market is, in itself, not new. Three out of four members of EFTA, Norway, Iceland and Liechtenstein, have participated in the internal market via the European Economic Area (EEA) since 1994.

⁵⁵ Michaela Dodini & Marco Fantini (2006), “The EU Neighbourhood Policy: Implications for Economic Growth and Stability”, *Journal of Common Market Studies*, volume 44, N 3, p. 511

“four freedoms”. Indeed, there are no direct references to the “four freedoms” in the Strategy Paper, as there were in the Wider Europe Communication.

Implementation of the Action Plans and the achievement of their priorities will be supported by increased and enhanced financial and technical assistance through a single and dedicated instrument (ENPI) from 2007. As mentioned before, the ENPI offers more financial resources than current allocations for financial assistance to the neighbourhood. The funding available for the ENPI during the budget period 2007-2013 will be just under 12 billion Euro , which means an increase of 32 per cent in real terms above the amounts available for the period 2000-2006.⁵⁶ The ENPI should also bring about efficiency gains by replacing existing separate budgeted lines. It is also hoped that the aid and finance provided by the ENPI will be more effectively disbursed than previously given that it can be more clearly targeted to achieving the objectives of the country-specific Action Plans. Another innovation is ENPI’s focus on cross-border cooperation through joint programs bringing together regions of member states and partner countries sharing a common land or a maritime border.⁵⁷

The ENPI also envisages extending forms of technical assistance to the partner countries such as Technical Assistance and Information Exchange (TAIEX), long- term twinning arrangements with EU Member States’ administrations (national, regional or local), as well as participation in Community programmes and agencies.

⁵⁶ In addition, TACIS beneficiaries Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan will be covered by the Development Co-operation and Economic Co-operation Instrument.

⁵⁷ Rutger Wissels (2006), “The Development of the European Neighbourhood Policy”, *Foreign Policy In Dialogue*, volume 6, number 19,p.11

Enhancing energy partnership between EU and neighbouring countries is a major element of the European Neighbourhood Policy. The first specific document related the energy in the ENP is the Communication “On the Development of Energy Policy for the Enlarged European Union, its Neighbours and Partner Countries”, which objectives were to:

- Enhance security of energy supply
- Strengthen the internal energy market
- Support energy system in partner countries
- Facilitate new energy infrastructure projects⁵⁸

The ENP Strategy Paper also reflects the EU priorities related to the energy. This is not coincidence that the European Union is the world’s largest energy (oil and gas) importer and the second largest consumer and is surrounded by the world’s most important reserves of oil and natural gas (Russia, the Caspian basin, the Middle East and North Africa). It will increasingly depend on imports, from its current level of 50% to 70% by 2030, on present projections.⁵⁹ At the same time, many countries seek improved access to the EU energy market, either as current or future suppliers (for instance, Russia, Algeria, Egypt, Libya and Azerbaijan) or as transit countries (Ukraine, Belarus, Morocco, Tunisia, Georgia and Azerbaijan). Improving energy network connections between the EU and its partners, as well as legal and regulatory convergence, are thus strong mutual interests.

⁵⁸ Commission of the European Communities (2003), *Communication on the Development of Energy Policy for the Enlarged European Union, its Neighbours and Partner Countries*, COM(2003) 262 final, p.4 http://eur-lex.europa.eu/LexUriServ/site/en/com/2003/com2003_0262en01.pdf

⁵⁹ COM(2004) 373 final, p.17

The Energy Section of the Strategy clearly puts the EU's energy security up front: *Neighbouring countries play a vital role in the security of the EU's energy supply.*⁶⁰ But it also proposes that the

*“Action Plans will contain concrete steps to increase energy dialogue and co-operation, and to foster further gradual convergence of energy policies and the legal and regulatory environment. This will include policies to promote increased energy efficiency and energy savings, as well as the use of renewable energy and co-operation in energy technologies, such as clean coal”*⁶¹

The transport and telecommunication networks also play a key role in promoting the commercial and economic integration at the regional level. The Action Plans will aim at developing and interconnecting the networks at the pan-European level, improving the transport system efficacy and safety, as well as the legislative harmonization.

Moreover, the partner countries will have the opportunity to participate in certain Community programmes. Some of the countries have already identified areas in which they want to be involved. Israel, Morocco, Ukraine and Tunisia, for instance, are involved in the European Global Navigation Satellite System (Galileo). Almost all partners have indicated interest in the EU's education and research networks (as TEMPUS, YOUTH, CORDIS).

⁶⁰ *ibid*,17

⁶¹ *ibid*,18

III. EUROPEAN UNION-AZERBAIJAN RELATIONS

Azerbaijan holds a strategic location between the European Union and Central Asia. This fact, together with the rich energy supplies of Azerbaijan, explains strong interests of the European Union member states in developing political and economic relationships with Azerbaijan.

In the initial years following Azerbaijan's independence, EU-Azerbaijan relations focused on dealing with the difficult humanitarian situation resulting from the break-up of the Soviet Union, the Nagorno-Karabakh conflict with Armenia and the unstable domestic situation. Some steps were also taken to lay the foundations for the transition to democracy and a market economy.

In 1996 the EU and Azerbaijan signed the Partnership and Cooperation Agreement (PCA), which is a typical agreement that the EU offered to the CIS and Mongolia.⁶² The entry into force of the PCA on 22 June 1999 Luxembourg Summit, marked an important stage in EU-Azerbaijan relations. To understand the extent of relations between Azerbaijan and the EU, one needs detailed examination of the PCA.

⁶² PCAs are based on respecting the democratic principles and the human rights and set the legal frame for the economic, political and commercial relations between the EU and the partner countries.

3.1. The Partnership and Cooperation Agreement (PCA)

3.1.1. Objectives

The Partnership and Cooperation Agreement (PCA) is a contractual basis of the relations between Azerbaijan and the EU. It is concluded with the aims of (i) providing a framework for a political dialogue, (ii) supporting the consolidation of Azerbaijan's democracy, the development of its economy and the completion of its transition to a market economy, (iii) promoting trade, investment, economic relations and development, (iv) providing a basis for cooperation and technical assistance in a variety of fields – legislative, economic and cultural and fostering democracy and human rights.⁶³

3.1.2. Content of the PCA

The PCA is a complex document covering almost all areas of relations and cooperation except defense. Valid for a period of ten years the document sets some of the elements as:

- Elimination of trade quotas and provision of most favored nation treatment (MFN)
- Intellectual, industrial and commercial property protection
- On investment: provision of MFN or national treatment to companies and freedom of capital movement
- Yearly political dialogue at ministerial, parliamentary and/or senior official levels

⁶³ EU-Azerbaijan “Partnership and Cooperation Agreement (PCA)”, p.5,web http://ec.europa.eu/comm/external_relations/ceeca/pca/pca_azerbaijan.pdf (10/8/2005)

- Financial cooperation in technical assistance
- Economic cooperation aimed at contributing to the process of economic reform and recovery and sustainable development of Azerbaijan.
- Cooperation on democracy and human rights ...etc⁶⁴

3.1.3. PCA Institutions

According to the provisions of the PCA, three institutions have been established between Azerbaijan and the EU. *The Cooperation Council* is the highest joint EU-Azerbaijan body supervising the implementation of the PCA and is empowered to take the action needed to attain its objectives. It is composed of members of the government of Azerbaijan and of the Council of the European Union and of the European Commission and meets once a year⁶⁵, rotationally presided by the Parties.

The Cooperation Committee prepares the meetings of the Cooperation Council, monitors the implementation of its recommendations, where appropriate, and in general ensures the functioning of the partnership and the agreement in general. The Cooperation Committee is composed of senior civil servants of the Azeri government and of the EU Council and EC Commission. Discussion regarding trade and investment take place in a special sub-committee.

The Parliamentary Cooperation Committee consists of members of the National Assembly of Azerbaijan and the European Parliament and is the forum for dialogue between members of the two bodies.

⁶⁴ Azerbaijan PCA, p.p.7-60

⁶⁵ To date, six EU-Azerbaijan Cooperation Councils have been held, began in October 1999 and the latest in Brussels in September 2004.

3.2. EU-Azerbaijan Political Dialogue

Based on the provisions of the PCA , regular political dialogue between EU and Azerbaijan are performed through the institutions mentioned above. Even before the institutions, the EU had special delegation for the Caucasus. Due to funding constraints and the political challenges of working on Armenia from Azerbaijan and vice versa, the EU in 1998 chose Tbilisi as the most practical location for its first Delegation of the European Commission in the region. Azerbaijani authorities did not want a Delegation Branch Office in Baku, like the similar facility opened in Yerevan in November 1999, and they demanded a full delegation.⁶⁶

Lack of opening a Commission Delegation in Baku, the European Commission decided in 1998 to appoint a Special Envoy to the Republic of Azerbaijan. Nevertheless, the Commission plans to open a Delegation in Baku in 2007.⁶⁷ Moreover, the Commission established the Europe House in Baku. The Europe House became operational September 2002 since that time provided technical support to the Commission in the areas generally related to the TACIS programme.⁶⁸

At the General Affairs Council of February 2001, the EU confirmed its willingness to play a more active political role in the South Caucasus region.⁶⁹ As manifestation of this

⁶⁶ International Crisis Group (2006), *ibid*, p.4

⁶⁷ Commissioner Benita Ferrero-Waldner made this pledge in a 16 June 2005 letter to Foreign Minister Elmar Mammadyarov, "EC Delegation to open in Baku in 2007", Press Centre of the Ministry of Foreign Affairs of Azerbaijan, http://www.mfa.gov.az/eng/news/mfa_press_releases/2005/050.shtm (23/11/2005),

⁶⁸ "Avropa İttifaqı-Azərbaycan", A Newsletter Published by the Europa House, Implementation and Management Support Office in Azerbaijan, May 2005.

⁶⁹ Commission of the European Union, (2005), "Annex to European Neighbourhood Policy, Country Report, Azerbaijan", Commission Staff Working Paper, SEC(2005) 286/3:Brussels,p.3

“willingness”, in July 2003, the Council decided to appoint the first EU Special Representative (EUSR) for the Southern Caucasus.⁷⁰

The Council decision of 14 June 2004 to include Azerbaijan (together with Armenia and Georgia) in the European Neighbourhood Policy marked a significant step forward in the relations between the Union and Azerbaijan, which will be handled detailed in the next part of the study.

