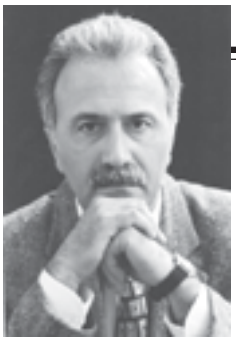
measures have a limited effect. Pervasive corruption and the huge scale of migration hinder the attempts to bring labor flows under control. All the more so since the divergence of the post-Soviet countries in terms of economic development and pay levels continues to grow, objectively spurring the movement of large masses of able-bodied people from poor to rapidly developing countries.

* * *

In summary, one can say that serious opportunities for a significant increase in mutual trade in the post-Soviet space are lacking, which is mostly due to the generally difficult conditions for development. Nevertheless, regional trade simply must become one of the instruments for ensuring sustainable economic growth. Even the most insignificant increase in foreign trade flows is of great importance for economic dynamics. Given the generally adverse conditions for development in the post-Soviet space, it is necessary to fight for every possible export niche, however insignificant it may seem.

Numerous bureaucratic groupings and associations in the post-Soviet space have a very weak impact on economic cooperation. The latter is developing under the decisive influence of market factors. Proto-integration trends in the post-Soviet space are based on the complementarity of the main factors of production. Until recently, the most noticeable phenomenon was the movement of migrant workers from labor-surplus to labor-shortage countries. Over the past few years, the activity of private capital from relatively capital-surplus Russia and Kazakhstan is gathering momentum in the post-Soviet space.



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ON THE INTERRELATIONSHIP BETWEEN POLITICAL AND ECONOMIC PROGRESS IN THE CENTRAL CAUCASUS

Abstract

The article analyzes the political and socioeconomic situation in the Central Caucasus. It reveals the common and particular features of the regional conflicts, the only universal principle for the settlement of which is not to permit a forceful

change in the interstate borders generally recognized and confirmed by international documents.

It looks, first, at the correlation between regional and interstate political stability and economic development and, second, at interstate dependence between political democracy and economic progress. It shows that in the interrelationship between regional economic development, on the one hand, and settlement of political conflicts, on the other, it is the second that comes first and so should be viewed as the absolute priority.

When three independent states appeared in the Caucasus, a principally new, but extremely paradoxical situation arose there: the rest of the world recognized their borders, but the Caucasians themselves did not. Although they have extremely rich natural and good intellectual resources, they nevertheless belong to the poor countries of the world. After finally restoring their own states, the Caucasians began mass migration to other countries…

Where is the key to understanding and resolving these paradoxes?

Political Situation in the Region

Armenia and Azerbaijan are in a state of war. It started at the end of the 1980s and has since taken tens of thousands of lives. After ten years of cease-fire, the hostilities have recently flared up again: there are reports every week about Azerbaijan's positions being fired on, and people being killed, wounded, and taken prisoner. Azerbaijan describes this war as aggressive on Armenia's part, while Armenia sees it as a war "to liberate" Nagorno-Karabakh (NK). Armenia currently occupies 20% of Azerbaijan's territory, most of which is outside NK. There are approximately one million refugees and forced migrants in the country, 60% of whom are living below the poverty line. Judging by everything, Azerbaijan will never reconcile itself to occupation of its territory and is determined to build up its military potential.

Georgia's territorial integrity is also a problem. Abkhazia and South Ossetia continue to claim their independence, integrating in reality with Russia, but not with Georgia. Another hotbed of potential separatism smolders in Samtskhe-Javakhetia, a region densely populated by Armenians. Admittedly, the nature of these territorial problems differs dramatically from Nagorno-Karabakh. In contrast to the Abkhazians and Ossetians, the Armenians have already achieved their national self-identity and have their statehood, so theirs is nothing like a "national-liberation" struggle. However, Azerbaijani territory is occupied by another state that has still not cancelled the official decision on annexation of this land. In both cases, Russia's role is similar, boiling down to direct military-financial support of the aggressor and the separatists.

Armenia has turned into a monoethnic aggressor-state. The Azeris forcefully deported from Armenia at the end of the 1980s were the last large non-Armenian ethnic group. The occupation of NK and its adjoining territory is now acknowledged everywhere, and this trend will apparently grow in the next few years. Due to its aggressive behavior toward its neighbors, Armenia is not included in the large regional projects being implemented in the Central Caucasus. It is also obvious that the degree of Armenia's foreign political-economic dependence (primarily on Russia) is much higher than Azerbaijan's and Georgia's.

Georgia is trying to become the political center of the Central Caucasus. Georgia believes that it is the only country in a position to "talk to all the neighbors." Several hundreds of thousands of Azeris densely populate Georgia, while there are about twenty thousand Georgians in Azerbaijan. All the main political forces of these countries are actively steering a course toward intensifying mutual integration. Azerbaijan and Georgia are jointly participating in several large regional programs, including building oil and gas pipelines and implementing the TRACECA transportation

projects. They are the co-founders and members of GUAM and support integration into the Euro-Atlantic space. But it can be presumed that a more specific and active attitude toward each other's territorial problems will be needed to bring the two countries closer together. As for interrelations with Armenia, Georgia does not have any major problems. At least both countries are trying to retain the semblance of this, although territorial claims against Georgia are being heard all the more frequently and insistently.