3.3. Azerbaijan-EU Economic Relations

3.3.1. Trade

Azerbaijan has close relations with the EU. Through the PCA, which also eliminates trade quotas and provides for the protection of intellectual, industrial and commercial property rights, the parties have accorded each other Most Favoured Nation (MFN) treatment and Azerbaijan benefits from the EU’s Generalized System of Preferences (GSP). Trade, Investment and related legal issues sub-committee of The Cooperation Committee too has significant role in enhancing trade relations among parties.

The EU is the main trading partner for the Azerbaijan, since over half of Azerbaijan’s trade is with the EU (see Table 3.1). According to the Table, Azerbaijan imports from the EU have increased steadily since 2001, with annual average increases of some 50%. Exports,

⁷⁰ The first EU Special Representative for the South Caucasus, Finnish diplomat Heikki Talvitie, was appointed on 7 July 2003 He was replaced by Swedish diplomat Peter Semneby as of 1 March 2006.

however, have remained essentially stable, with small decreases up to 2005. In 2005, a significant increase was realized, which was probably related to energy. Indeed, exports primarily relates to cotton, oil and gas. However, some studies suggest that even in Azerbaijan, foodstuffs, cotton, and textiles could play a large role in the country's export basket.⁷¹

Table 3.1
Azerbaijan, Trade with the European Union (2001-2005, mio €)

Year	Imports	Yearly % Change	EU share	Exports	Yearly % Change	EU share	Balance	Imports + Exports	EU share
2001	329		20.61	1 814		70.18	1 485	2 143	51,26
2002	431	30.8	24.48	1 593	-12.1	69.53	1 163	2 024	49,90
2003	866	101.1	33.99	1 194	-25.1	72.48	328	2 059	49,11
2004	1 370	58.3	40.19	1 077	-9.8	56.46	-294	2 447	46,02
2005	1 646	20.1	41.17	2 162	100.8	72.30	515	3 808	54,49

Source: http://www.azstat.org/statinfo/external_economic_activities/en/index.shtml (12/08/2006)

However, Azerbaijan is only the 59th EU trade partner with 0.2% trade share⁷². Energy products (oil and gas) completely dominate EU imports from Azerbaijan, with a share of 93.8% in 2005. (See Table 3.2) Other notable imports include agricultural products (especially cotton), textiles and some chemicals. Trade in textiles between EU and Azerbaijan is not covered by the PCA, but was covered until the end of 2004 (when the multi-fibre agreement terminated) by a bilateral agreement according to which no quantitative restrictions

⁷¹ Centre for Economic Reforms, (2004). “*Study of Azerbaijan’s Current and Potential Comparative Advantages*”, Baku.

⁷² Retrieved from the Commission’s external trade website http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_113347.pdf (25/09/2006)

should be applied. Exports to Azerbaijan are significantly more diversified, yet with machinery and equipment taking the lion's share (in 2005, 60% of total, or € 900 million).

Table 3.2
European Union, Trade with Azerbaijan (by Product Groups, mio €)

	Import						Export					
	2001	%	2003	%	2005	%	2001	%	2003	%	2005	%
Agricultural	17	1,3	17	1,3	63	2,6	43	10,8	46	5,8	81	5,4
Energy	1254	96,1	1240	95,4	2246	93,8	4	1	8	1	7	0,5
Machinery	7	0,6	10	0,8	17	0,7	120	30,2	311	39,6	557	37,5
Transport equip.	8	0,6		0	1	0	27	6,9	49	6,2	342	23
chemicals	4	0,3	12	0,9	9	0,4	45	11,4	66	8,4	105	7,1
Textiles and clothing	1	0,1	2	0,1		0	14	3,5	19	2,4	27	1,8
total	1305		1301		2395		396		786		1487	

Source: http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_113347.pdf (25/7/2006)

3.3.2. Energy

Azerbaijan is a strategic player in Caspian energy (oil and gas) politics, both as a producer and as a transit country. At the same time, the EU is the second largest energy consumer in the world and the greatest energy importer and its dependence for energy is constantly increasing.⁷³ Hence the EU gives great importance to dialogue with the suppliers and the countries on the transportation routes. Consequently, today's EU-Azerbaijan dialogue is "much more focused and cooperation has been strengthened notably in the energy and

⁷³ Commission of the European Union (2001), "Towards a European Strategy for the Security of Energy Supply", Green Paper, http://europa.eu.int/comm/energy_transport/doc-principal/pubfinal_en.pdf (12/10/2005)

transport sectors”.⁷⁴ The creation of the new sub committee on Energy and Transport in February 2005 was a confirmation of the importance paid by both the EU and Azerbaijan to such strategy issues.

A dialogue on energy matters has started under the Partnership and Cooperation Agreement. The PCA states that the cooperation should include:⁷⁵

- formulation and development of energy policy,
- improvement in management and regulation of the energy sector
- improvement of energy supply, including security of supply
- promotion of energy saving and energy efficiency
- modernization of energy infrastructures,
- Improvement of energy technologies in supply and end use across the range of energy types.

In the early years, TACIS concentrated on assisting the development and modernization of the energy sector and supported the Ministry of Fuel and Energy. The recent Indicative Programme (The NIP for 2004-2006) does not include assistance for the energy sector. Nevertheless, the regional dimension of energy is reflected in the work carried out under the INOGATE (cross border energy initiative funded by TACIS) programme. The INOGATE programme aims to promote regional integration of the oil and gas pipeline

⁷⁴Commission of the European Union (2005), “European Neighbourhood Policy, Recommendations for Armenia, Azerbaijan, Georgia and for Egypt and Lebanon”, COM(2005) 72 final:Brussels,p.4

⁷⁵ Azerbaijan PCA, p.p. 33-34

systems and opens up new perspectives for Azerbaijan⁷⁶ as well as other newly-independent states to implement trans-boundary projects and acts as a catalyst for attracting investment from international financial institutions and private investment funds. Under INOGATE, the EU has supported the feasibility studies of ways to export from Shah Deniz and contributed to development of a pipeline from Azeri port of Baku to the Georgian port of Supsa.⁷⁷ Furthermore, INOGATE has supported the construction of the Shirvanovka and Kazakh gas metering systems in Azerbaijan with the €2 million budget.⁷⁸

3.3.3. Transport

Another significant cooperation field between Azerbaijan and EU is transportation, which is also generally related to the oil and gas. EU's contribution to Azerbaijani transport sector is undeniable since establishment of the Ministry of Transport funded by the TACIS, intends building legal and regulatory framework for the transport sector. A high-level dialogue on transport aims the development of a regional energy and transport market and its progressive integration with the EU market. In this context, development of the TRACECA (Transport corridor Europe - Caucasus - Asia trade) route is noteworthy, because it provides enhanced trade relations as well as modernization of major routes of common interest and the trans-European links.

⁷⁶ Officially it joined the INOGATE Programme on 22 July 1999 during the Kiev INOGATE Summit when the Prime Minister of Azerbaijan Republic Mr. Artur Rasi-Zade signed the Umbrella Agreement

⁷⁷ Sanem Özer (2006), "*A Common Foreign and Security Policy Towards the Caucasus: with Special Reference to some EU Member States*", Doctorate Thesis, Marmara University, European Union Institute: Istanbul , p.145

⁷⁸ INOGATE Brochure 2001-2004 (2004) <http://www.inogate.org/inogate/en/resources/publications>, (21/09/2006)

The TRACECA programme was launched at a conference in Brussels in May 1993, where it was agreed to implement a programme of EU funded technical assistance to develop transport corridor on a west - east axis from Europe, across the Black Sea, through the Caucasus and the Caspian Sea to Central Asia. Azerbaijan is the EU's most important contributor of the TRACECA trade route due to its strategic location between EU and Central Asia. To date the more than 40 projects have been realized by TRACECA programmes in Azerbaijan.⁷⁹

3.4. EU and the Nagorno - Karabakh Conflict

The Nagorno-Karabakh was an autonomous region of the Azerbaijan SSR between 1923 and 1991. The conflict emerged at the end of the Soviet era, when, in February 1988, the Karabakh region, mainly populated by Armenians⁸⁰, declared its desire to separate from Azerbaijan SSR and join to Armenia SSR. After the collapse of the USSR and the Azerbaijani declaration of independence, an undeclared war broken out between Azerbaijan and Armenia.

In May 1994, a ceasefire agreement signed between the parties. As consequence of the war, Azerbaijan lost 20 percent of its territory. The territory includes the Nagorno-Karabakh Autonomous Province, as well as its surrounding regions of Lachin, Kelbajar, Agdam, Fuzuli, Jebrail, Qubatli and Zengilan. Moreover, almost one million Azerbaijanis became internally

⁷⁹ Нурлан Алиев, (2005), "Азербайджан-Европейский Союз: Состояние и анализ Экономического Сотрудничества", *Diplomatiya Aləmi Jurnalı*, N:10, january-march 2005, p.150

⁸⁰ At the moment when the conflict started, 185,000 people were living in Nagorno-Karabakh. 73 percent were Armenians and 27 percent were Azerbaijanians.
Rza Ibadov,(2005), "Azerbaijan and the European Union Neighbourhood Policy: Building a Privileged Relationship", London: Larko Publishing House, p. 62

displaced persons (IDPs), 30000 Azerbaijanians died, 200000 were wounded, and thousands are missing.⁸¹

Since 1992, the conflict resolution process is held under the auspices of the Minsk Group⁸² of the Organization for Security and Cooperation in Europe (OSCE), chaired by representatives from Russia, the United States and France. Despite the advances made in negotiations under the Minsk Group, the reality is that a resolution to the conflict is still invisible.

Although the EU “accords very high priority to measures which can underpin a peace settlement”⁸³, it has not been active in and around Nagorno-Karabakh since the end of active warfare and its unofficial policy has been to wait for a settlement. Brussels is much more comfortable in providing aid and supporting the work of OSCE Minsk Group than engaging by itself directly in settlement. This is partly because of the contradiction hidden under the nature of the ‘conflict settlement’ logic. More precisely, EU has to act dual, as it is interested in Azerbaijani energy supplies on the one hand, face Armenian Diasporas especially in France on the other hand. Hence, it supports territorial integrity of Azerbaijan⁸⁴, yet does not recognize Armenia as the aggressor in the conflict.⁸⁵

⁸¹ Arif Yunusov,(2005), “*Karabakh. Past & Present*”, Baku : Yeni Nesil Publishing House,p.17

⁸² The establishment of the Minsk Group realized on 22 Mart 1992, when Council of the Ministers of the CSCE (Conference on Security and Cooperation in Europe, at present OSCE) decided to hold the Minsk Conference aimed at reaching a comprehensive peaceful settlement of the conflict.

⁸³ Commission of the European Union (2003), *TACIS National Indicative Programme for Azerbaijan 2004-2006*, 22 May 2003. Brussels, p.4, http://ec.europa.eu/comm/external_relations/azerbaidjan/csp/04_06.pdf (10/12/2005)

⁸⁴ Gülgöz Əliyeva (2004), “Azərbaycan Respublikasının Avropa İttifaqı ilə Münasibətləri Haqqında”, *Diplomatiya Aləmi Jurnalı*, N:8 ,p. 106

⁸⁵ “Heikki Talvitie: EU to prepare report on South Caucasus countries”, “AzerNews” Newspaper, 11 November 2004

Nevertheless, the EU undeniably interested in the settlement of the Conflict, since peace between Armenia and Azerbaijan would have an enormous impact on stability and security in the whole South Caucasus and contribute to improving the lives of the people of the region. The appointment of the EU Special Representative to Southern Caucasus (EUSR), which one of the tasks is “assisting the conflict settlement mechanisms in the region”, may be considered in this context.

3.5. EU as a Financial Actor

3.5.1. TACIS

The main technical assistance instrument for Azerbaijan as well as for, other post - Soviet countries,⁸⁶ is the TACIS Programme. The EU supports the economic reforms in Azerbaijan by transfer of relevant technical assistance and expertise through TACIS program. In the framework of the Country Strategy Paper for Azerbaijan (2002-2006), the TACIS National Indicative Programme (NIP) 2004-2006 focuses, in the overall context of poverty reduction, on support for institutional, legal and administrative reform, support for the private sector and assistance for economic development.

⁸⁶ TACIS (Technical Assistance to the Commonwealth of Independent States) program was established in 1991 with the purpose to provide technical assistance to the 12 countries of the former Soviet Union and Mongolia. Every three or four years an indicative programme is established to set up the overall objectives and structure to TACIS support.

Table 3.3

TACIS-Priorities for Azerbaijan (1998-2006)

TACIS Priorities	1998/99	2000/01	2002/03	2004/06
Institutional, legal & administrative reform	PCA	PCA	PCA	PCA
	Ministry of Transport	Ministry of Transport		
	Ministry of Fuel and Energy	Ministry of Fuel and Energy	Ministry of Fuel and Energy	
		Pay policy reform		
		Cabinet of Ministers reform		
	Social targeting of assistance			Social targeting of assistance
				Border guards and anti people traffic
	Customs	Customs	Customs	Customs
	Statistics	Statistics	Statistics	Statistics
				Ministry of Ecology
				Institution Building partnership incl. Civil society
Private sector & assistance for economic development.	SME Development	SME Development	SME Development	SME Development
	Rural Credit	Rural Credit		
			Ministry of Tax	Ministry of Tax
		Securities market		
		International accounting standards		International accounting standards
				Vocational training strategy
		MTP Tempus	MTP Tempus	MTP Tempus
TACIS Total	€ 16.0 m	€ 14.0m	€ 14.0m	€30.0m

Source: http://ec.europa.eu/comm/external_relations/azerbaidjan/intro/index.htm (22/02/2006)

In particular, the cooperation programme includes support for the implementation of the PCA, modernization of public finance and tax systems, social protection, as well as improvement of the judiciary and border management. For private sector development, assistance is targeted at improving the investment climate, at SMEs and regional development, as well as strengthening of higher general and technical education and

vocational training (See Table 3.3). The NIP 2004-2006 envisages a total contribution of €30 million. Out of €30 million, total budget allocation to the legal and administrative reforms is approximately € 17 m.

Azerbaijan also benefits from the TACIS Regional Programmes such as TRACECA and INOGATE.

3.5.2. Food Security Programme

The European Commission Food Security Programme aims at tackling the causes of food insecurity related to economic recovery. The Programme in Azerbaijan started in 1996 and implemented through the national budget since 1997. Initially the FSP was in the form of food aid, over the period of assistance there has been a shift to structural assistance, in the form of foreign currency facility with the counter-value funds being ascribed to the national budget.⁸⁷

Since 1996, the Commission has committed to the Republic of Azerbaijan over € 77 million within the FSP framework. Among the beneficiaries are the Ministry of Agriculture, the State Land and Cartography Committee, the Ministry of Labour and Social Protection, the State Social Protection Fund, the orphanage department of the Ministry of Education and the

⁸⁷ Commission of the European Union (2001) , “Country Strategy Paper 2002-2006 and National Indicative Programme 2002-2003 for Azerbaijan”, 27 December 2001, Brussels.p.13,http://ec.europa.eu/comm/external_relations/azerbaidjan/csp/02_06_en.pdf (10/12/2005)

State Statistics Committee⁸⁸. Recently, the primary areas are Social Protection and Pension, as well as rural development and Agriculture.

3.5.3. Other Programmes

In addition to the TACIS and the FSP, the Humanitarian Aid Office (ECHO), as well as other programmes, provided most needed assistance in a very difficult period (See Table 3.2). In 1997, as an extension to the ECHO programme, the European Union made available approximately 18 million euro under the Rehabilitation programme (REHAB) for the rehabilitation of the war-damaged infrastructure of the regions Fizuli, Agdam and Agjabedi following the Nagorno-Karabakh conflict. The Rehabilitation programme focuses on the rehabilitation of electricity Networks and power stations, water supply systems, irrigation systems, railways, roads and social infrastructure such as schools, houses and community centers in these war-affected regions.

Table 3.4
Total EC Grants to Azerbaijan since 1992 (does not include TACIS Regional Programmes, million €)

	1992 1994	1995	1996	1997	1998	1999	2000	2001	2002 2003	2004 2006	<i>Total</i>
TACIS	20,5	6	8	8	8	8	7	7	14	30	116,5
ECHO	31,1			28,82	9,69	6,1	9,66	5,15	1,57		92,09
FSP			15	16	14	12			20		77
EXAP					10	10	10				30
REHAB			3	4	4,5	3,2	3,67				18,37
FEOGA		43	22,7								65,7
EHA		8						1,5			9,5
<i>Total</i>	51,6	57	48,7	56,82	46,19	39,3	30,33	13,65	35,57	30	409,16

Source: www.europahouse-az.org (22/07/2006)

⁸⁸ "Avropa İttifaqı-Azərbaycan", (2005), A Bulletin Published by the Europa House, Implementation and Management Support Office in Azerbaijan.

Moreover, by The Exceptional Assistance Programme (EXAP), the European Union made available 30 million euro for Exceptional Assistance to Azerbaijan to improve the living conditions of the people. The EU and the government of Azerbaijan agreed to use the funds for several capital investment projects. The Exceptional Assistance Programme (EXAP) is being implemented by Agency for Rehabilitation and Reconstruction of Areas (ARRA) and has finalized or is working on an impressive list of projects. Examples include the Isotope, for storage of radioactive material, the newly finalized Baku Underground station Hazi Aslanov, the HIV/AIDS prevention project, flood protection measures in the regions of Gabala, Sheki and Zakatala as well as the Tuberculosis treatment unit of the Bina prison.⁸⁹

⁸⁹"*European Union and Azerbaijan Partnership and Cooperation*" (2003), A publication of the Europa House, Implementation and Management Support Office in Azerbaijan, http://www.europahouse-az.org/publications/eh/NL/EHNewsletter_en.pdf (12/12/2005)

IV. THE ENP TOWARDS AZERBAIJAN

The “big bang” enlargement brought the EU closer to the South Caucasus. Geographic proximity, energy resources, pipelines and the challenges of international crime and trafficking make stability in the region a clear EU interest. Even at these conditions, the regional countries were excluded from the European Neighbourhood Policy the EU announced in early 2003. However, the Report of the European Parliament on the Commission proposal on “Wider Europe” and the European Security Strategy adopted by the European Council of December 2003 motivated the Commission to take further action towards inclusion of the region in ENP. The European Parliament called on the Commission and Council to develop a special policy within the framework of the “Wider Europe-Neighbourhood Policy” for the countries of the Southern Caucasus, according particular importance to conflict prevention”⁹⁰ and the European Security Strategy, clearly identified importance of the South Caucasus as :

“We should now take a stronger and more active interest in the problems of the South Caucasus which will in due course also be a neighbouring region”⁹¹

Moreover, the Parliament Resolution as of 26 February 2004 played an important part because it recommended that the area get a “final status within the neighbourhood policy, according to the principle of avoiding new dividing lines in Europe, both to stimulate the

⁹⁰ European Parliament “*Report on the ‘Wider Europe-Neighbourhood: A New Framework for Relations with our Eastern and Southern Neighbors,*”p.8

⁹¹ “*European Security Strategy: A Secure Europe in a Better World*”, p. 8

region countries to develop by adopting the economic and political reforms, and to answer the EU interest to increase its political role in the region and in solving conflicts”⁹²

Consequently, the European Commission, by taking account of the views expressed by the European Parliament, mentioned in the Strategy Paper the possibility to extend the policy to the Southern Caucasus states. In June 2004, Azerbaijan (together with Armenia and Georgia) was included in the European Neighbourhood Policy, following the General Affairs and External Relations Council of 14 June 2004, which had determined the inclusion in ENP of Caucasus Countries.

4.1. Action Plan

The first step towards implementing the ENP in the Azerbaijan took on 2 March 2005, by publishing the Country Report. On the same they, the Commission recommended the development of an Action Plan with the objectives of⁹³:

“strengthening the rule of law, democratic structures and pluralism (improved institutional division of powers, reform of local self government) and strengthening of electoral legislation and processes so as to enhance democratic election standards; implementation of effective reform in field of rule of law (judiciary, law enforcement agencies); enhanced protection of human rights and of freedom and independence of the media; increased efforts towards a balanced development of the overall economic system;

⁹² The European Parliament Resolution no. 2003/2225(INI), p. 5.
<http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+TA+P5-TA-2004-0122+0+DOC+PDF+V0//EN&language=EN> (25/09/2006)

⁹³ “European Neighbourhood Policy, Recommendations for Armenia, Azerbaijan, Georgia and for Egypt and Lebanon”, p.4

improvements in the business climate as well as public sector modernization; reform of tax and customs administrations and legislation in line with international and EU standards; effective combating of corruption and fraud; increased transparency in the management of oil revenues and in the privatization process; progress in poverty reduction; sustainable development and environmental protection; WTO accession; progress in conflict resolution and enhanced regional cooperation.”