Economic Situation in the Region

General comparisons. All three Central Caucasian states are relatively poor. The most recent rating of the World Bank (July 2006) ranks them in the group of countries with "relatively low gross national income (GNI) per capita."[1] And they have still been unable to compensate for the economic losses inflicted by the collapse of the Soviet Union. In 2003, Azerbaijan's GDP amounted to 79.6% of the 1990 level, Armenia's to 96%, and Georgia's to 46%.[2] Azerbaijan leads in the region in terms of such economic indicators as GDP, state budget, investments in basic capital and foreign direct investments, and foreign trade volume. In 2005, it occupied first place in the world in terms of GDP increase with a growth rate of 26.4%. The economic growth rates in Georgia and Armenia are also quite high (see Table 1).

The indicators of prosperity leave much to be desired. The percentage of the population living below the poverty line is quite high. Until 2005, the poverty level was higher in all three states than the same indicator for countries with an approximately identical per capita GDP taking into account purchasing power parity. Since 2005, Azerbaijan has been on the trend line (see Fig. 1 on p. 114).

However, several factors which distort the poverty indicators should be kept in mind. First, each country applies its own poverty criteria, which differ from the ones used by the others. In order to

Table 1

Some Key Socioeconomic Indicators of the Central Caucasian Countries

Indices \ Countries	Azerbaijan	Georgia	Armenia
Territory (*thou. km²*)*	**86.6**	**69.7**	**29.8**
Population (*thou., 2004*)*	**8,279.5**	**4,521.0**	**3,049.7**
Change in population size (%)*			
2001	**0.77**	**– 0.72**	**– 0.82**
2002	**0.75**	**– 0.9**	**– 0.61**
2003	**0.74**	**– 0.99**	**– 0.4**
2004	**0.56**	**– 1.01**	**– 0.2**
GDP (*million USD, 2004*)*	**8,523.1**	**5,091.2**	**3,549.4**

[1] See: [http://siteresources.worldbank.org/DATASTATISTICS/Resources/CLASS.XLS]. The countries of the world are divided into four groups: low gross national income (GNI), $875 or less, lower middle income, $876-3,465, upper middle income, $3,466-10,725, and high income, $10,726 or more.

[2] See: *Statisticheskie pokazateli Azerbaidzhana—2005,* Baku, 2005, p. 805.

Table 1 (continued)

Indices \ Countries	Azerbaijan	Georgia	Armenia
GDP (*billion USD, PPP, 2005, estimate*)**	36.53	16.13	15.27
GDP per capita (*USD, 2004*)***	1,029.4	1,126.1	1,163.9
GDP per capita (*USD, PPP, 2005, preliminary data*)**	4,600	3,400	5,100
Annual increase in GDP (%)			
2002*	10.55	5.48	13.19
2003*	11.2	11.2	13.91
2004*	11.2	8.51	10.1
2005****	26.4	7.7	13.9
State budget for 2006 (*million USD*)*****			
–revenues	3,743.2	1,704.4	848.8
–spending	3,949.8	1,825.0	1,004.2
–deficit	206.6	120.6	154.5
Investments (*% of GDP, all sources, 2004*)*	53.18	24.35 (2003)	24.18
Foreign direct investments (*million USD, 2000-2003*)***	5,033.9	46.2	405.7
FDI per capita (*USD, 2000-2003*)***	613.47	161.55	131.78
Foreign trade (*million USD, 2005, preliminary data*)**			
–export	6,117	1,400	800
–import	4,656	2,500	1,500
Ratio of export to GDP (*%, 2004*)*	43.97	31.78 (2003)	34.66
Foreign debt (*million USD*)**	2,253 (2005, preliminary)	1,900 (2003)	1,868 (31.12.2004)
Ratio of foreign debt to export	0.368	1.357	2.235

Table 1 (continued)

Indices \ Countries	Azerbaijan	Georgia	Armenia
Average monthly nominal wages (*USD, 2004*)******	**98.3**	**81.7**	**78.8**

* See: *The World Development Indicators—2005*, available at [http://devdata.worldbank.org/wdi2005].

** *See: CIA—The World Factbook—2005*, available at [http://www.cia.gov/cia/publications/factbook/index.html].

*** Calculated according to: *The World Development Indicators—2005*, available at [http://devdata.worldbank.org/wdi2005].

**** Data of the CIS Interstate Statistics Committee, available at [http://www.cisstat.com/rus/index.htm].

***** Indicators for Azerbaijan: Official site of the Azerbaijan Parliament, available at [http://www.meclis.gov.az/qanunlar/index.htm]; for Georgia: Internet newspaper Day.az, available at [www.day.az/news/georgia/37749.html]; for Armenia: IA REGNUM, available at [www.regnum.ru/news/550625.html].