However, the “Cyprus problem” blocked process just after starting. The problem broke out due to a commercial flight between Baku and northern Cyprus by the private Azerbaijani Imair airlines on 27 July 2005. Cyprus considered this an infringement of its national sovereignty and caused the EU to suspend Azerbaijan’s Cooperation Committee meeting in fall 2005. Nevertheless, after a delay the process restarted in following month.⁹⁴ Azerbaijan did not submit a “framework proposal”. It received a draft Action Plan prepared by the Commission in August 2005 and commented in October and November⁹⁵. On 12 December 2005 the official start of discussions of the Action Plan between Azerbaijan and EU within the European Neighbourhood Policy was launched. On the Commission’s insistence, the Action Plan set “strengthening of democracy, human rights protection, and rule of law”, including constitutional reform to provide for genuine separation of powers, as key priorities. It also prioritise “enhancement in the field of Justice, Freedom and Security”, including border management. Surprisingly, Azerbaijan did not insist that Nagorno-Karabakh resolution be a top priority.⁹⁶

⁹⁴ It should be noted that Cyprus was against continuation of the negotiations. However, after the representatives of Ministry of Foreign Affairs of Cyprus visited Azerbaijan, Cyprus withdrew its demand and negotiations continued. See “Azerbaijan and EU start dialogue on New Neighborhood program”, *Today.Az*, 13 December 2005, <http://www.today.az/news/politics/21749.html> (20/09/2006)

⁹⁵ International Crisis Group (2006), *ibid*, p.9

⁹⁶ *ibid*, pp 11-12

The second round of the negotiations took place in Brussels on 7 March 2006. However the parties failed to agree upon approval of a joint Action Plan. Azerbaijani officials declared that “the parties decided to continue the discussions due to the failure to reach agreement on some issues,”⁹⁷ but did not clarify the specific issues that the parties failed to agree upon. Even the third round of the negotiations which held on 17 July could not solve the problems; two issues remained unresolved.⁹⁸ Although EU pressure for rapid conclusion of the process Azerbaijani side insisted on its interests. Azerbaijani analysts understand their country’s policy as one that is balanced between the EU and Russia.⁹⁹

At last, the EU solved the problem by “stick” method; either the Action Plan should be accepted or the inclusion of Azerbaijan to the policy will be reconsidered again.¹⁰⁰ Consequently, after the EU trio visit to Azerbaijan, Azerbaijan Foreign Minister declared on 3 October that all the issues regarding the ENP Action Plan had been agreed and would be signed in Brussels on November 14.¹⁰¹

So it is possible to mention that the negotiation harmed the “joined ownership” principle¹⁰² of the policy, which was explained in the Strategy Paper and was stressed as “the EU does not seek to impose priorities or conditions on its partners” or “there can be no

⁹⁷ “EU-Azerbaijan talks fruitless”, Today.Az , 10 March 2006, <http://www.today.az/news/politics/23999.html> (20/09/2006)

⁹⁸ “EU and Azerbaijan not Agreed on two Issues”, Today.Az , 19 July 2006, <http://www.today.az/news/politics/28273.html> (20/09/2006)

⁹⁹ Şahnaz Bəylərqızı, “AB payızadək «Yeni Qonşuluq Siyasəti» haqda sənədi imzalamaq istəyir”, 17 July 2006, <http://www.azadliq.org/Article/2006/07/17/20060717182014113.html> (20/09/2006)

¹⁰⁰ The idea stated by the European Union Special Representative for the South Caucasus, Peter Semneby, see “AB Bakıya Şərt Qoydu”, “Express” Newspaper , 15 September 2006,

¹⁰¹ “European New Neighborhood Policy Action Plan to be signed with Azerbaijan on November 14”, Today.Az , 3 October 2006, <http://www.today.az/news/politics/30979.html> (09/10/2006)

¹⁰² ‘Differentiation’ principle, which means relations tailored to each state according to its capacity as well as interest, is also under question. This became evident in late 2005 when disagreements between Azerbaijan and Cyprus resulted in the suspension of Action Plan talks for all three South Caucasus states. Armenia and Georgia discovered that progress on their documents was hostage to the spat between Baku and Nicosia

question of asking partners to accept a pre-determined set of priorities”¹⁰³. Hence, Azerbaijan stepped back from the “free trade area” (FTA) and “free movement of persons” requests¹⁰⁴ and had to appease from the Northern Cyprus policy.

There is difference of opinion among Azerbaijani analysts and official bodies related to the Action Plan. Some analysts consider the Plan as imperfect and criticize the neglected interests. They especially skeptical about the ambiguity of Nagorno-Karabakh issue under the policy. On the other hand, officials are optimistic. According to Deputy Foreign Minister, the Plan is sufficient and Nagorno-Karabakh has set as a priority. He also mentions the further possibility of FTA and free movement of persons in the following five year implementation period of the Action Plan.¹⁰⁵

4.2. PCA versus Action Plan

There are several similarities and differences among PCAs and Action Plans both in terms of methodology and rationale¹⁰⁶. First of all, it needs to be recognized that the ENP maintains the principal foundation of the earlier policies, which is similarly to exclude the perspective of future membership. The ENP is not, therefore, designed as a radically new policy and does not seek to replace but rather to reinforce the *acquis* of earlier policies and the institutions and policies set up by the PCAs. Hence Action Plans are not legal agreements: the PCAs remain the key frameworks defining bilateral relations.

¹⁰³ COM(2004) 373 final, Brussels, 12 May 2004, p. 8

¹⁰⁴ “AB Üçliyyə Bakıdan Əliboş Getmədi”, “Express” Newspaper, 4 October 2006

¹⁰⁵ “Express”, ibid

¹⁰⁶ Since Azerbaijan Action Plan has not been signed, this section will be evaluated in a general sense.

The ENP is, in an important sense, an attempt to reform the limits of the PCAs. Therefore, several features of the PCA method must be noted. First, PCAs reveal the heavily technocratic and non-political heart of the EU's approach to the concerned states.¹⁰⁷ These agreements are deeply focused on trade and economic questions. Secondly, the PCAs are essentially static, that offers little indication of progression in the relationship. The PCAs offer little in terms of market access to the states, providing no preferential treatment in trade. It simply concentrated in establishing a general linkage between democratization, cooperation and technical assistance, but not offers enough incentives for the countries to initiate reforms. Thirdly, the PCAs combined with the TACIS programme to categorize the Eastern neighbours under a 'CIS' heading, thus give them a regional dimension. The Eastern neighbours perceive this category as confining them to a "*black hole*" in terms of any possibility of eventual accession.¹⁰⁸

In the light of the limits of the PCA method explained above, there are two main aspects or innovations within the ENP, which can be said to provide "added value" to PCA. The first is the claim that the ENP offers a bigger prize to its partner countries which, while falling short of membership, is nevertheless attractive and substantial. The offer of a "stake in the EU's internal market" and further integration and liberalization to promote the free movement of persons, goods, services and capital represents the most concrete expression of this improved offer or prize.

Second, the ENP is packaged as an effort to apply the tools of the accession process, namely incentives, monitoring and conditionality (without the carrot of membership), to non-

¹⁰⁷ Dov Lynch, (2003), "*The New Eastern Dimension of the Enlarged EU*", in "Partners and Neighbours: A CFSP for a Wider Europe", Chaillot Papers N: 64, Paris: Institute for Security Studies, p.43

¹⁰⁸ *ibid*, p.44

member partnership countries. In fact, the conditionality has been present in the “essential elements” clauses in the PCAs,¹⁰⁹ as well as in the TACIS Regulation on financial and technical assistance but used in a more sporadic and ad hoc way.¹¹⁰ In addition, ENP proposes that it will be better resourced than the pre-ENP neighbourhood policies. The ENPI by a budget of EUR 12 billion for the period 2007-2013 represent a significant increase from the EUR8.5 billion allocated to TACIS.

Furthermore, the legal foundation envisaged for the ENP is more exclusive than for its predecessors. Relations with Azerbaijan as well as other ENP partners are based on the general provisions for the Common Foreign and Security Policy as laid down in Title V of the Treaty on European Union. In the Constitution for Europe, however, the neighboring states have been granted special mention: Art. I-57 explicitly addresses the “Union and its neighbours.”¹¹¹

4.3. ENP and the Nagorno-Karabakh Conflict

The primary focus of all Azeri politicians and the vast majority of its populations are the continued occupation of 20% of its territory by Armenia. Nagorno-Karabakh creates a barrier to reform, deters development, embarrasses decision-makers and will prevent both countries from fully utilising their potential for enjoying a close and rich partnership with the

¹⁰⁹ The PCA with Belarus, for example, has not been ratified by the EU or its Member States, and TACIS assistance has been very limited, because of concerns about standards of democracy

¹¹⁰ Marise Cremona (2004), *ibid.*p.6

¹¹¹ Andreas Marchetti (n.a) “*Widening without Enlarging .The European Neighbourhood Policy and the South Caucasus*”, http://www.esiweb.org/pdf/esi_turkey_tpq_id_63.pdf (20/8/2006)

EU. The Azeri society is disfigured by the problems created by the lack of a permanent and fair solution to the conflict. Each election, the mandate of every politician and the focus of the media and society of Azerbaijan, is first and foremost centered on the need for the conflict to be finally declared solved and the displaced people to return to their homes. Hence, the European Neighbourhood Policy is considered as a significant potential opportunity to find a method to bring about a solution to the conflict.

However there are sufficient evident to feel skeptical about the role of the Action Plans in settlement of the conflict. As mentioned before in this study, conflict resolution is not the central objective the ENP and the ENP is underdeveloped in this sense. Moreover, the EU seems to continue its indirect “supporter” role. EU’s past engagement in Nagorno-Karabakh conflict also strengthen the idea, since its policies has been oriented to “wait for settlement”. The EU avoids taking responsibility, thus limits itself only providing aid and supporting the work of OSCE Minsk Group.

The early 2006 versions of the Action Plan drafts would not strengthen the EU’s role in supporting resolution of the Nagorno-Karabakh conflict or commit the parties to reach a negotiated settlement¹¹². In drafting them, the Commission wanted to get Baku and Yerevan to agree to the same text, but only four specific actions are intended to “contribute to the peaceful solution of the conflict”: increased diplomatic efforts; continued support for a peaceful solution; and increased support for the OSCE Minsk Group negotiation process; and likewise for people-to-people contacts¹¹³. Other sections of the drafts refer to promoting

¹¹² International Crisis Group (2006),ibid, p.12

¹¹³ ibid, p.12

sustained efforts for peace, de-mining, aid for internally displaced persons (IDPs) and refugees, and promoting the active involvement of civil society.

The EU officials clearly state that “*the action plan is not a tool for the solution of Nagorno Karabakh conflict*”¹¹⁴. Nevertheless, Brussels believes that the ENP can contribute to conflict settlement “*through promoting democracy and regional cooperation, boosting national reform programmes and improving the socio-economic prospects of the region.*”¹¹⁵ Although the EU considers “regional cooperation” as a tool for conflict settlement and even calls “*economic integration in the South Caucasus a necessary condition for regional stability*”¹¹⁶, the idea does not sound reasonable, since Azerbaijan and Armenia approach differently to regional cooperation. Armenia wants regional cooperation as a means to break out of its isolation and agreed to the approach that “democratic reforms, strengthening institutional capacities, reconstruction of economies and building strong civil societies are conducive to conflict resolution”, while strongly rejecting the idea that implementation of the Action Plan could be made conditional on progress in conflict resolution.¹¹⁷ However, Azerbaijan officials are insistent that they cannot take part in “enhanced regional cooperation” until there is a lasting solution to this problem.

¹¹⁴ The idea expressed by Finland Foreign Minister as “The action plan is not a tool for the solution of Nagorno Karabakh conflict. We support OSCE Minsk Group activity on this problem.”, see “European New Neighborhood Policy Action Plan to be signed with Azerbaijan on November 14”, *Today.Az*, 3 October 2006, <http://www.today.az/news/politics/30979.html> (09/10/2006)

¹¹⁵ Benita Ferrero-Waldner (2006) “*Political reform and sustainable development in the South Caucasus: the EU’s approach*”, Speech at “Caspian Outlook 2008” Bled Strategic Forum, Slovenia, 28 August 2006 <http://europa.eu.int/rapid/pressReleasesAction.do?reference=SPEECH/06/477&format=HTML&aged=0&language=EN&guiLanguage=en> (29/09/2006)

¹¹⁶ It was expressed by Commissioner Ferrero-Waldner, during her visit to Armenia. See Anna Saghabalian, “*EU Signals More Attention to Political Reform in Armenia*”, RFE/RL, Armenialiberty, 17 February 2006, <http://www.armenialiberty.org/armeniareport/report/en/2006/02/84CE2183-237B-4641-92EE-899C68818D0B.as> (29/09/2006)

¹¹⁷ International Crisis Group (2006), *ibid*, p.12

Supporting democracy in Azerbaijan and Armenia, as well as *improving economies* of the countries also would not necessarily lead to greater prospects for conflict resolution. Democracy would be only effective in the long-run and may help future prevention of conflicts once peace sustained. In the case of thinking improvement of economies as a conflict settlement tool, it should be recognized that Azerbaijan considers its economic development as a power, either political or power, to get back its occupied territories.¹¹⁸

4.4. Probable Effects on Azerbaijani Democracy and Human Rights

The transition towards Azerbaijani democracy and greater emphasis on respect for human rights and fundamental freedoms began with independence in 1991, after 70 years of Soviet dictatorship. The Constitution of the Republic of Azerbaijan provides for freedom of thought and speech, conscience, association and assembly¹¹⁹. In addition, Azerbaijan has ratified all the major international human rights treaties, including the International Covenant on Civil and Political Rights, the Convention against Torture and Other Cruel, Inhuman or Degrading Treatment or Punishment, the Convention on the rights of the Child. After been acceded to the Council of Europe (CoE) in 2001, it also signed and ratified the European Convention on Human Rights and Fundamental Freedoms. However, despite of the positive steps taken so far, Azerbaijan still is characterized by “not-free” democratic status¹²⁰ (see also Table 4.1), and has long-standing human rights problems related to elections, torture and ill-

¹¹⁸ For example, Azerbaijan has boasted that its military budget in 2007 will be the size of the total budget of Armenia. see , “*EU Neighbours Drifting Into War, Brussels Warns*” , *Today.az*, 29 August 2006, <http://www.today.az/news/politics/29522.html>

¹¹⁹“*Azərbaycan Respublikasının Konstitusiyası*”(2002), “Qanun” Publishing House, Baku , ,Articles 47,48 and 49,p.15

¹²⁰ “*Freedom in the World 2006. Country Report :Azerbaijan*”,(2006).Freedom House Publication, <http://www.freedomhouse.org/template.cfm?page=22&year=2006&country=6915> (29/08/2006)

treatment, independence of judges and lawyers, media freedom, freedom of assembly, and civil society.¹²¹

Clearly, the European Neighbourhood Policy Action Plan provides the EU unique opportunity to strengthen incentives for change in Azerbaijan. The Action Plan draft envisages several steps towards strengthening of democracy, human rights protection, and rule of law, including constitutional reform to provide for genuine separation of powers, in particular, ratification and implementation of the Optional Protocol of the UN Convention against Torture, better implementation of its Law on Freedom of Information, developing an independent public broadcasting service...etc. However, realization of intended accomplishments in reforms is questionable, since there are several and serious obstacles to the ENP.

The first challenge of the policy is related to “*cost-benefit*” relation. The question is whether the incentives offered are sufficient to motivate Azerbaijan to take reforms or not. It is clear that, the ENP does not offer membership perspective, the “golden carrot”. Even Azerbaijani officials are skeptical about their chances for future membership. This situation, of course, lead lower interests in strengthening ties to Brussels. In addition, the incentive of “a stake in Internal Market” does not sound realistic, taking into consideration the exclusion of FTA interest of Azerbaijan from the Action Plan. The Action Plan also does not meet the expectations concerned with the settlement of Nagorno-Karabakh conflict. Hence, it is

¹²¹ “*Azerbaijan and the European Neighbourhood Policy*” (2005), Human Rights Watch Briefing Paper, p.4, <http://hrw.org/backgrounder/eca/azerbaijan0605/azerbaijan0605.pdf> (26/08/2005)

possible to conclude that, motivation will not be adequate to cover the “costs” of adaptation, given such regime “*swings between democracy and authoritarianism*”.¹²²

Table 4.1
Democracy Score of Azerbaijan¹²³, 1997-2006

	1997	1998	1999	2001	2002	2003	2004	2005	2006
Electoral Process	5.75	5.50	5.50	5.75	5.75	5.75	6.00	6.25	6.50
Civil Society	5.00	5.00	4.75	4.50	4.50	4.25	4.50	4.75	5.00
Independent Media	5.50	5.50	5.50	5.75	5.50	5.50	5.75	6.00	6.00
Governance	6.25	6.25	6.25	6.25	6.00	5.75	5.75	6.00	6.00
Judicial Framework and Independence	5.50	5.50	5.50	5.25	5.25	5.25	5.50	5.75	5.75
Corruption	-	-	6.00	6.25	6.25	6.25	6.25	6.25	6.25
<i>Democracy Score</i>	5.60	5.55	5.58	5.63	5.54	5.46	5.63	5.86	5.93

Source: Freedom House, *Nations in Transit 2006*,
<http://www.freedomhouse.hu/nitransit/2006/azerbaijan2006.pdf> (02/09/2006)

Another obstacle is the *credibility problem* of the EU resulted from its past performance. Even though Azerbaijan is a member of the Council of Europe since January 2001 and has ratified the European Convention on Human Rights and Fundamental Freedoms, there is no intention to sanction or penalize Azerbaijan for any lack of democracy, including the existence of any barriers to free and fair elections, the independence of the media or

¹²² Svante E Cornell, (2001), “Democratization Falter in Azerbaijan”, *Journal of Democracy*, volume 12, no 2, page 120

¹²³ The ratings are based on a scale of 1 to 7, with 1 representing the highest level of democratic progress and 7 the Lowest. The Democracy Score is an average of ratings for the categories tracked in a given year.

corruption within business and government. Some analysts explain this dilemma by pointing the oil factor, which dampens the EU, as well as USA, criticism.¹²⁴

In addition, there is a negative prejudice towards the EU accomplishment in democracy and human rights promotion due to its past “*ineffectiveness*” (See Table 4.1.) When considering the Table 4.1 it is clear that, unfortunately, until recently the EU's attempts to promote democracy in Azerbaijan have had little success. In other words, there is almost no improvement since the PCA came in force by the beginning of 1999.

On the other hand, there are sufficient evidences to be hopeful. First at all, the effects of Soviet mentality diminishing by the time and new generation are more conscious and sensitive to democracy and human rights than their predecessors. Furthermore, the existences of extra motivational sources, in the absence of membership, are also noteworthy. One is the external developments such as “Rose” and “Orange” revolutions in Georgia and Ukraine respectively, which cause Azerbaijani authorities to be more sensitive, since they are aware of potential similar threats. Another motivation is hidden under the fact that further cooperation with EU under the ENP is based on these values. Azerbaijan would not want to be excluded from the policy, since it would be a prestige loss for the government, especially in case of inclusion of Armenia.

¹²⁴ See Shahla Ismayilova, “*Evolution and Resistance: Democracy in Azerbaijan*”, <http://www.johnsmithmemorialtrust.org/web/site/Articles&News/FellowsArticles/Ismaililova.asp> (10/8/2006) and Arifə Kazımova, “*Demokratiya neftin qurbanına çevrildi?*”, 29 May 2006, <http://www.azadliq.org/Article/2006/05/29/20060529171707503.html> (10/09/2006)

V. THE ENP FROM THE ECONOMIC PERSPECTIVE

Overall, the economic policy measures as (a) enhanced preferential trade relations; (b) “a stake” in the EU internal market; (c) improved interconnection with the EU (such as in energy, transport and telecoms); (d) the progressive participation in a number of EU policies and programmes; (e) increased financial and technical assistance, envisaged by the ENP have the potential to stimulate investment and growth in the neighbouring countries. Based on these measures, this part of the study aims to analyse the effects on Azerbaijani economy expected from the ENP. Given that the ENP is still at a relatively early stage of development and a quantitative analysis¹²⁵ of the effects will be possible once the ENP instruments - notably the Action Plan - are fully deployed and implemented, the analysis is based on qualitative measures. Moreover, it is significant to point that the expectations are based on the successful implementation of the ENP.

5.1. Enhanced Trade Preferences

Azerbaijan has not yet fully liberalized its own economy within the multilateral trade negotiations, and tariffs and non tariff barriers are still substantial with the EU.(see table 5.1) Despite of its progress towards more trade liberalization, there is yet no preferential trading policy between Azerbaijan and the EU given that bilateral trade with the EU is still covered

¹²⁵ There is still very little economic literature on this topic. Existing studies are very general; since they mainly describe the new EU neighborhood policy and only provide some basic intuitions about its potential effects. For the first and only quantitative analysis, see Nicolas Peridy (2005) “Trade Prospects of the New EU Neighborhood Policy: Evidence from Hausman and Taylor’s Models”, *Global Economy Journal*, vol. 5, NO: 1.

by MFN or GSP. In addition , total EU preferential imports from Azerbaijan are heavily concentrated in two products with fuel oils and hazelnuts. Hence, the enhancement of reciprocal trade liberalisation under the ENP should further reinforce the existing close trade relations between Azerbaijan and the EU.

Table 5.1

Tariff Levels in Azerbaijan, in %

	simple average of applied <i>ad-valorem</i> duties			Non- <i>ad-valorem</i> duties (% of total tariff lines)
	All goods	Agricultural Goods	Non-Agricultural Goods	
Azerbaijan	8.8	12.7	8.3	4.4
EU-25	4.2	4.0	5.9	

Source: WTO, *Trade Profiles 2006*

<http://stat.wto.org/CountryProfile/WSDBCountryPFReporter.aspx?Language=E>

From a theoretical point of view, welfare gains associated with the ENP proposition of enhanced trade relations are potentially large.¹²⁶ In fact, the ENP offers a long way starting from the “enhanced trade relation” towards to the “a stake in EU Internal Market”, which envisages a FTA in the medium run depending on the compliance with the *common values*. In this context, under the assumption of successful implementation of the process, some of the economic benefits of Azerbaijan expected to be:

- Better access to large EU Internal market ,
- Enhanced efficiency in production due to increased *international specialization*, in accordance with the “law of comparative advantage”,

¹²⁶ For the effects of FTA and Customs Union, See: Peter Robson, (1998). “*The Economics of International Integration*”, fourth edition, London: Routledge, pp 17-37

- Increased production levels caused by better *exploitation of economies of scale* resulted from increased size of the market,
- *Better terms of trade* and improved international bargaining position, made possible by the larger size,
- Dynamic efficiency gains due to *increased competition* and *technological advances*,
- *Production effect* : resulted from the saving in the real cost of goods previously produced domestically,
- *Consumption effect* due to the gain in consumer surplus from the substitution of lower cost for higher cost...etc

The extent of the welfare gains from further trade liberalisation will depend on the degree to which the ENP effectively reduces tariff and non-tariff barriers to trade in those sectors that are important for Azerbaijan. It also will differ by type of the traded good and services. For *industrial goods*, lower duties levied by Azerbaijan on EU imports means more imports from EU than from other regions. This might provide a significant competitive advantage to EU exports. Azerbaijan would not increase its export since, in addition to tariff barriers, the non-alignment to internal market legislation (such as in the areas of standards and conformity assessment) and customs procedures constitute significant non-tariff barriers on exports to the EU. Hence, their removal should positively affect exports of Azerbaijan's products, provided that producers succeed in upgrading their output to meet EU quality requirements.

Table 5.2
Economic activity in Azerbaijan (as percentage of GDP)

	2000	2001	2002	2003	2004	2005
Industry	36	37,6	37,4	37,2	38,3	47,5
of which: crude oil and natural gaz extraction	27,6	29,6	28,8	27,5	29	39,4
Manufacturing	5,3	6,2	7,4	8,6	8,3	7,2
Agriculture	16,1	14,9	14	12,4	11	9,2
Construction	6,5	5,8	8,7	11,2	12,5	10
Service	36,1	35,5	32,5	31,6	29,9	26,1

Source: http://www.azstat.org/publications/azfigures/2006/en/010.shtml#t10_3 (15/09/2006), and own calculations

The *agricultural sector* is significant for Azerbaijan, as indicated by the share of the GDP generated in this sector (see Table 5.2) and the share of employment, which is nearly %40 in total employment. The economic impact will be stronger if greater market access for agricultural products is included. Trade in agricultural products is currently subject to a higher level of tariff protection than trade in industrial goods. Azerbaijan protects its domestic agricultural sector from external competition. Lower tariff barriers could lead to increases in Azerbaijan's imports of EU agricultural goods in specific product ranges and countries. Overall, however, liberalisation is likely to result in a boost to Azerbaijan's net exports as the some agricultural products of Azerbaijan (tobacco, apple, nuts, tea, vegetables, oil seeds, raw cotton, and pharmaceutical plants growing, as well as processing fruit juices, cigarettes, manufactured tobacco, animal skins, cotton linters, carded and combed cotton, cotton seed oil,

safflower oil) are competitive compared to the EU¹²⁷. Given the large size of the EU market, even a modest degree of opening may lead to a substantial rise in Azerbaijan's export levels and, given the high share of agriculture in GDP, to higher living standards.

Liberalisation of *trade in services* has also the potential to yield considerable economic benefits to Azerbaijan. The improvements in information and communication technologies have significantly facilitated the international provision of services and their benefits have yet to be fully realised. Although only a limited portion of services is tradable, the benefits from services trade liberalisation are widely recognised: greater competition leads to efficiency gains in both the service sector itself and all other sectors of the economy relying on services as an input. This is particularly relevant for the liberalisation financial services, energy and telecommunication. Liberalisation of service sectors is particularly important for Azerbaijan given its background of traditionally inefficient and/or underdeveloped services.

5.2. Participation in the EU Internal Market

As stated earlier, the offer “*a stake in the EU Internal Market*” and “*further integration and liberalisation to promote the free movement of persons, goods, services and capital*” is the most novel and far reaching aspect of the policy which is based on the progress in legislative and regulatory convergence towards the *acquis communautaire*, as well as the commitment to the common values as democracy and human rights. In addition to further trade liberalisation in goods and services it provides the liberalisation of movement of factors

¹²⁷ Centre for Economic Reforms, (2004). “*Study of Azerbaijan's Current and Potential Comparative Advantages*”, Baku, p.23

of production. What is more, the regulatory and legislative convergences have the potential to promote regulatory environment in Azerbaijan and to help realisation of growth-enhancing structural reforms.

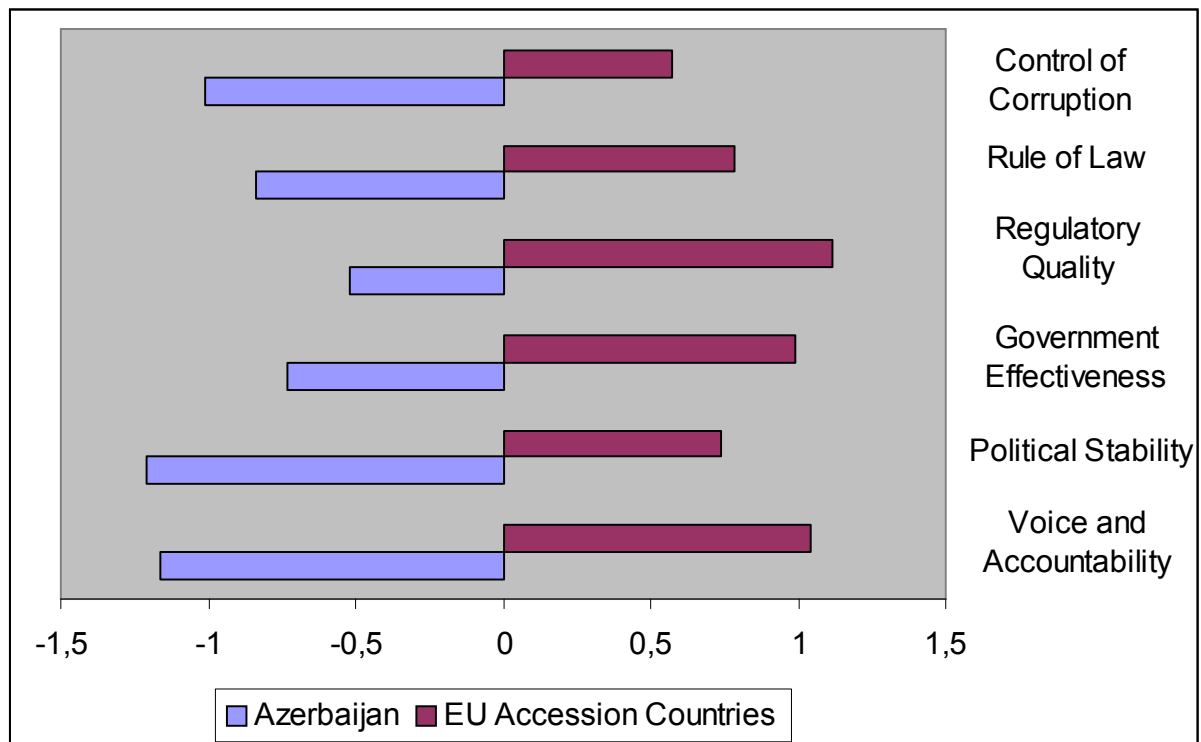
5.2.1. Growth-Enhancing Structural Reforms

The adoption of parts of the *acquis communautaire* could result in a growth-enhancing upgrade in the regulatory environment. Of course; it is based on the assumption that the internal market institutional set-up is superior to that existing in Azerbaijan. Although the ENP is not expected to show exactly the same results as Accession Process¹²⁸, a comparison between the regulatory environment of Azerbaijan and the EU accession countries, which have taken on the *acquis communautaire* as a condition to joining the Union, can offer useful insights. Figure 5.1 reports the indicators for governance in Azerbaijan and EU Accession Countries. The chart shows a clear positive difference between the scores of EU accession countries and that of Azerbaijan, suggesting strongly that adopting the EU *acquis*, irrespective of any imperfections, would still represent an improvement over the status quo. The potential for improving the economic environment in Azerbaijan appears significant. Azerbaijan has, like other former Soviet bloc countries, a history of extensive state intervention in the economy; this has left behind a legacy of regulations that, even after a decade or more of reform, are inadequate to the needs of modern economies. By offering to Azerbaijan the prospect of participating in the EU Internal Market, the ENP may therefore be seen as a way of spreading the benefits of the EU accession process beyond the current circle of eligible

¹²⁸ For the differences among neighbourhood countries and accession countries See, Gergana Noutcheva and Michael Emerson (2005), “*Economic Regimes for Export: Extending the EU’s Norms of Economic Governance into the Neighbourhood*”, Brussels: CEPS Working Document, p.18-20

countries. Nevertheless, the ENP cannot be a substitute for domestic commitment to reforms. The outcome will depend on the willing of Azerbaijan in implementation of the ENP.

Figure 5.1
Governance in Azerbaijan and EU New Member States (2005)



Source: World Bank, *Worldwide Governance Indicators 1996-2005 (2006)*, http://info.worldbank.org/governance/kkz2005/sc_country.asp (10/09/2006)

5.2.2. Free Movement of Capital and Labour.

Internal Market rules provide for the liberalisation of movement of capital and labour in addition to the free movement of goods and services. However, the process is more sensitive than that of trade in goods and services and requires sound policies and institutions in order to minimise the risks. Given its sensitivity, the EU is not consistent about the “freedoms”. While it had been clearly expressed in the “Wider Europe Communication”, it

was not mentioned in the “*Strategy Paper*”. Therefore the liberalisation of factor movement may be considered only as long- term goal.

Nevertheless, if liberalisation of factor movement realised it has a potential for large positive effects. In particular, *liberalization of capital movements* leads to efficiency gains in the allocation of savings, increases access to foreign markets to finance trade and investments, expands the opportunities for portfolio diversification and enhances the efficiency of the domestic financial markets by exposing them to increased competition.¹²⁹ It also permits foreign direct investments, usually a vehicle for technological transfers and efficiency improvements. *Free movement of workers* promotes an efficient allocation of labour resources. In the future, this may be increasingly the case if higher specialization of workers becomes widespread, rendering the geographical match between demand and supply of specific skills more difficult to achieve.¹³⁰

5.3. Emphasis on Sound Macroeconomic Policies

The ENP is also has potential to serve the adaptation of Azerbaijan to sound macroeconomic policies. The Action Plan which is expected to be signed by the end of 2006, will likely envisage that Azerbaijan should, as a minimum, commit to sustainable fiscal and monetary policies, given that the “*prudent macroeconomic policies need to be maintained to support effective implementation of an Action Plan.*”¹³¹ The expectation regarding the content

¹²⁹ Michaela Dodini & Marco Fantini (2006),ibid, p. 523

¹³⁰ ibid,p.524

¹³¹ “European Neighbourhood Policy, Recommendations for Armenia, Azerbaijan, Georgia and for Egypt and Lebanon”,p.4

of the Action Plan in this context, is also based on the fact that, Action Plans agreed so far offer a specific focus on sound macroeconomic policies. Issues such as fiscal consolidation, public debt, public finance management and monetary policy are typically covered in the jointly agreed Action Plans.¹³² Although less prominent than those concerning the internal market acquis, the importance of these commitments for sustainable growth should not be underestimated that a stable macroeconomic environment is commonly considered to be conducive to long-term growth.

Table 5.3 gives an overview of the Azerbaijan in terms of a number of basic macroeconomic stability indicators. It appears that Azerbaijan has made remarkable progress in stabilising its economy and appears to be starting its economic integration with the EU from fairly favourable macroeconomic terms. It has positive growth rates over 10%, even more impressive one in 2005 which was driven by high oil prices and increased oil production. In addition it characterised by moderate levels of inflation in spite of recent rapid increases. However, macro imbalances remain. The major challenges remain on the social front .Indeed, it displays very high level of unemployment and low per capita income level although the official unemployment rate seems less than 1, 5 %, and the real unemployment rate is much higher, as revealed by survey estimating the unemployment rate at 10.7%.¹³³ Moreover, the current account balance may be considered as problematic. Hence, the role of ENP as a macroeconomic policy anchor is noteworthy.

¹³² See For Example, Action Plans for Ukraine and Moldova,
http://ec.europa.eu/world/enp/pdf/action_plans/ukraine_enp_ap_final_en.pdf
http://ec.europa.eu/world/enp/pdf/action_plans/moldova_enp_ap_final_en.pdf(both ,25/9/2006)

¹³³ State Statistical Committee of the Republic of Azerbaijan (2004), “*Survey of the Economic Activity of the Population of Azerbaijan: Methodology and Analysis of the Labour Market Situation*”, Baku.

Table 5.3

Macroeconomic Stability in Azerbaijan: Key Indicators, 2000-2005

	2000	2001	2002	2003	2004	2005
Real GDP Growth (% change)	11,1	9,9	10,6	11,2	10,2	26,4
GDP per capita (in US\$)	665	714	774	897	1041	1518
Inflation CPI	1,8	1,5	2,8	2,2	6,7	9,6
Unemployment (official rate)	1,2	1,3	1,3	1,4	1,4	1,4
Central government balance (% of GDP)	-1	-0,5	-0,4	-0,2	-0,2	-0,7
External debt (% of GDP)	19,8	20,2	20,1	19,7	18,5	11*
Current account balance (% of GDP)	-3,2	-0,9	-12,3	-27,8	-29,8	1,3
Trade Balance (% of GDP)	6,1	10,8	7,7	-1,3	1,8	26,3
Import cover (months)	5,3	5,9	4	3,5	3,9	-

Source: National Bank of Azerbaijan, Ministry of Finance of Azerbaijan, The State Statistical Committee of Azerbaijan, and own calculations

* As of April 1, 2006

5.4. Increased Sectoral Cooperation: Energy Example

Undoubtedly the energy sector is very significant for both Azerbaijan and the EU. On the one side, the Azerbaijani economy is highly dependent on oil and gas related activities, accounting for a considerable share of total exports and of budget revenues. On the other side, the EU is a major importer of the oil and gas and would like to see increased reliance on

external energy resources, which forms a potential threat to its energy and geopolitical security. Hence, it is no coincidence that the EU is going to also sign a Memorandum of Understanding with Azerbaijan in energy section following the confirmation of the Action Plan¹³⁴.

The ENP's focus on energy safety and security, as is explained in the *Communication on the Development of Energy Policy for the Enlarged European Union, its Neighbours and Partner Countries*, is a potential opportunity for Azerbaijan both as an energy producer and as an energy transporter. In addition, the Action Plan will build on existing bilateral and regional energy and transport initiatives, such as, the INOGATE Programme dealing with the Caspian basin, the TRACECA transport Project. These initiatives have helped establish a roadmap for institutionalised partnership, with concrete measures to harmonise the legal and regulatory framework for energy sector. Increased energy efficiency, the use of renewable energy, and cooperation in energy technologies are also promoted by these programmes. This historic "credibility" provides the EU more effective role in contribution to solution of infrastructural problems in Azerbaijan. Sustaining sufficient infrastructure, at the same time, can especially increase the gas exports to both EU and the region.

Moreover, increased energy cooperation provides mutual business opportunities and can also contribute to socio-economic development and improvement to the environment. The environmental issues especially noteworthy since the Apsheron Peninsula and the Caspian

¹³⁴ "Azerbaijan and the European Union can sign an agreement on energy cooperation after the Action Plan was confirmed", *Today.Az*, 20 September 2006, <http://www.today.az/news/business/30420.html>, (22/09/2006)

Sea are considered among the most devastated areas in the world due to severe soil and water pollution, linked to oil extraction.¹³⁵

5.5. Risks of the ENP

The implementation of the ENP does not seem likely to create major risks of economic and financial instability. This judgment is based on several considerations as:

- gradual nature of the implementation of ENP measures over a long period of time, which allows time for remedial action;
- considerable flexibility in adapting measures to local conditions
- the fact that all measures are negotiable
- in the comparatively riskier areas of capital and labour mobility, there are few or no short-term commitments.

5.5.1. Trade Diversion

Nevertheless, closer integration to the EU may involve risks in specific contexts. Firstly, the breaking down of existing barriers to trade carries economic costs. According to theory, the economic integration could have some downsides due to *trade diversion*. Hence the welfare gains from trade liberalisation should be weighted against the costs of possible trade diversion associated with the reorientation of trade towards EU. However, the fact that

¹³⁵ Jason Anderson, Samuela Bassi and Vanessa Aufenanger (2005), “*The Energy and Climate Change Dimensions of the European Neighbourhood Policy*”, Report Commissioned by WWF European Policy Office and Authored by the Institute for European Environmental Policy (IEEP): Brussels, p.30

the EU is the main trading partner of Azerbaijan and the trade relations are based mainly on fuel and oil reduces the magnitude of risk for trade diversion. Yet another “trade diversion” risk exists that, following the differentiation principle, if some participants, especially Ukraine and Georgia that have good trade relations with Azerbaijan,¹³⁶ obtain better market access to the EU, this will divert their trade from Azerbaijan, that do not make fast enough progress in the ENP, to EU member states.

5.5.2. Supply-Side Specialisation

The most characteristic risk for Azerbaijan resulted from breakdown of barriers to trade, may be the *supply-side specialisation*. Historically, in Azerbaijani economy, the oil sector improves rapidly while other sectors underdeveloped or fallen. This kind of “Holland syndrome”¹³⁷ may be move ahead by the ENP, since by increasing the size of the market; it raises the possibility of further specialisation in the export of oil materials. Such a high supply concentration can mean heightened vulnerability to terms-of-trade shocks, as occurred in 1998.¹³⁸

5.5.3. Fiscal and Debt Management Risks

Fiscal risks are also potential that the integration affects the government revenues due to elimination of tariffs. In Azerbaijan, tariff revenues still make up an almost 10% of

¹³⁶ For Example they were 10th and 11th trading partner of Azerbaijan in 2005,
http://www.azstat.org/publications/azfigures/2006/en/018.shtml#t18_3 (10/9/2006)

¹³⁷ Osman Nuri Aras(2003), “*Azerbaycan Ekonomisi: Makro Ekonomik ve Sektörel Analiz*”, A Publication of “Kafkasya Araştırmaları Merkezi”, Baku, p.149

¹³⁸ Susanne Milcher and Ben Slay, (2005). “*The Economics of the ‘European Neighbourhood Policy’: An Initial Assessment.*”, Paper for the conference “Europe after the Enlargement”, Case Foundation, Warsaw, April 8-9,
<http://www.case.com.pl/dyn/plik--4592639.pdf> (10/3/2006)

budgetary income (See table 5.4). Furthermore they are easier to collect than other taxes, caused from the psychology of society “collecting tax at source”, which is prohibited from the former Soviet Union.¹³⁹ Therefore, in addition to revenue losses, reducing budgetary reliance on duties, as mandated by the ENP, will generally require an upgrade of the tax collection system.

Table 5.4
Contribution of Duties to Revenues in Azerbaijan

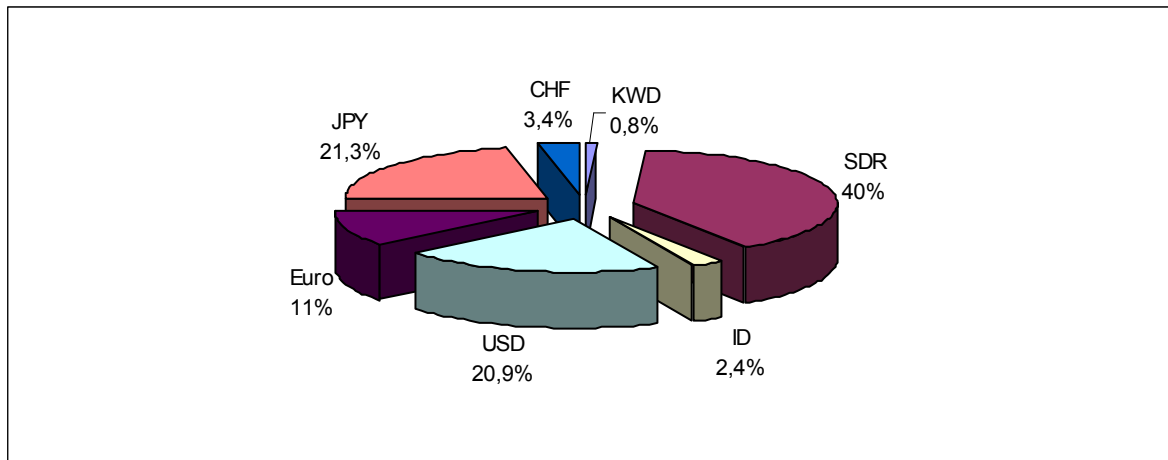
	2000	2001	2002	2003	2004	2005
As % of Total Revenues	8,9	7,6	8,3	7,6	6,7	10
As % Total Tax Revenues	10,6	8,3	8,9	9,1	8,2	11,6

Source: <http://www.azstat.org/publications/azfigures/2006/en/020.shtml> (10/9/2006)

Another issue relates to the consequences of higher trade shares with the EU on external *debt management*. Currently, only %11 Azerbaijan’s outstanding debt is denominated in euros. (See Figure 5.2) If exports to the euro area are denominated predominantly in euros, debt exposure in dollars and other currencies will increase risks to sustainability. However, this risk can be hedged by appropriately matching exposure to the denomination of export receipts, or by diversifying the denomination of debt.

¹³⁹ Ercan Sancak (2001), “Azerbaycan’da Uygulanan İstikrar Politikası ve Enflasyon”, Paper for the Conference ‘Bağımsızlığının 10. Yılında Türki Cumhuriyetler’, Istanbul: Marmara University, 2001

Figure 5.2
External Debt of Azerbaijan per Currency



Source: http://www.maliyye.gov.az/download/Xarici_Dovlet_Borcu/charts_eng_i_2006.pdf
(15/9/2006)

5.5.4. Risk of Over-Regulation

By considering the clumsy and bureaucratic structure of Azerbaijani administration organs, the *risk of over-regulation* also may be materialised, since Internal Market regulation consists of several thousands pages of legislation, often highly technical, which was not devised with the prospect of adoption by less economically developed countries as Azerbaijan in mind. Hence, many of its provisions might be irrelevant, inadequate or even harmful in this context. Premature adoption of the *acquis* would not only risk saddling the private sector with compliance costs, but might also divert administrative resources away from higher priority tasks. An additional Internal Market related complication is that there is no idea about which elements of internal market legislation are essential to its functioning and which are superfluous.¹⁴⁰

¹⁴⁰ Anne Warren, (2004), “*The Economic Effects of Wider Europe*”, CEPS Articles: Brussels , http://www.ceps.be/Article.php?article_id=358 (12/12/2005)

VI. CONCLUSION

The ENP can be thought as a new solution of the EU, in the impossibility of further enlargement, for preventing the challenges likely after the “big-bang” enlargement. Hence the main motivational factor of the policy is the cross-border security issues as environmental and nuclear hazards, communicable diseases, illegal immigration, trafficking, trans-national organised crime or terrorist networks. Moreover, the security of energy supply, the energy safety and security in the region, carries significance to the EU, given its high dependence on external resources.

Therefore, the EU intention to be more active global power in the South Caucasus is not confused, since instability in the region is a threat to EU security. Geographic proximity, energy resources, pipelines and the challenges of international crime and trafficking make stability in the region a clear EU interest. Yet, the unresolved Nagorno-Karabakh, Abkhazian and South Ossetian conflicts have the potential to ignite into full-fledged wars in Europe’s neighbourhood. Consequently, the EU felt a need for including the Caucasus to the ENP, which seems to offer “added value” by motivating the implementation of the existing PCAs and offering bigger prize as well as the more effective and frequent use of methodologies of the accession process like monitoring and conditionality. In this context, the inclusion of Azerbaijan to the policy may be considered as EU ambition to guarantee its own security, either energy or conflict oriented.

The analysis contained in this study suggests that, in addition to its significance as a political tool, the ENP has the potential to foster economic growth in Azerbaijan. The study identifies a number of ways through which this might happen, both directly through economic channels and indirectly, by providing support for proper structural and macroeconomic policies. Directly, the reduction of tariff and non-tariff barriers to trade should bring about efficiency gains and improve welfare through increased market integration. The indirect effects are even larger. By bringing the Azerbaijan closer to the EU economic model, also through the adoption of international best practices, the ENP and particularly the proposed extension of the internal market, will improve the investment climate in Azerbaijan. It will provide a more transparent, stable and enabling environment for private sector. A positive impact on foreign direct investment inflows is expected as a result of a more favourable policy environment, falling trade and transaction costs, attractive relative labour costs and reduced risk. In addition, the economic transformations prompted by closer integration with the EU should not, as a general rule, endanger economic and social stability. Likewise, increased energy cooperation provides business opportunities and can also contribute to socio-economic development as well as environmental issues.

The study also highlights a number of possible risks due to integration of the EU. Although the ENP is not expected to create major risks, risks as *supply-side specialisation*, linked to high concentration on oil sector and *over-regulation* due to complex internal market legislation joined static and bureaucratic government organs, are probable main risks. Likewise, trade diversion, government revenue losses resulted from tariff reduction, as well as debt management risks is expected by theoretical point of view.

It should be stressed that the expectations are shaped by assuming the successful implementation of the ENP towards Azerbaijan. The successful implementation of the policy requires the commitment to values as democracy and human rights as well as other agreed priority measures which will be monitoring after six months from the final signature of the Action Plan. In other words, the success of the ENP depends on the people of Azerbaijan. In this study, the likelihood of accomplishment of obligations by Azerbaijan in this context is also intended to explain. The evidences as social pressures and tendencies in official bodies towards more transparent and democratic political environment, provide to be hopeful about the future of the policy. However it is crucial that the EU has credibility problem in contribution to democracy and human rights of Azerbaijan, since historically it was neither effective nor consistent in its related policies. Yet, the ambiguity about EU consistency whether it will conciliate from its energy interests and expel Azerbaijan from the ENP in the lack of success, does not overshadow the implementation of the process; it only means failure in democratically development.

In order to achieve the commitments related to common values, it would be better the Action Plan to include concrete benchmarks focusing not only on improvements in Azerbaijan's legislative framework that can be achieved in the short term, but also on implementation, which may require a longer term approach. Long and short-term benchmarks should have a clear timetable for implementation and should be followed up with a rigorous monitoring system. In this context, the Cooperation Council may set up a body charged with monitoring of the benchmarks. Further, in order to ensure consistency with international human rights standards when carrying out reforms through changes in legislation or the

creation of other legal documents, the EU should coordinate with other international institutions, as the Council of Europe, the OSCE, the UN, and bilateral partners, including the United States, to ensure that the benchmarks in the Action Plan are consistent with and complementary to other current or prospective programs. To overcome the consistency problem, the implementation of the process can be reviewed by the other independent body of experts. Moreover, to maximize the potential of the ENP process, the EU should consult and speak not only with Azerbaijani government, but also engage with Azerbaijani media and civil society about the process, the benchmarks, and results of monitoring.

In addition to commitment to the common values, in order for the ENP to succeed in the long run and deliver on its ambitions, a number of conditions need to be ensured during its implementation in both the EU and Azerbaijan. Its success will depend mainly on the existence of a conducive domestic environment for reform. Ownership of the ENP programme by Azerbaijan and consistency with their development goals are also key to its sustainability and to the capacity to deliver actual benefits. In this respect it could be desirable to widen the scope of consultations to other interest groups in the ENP, such as the business sector, local governments and civil society, who will ultimately bear the effects of liberalisation and closer integration with the EU. With specific reference to the Internal Market, choices will have to be made about where the greatest potential benefits for Azerbaijan lie and about the proper sequencing of legislative approximation and other economic reforms. From Azerbaijan's perspective, priority should be given to legal and regulatory approximation for greater market access to the EU. To minimize the risks, participation in it should be constantly tested and proceed gradually. In general terms, it

would be more beneficial if parties take full advantage of the ENP principle of “differentiation” and keep a benefit-based approach to regulatory alignment.

Moreover, the success of the policy as well as the future EU–Azerbaijan economical and political relations, depend on its effects on resolution of Nagorno-Karabakh conflict that it is the primary focus of Azerbaijani society. The study shows that, the ENP is not likely to go beyond the traditional indirect “supporter” role of the EU. The ENP also prefers contributing to conflict settlement through promoting democracy and regional cooperation, boosting national reform programmes and increased diplomatic efforts that do not seem rational and effective.

However, by considering the significance of the issue, the Action Plan should, at least, define the peaceful resolution of the Nagorno-Karabakh conflict as a priority. In addition, to become more effective, the EU should increase its political visibility. One way of doing so may be through strengthening the EUSR’s regional presence and maybe provide participation in the OSCE Minsk Group as an observer.

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