****** Data in national currencies—according to the official sites of the Azerbaijani, Georgian, and Armenian Central Banks, available at [www.nba.az], [www.nbg.gov.ge], [www.cba.am]. Currency exchange rates: according to CIA: *The World Factbook—2005*, available at [http://www.cia.gov/cia/publications/factbook/index.html].

unify the criteria, international financial institutions use indicators of the size and percentage of the population living on an income of less than one and two dollars. But, in our opinion, these indicators make it possible to best characterize the prosperity level only in the poorest countries of the world. Second, in an effort to obtain additional political or economic dividends (for example, more foreign financial aid), many countries often try to artificially raise their own poverty data, making it look worse than it is. And finally, the third factor distorting the picture is the informal economy, which if taken into account would make both per capita GDP and incomes in particular higher than the official statistics show.[3] It should also be kept in mind that in states where natural resource (particularly oil) production and export predominate, the increase in GDP is higher than the increase in incomes. This factor, which is important for Azerbaijan, is having a negative impact on reducing poverty as per capita GDP rises.

Unemployment remains high. Unfortunately, the statistics in this area are imprecise and mainly reflect the registered unemployed, who register largely to obtain benefits. In 2000-2002, the lowest unemployment level was registered in Azerbaijan at 1.3% of the able-bodied population. In Armenia, it amounted to 9.4% and in Georgia to 12.3%.[4] But the real level of unemployment is much higher, approximately identical in all three countries and, according to our calculations, fluctuates between 20% and 25%.[5] In Georgia, it is possibly a little higher than the average Caucasian index.

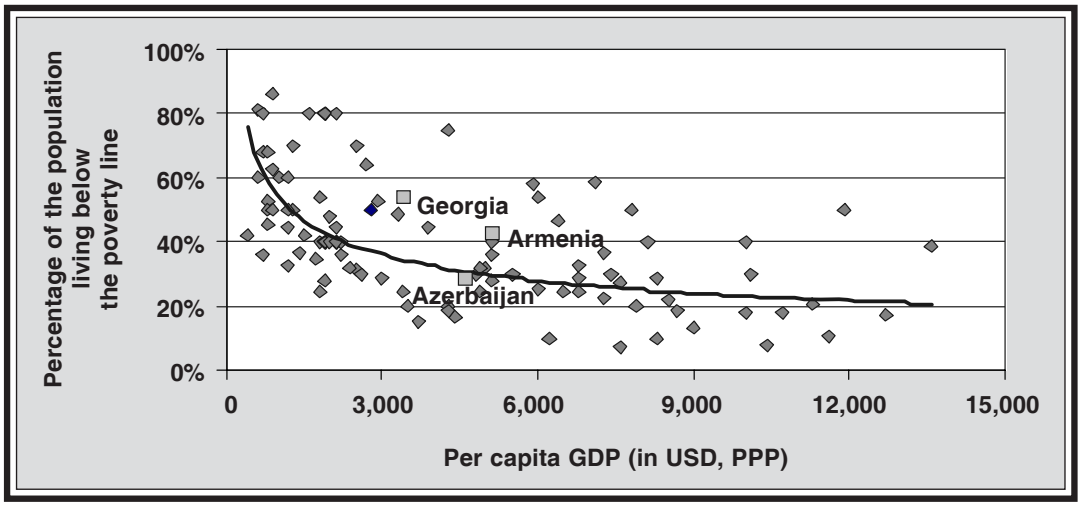
[3] There is no generally accepted methodology for calculating the percentage of the informal economy. The most reliable are Schneider's calculations, which the World Bank usually refers to. According to them, in 2000, the informal economy in Georgia amounted to 67.7% of the gross national product, to 60.6% in Azerbaijan, and to 46.3% in Armenia (see: F. Schneider, *Size and Measurement of the Informal Economy in 110 Countries around the World,* July 2002, p. 13, available at [http://rru.worldbank.org/Documents/ PapersLinks/informal_economy.pdf]).

[4] See: *World Development Indicators—2005*, Table 2.4, Unemployment, available at [http://devdata.worldbank.org/wdi2005/Section2. htm].

[5] According to official statistics, in Azerbaijan the employed population amounts to 76% of the labor resources (calculated according to: *Statistical Indicators for Azerbaijan—2005*).

Figure 1

Correlation between Per Capita GDP and the Poverty Level[6]



The thing is that in Azerbaijan, oil and gas production, as well as the transportation of hydrocarbons are not labor-intensive sectors: at present, despite its enormous share in the structure of the economy, a little more than 1% of the able-bodied population is employed in the oil industry. One of the targeted precepts of the very ambitious Development Program for Azerbaijan's Regions in 2004-2008[7] is to create 600,000 new jobs in the non-petroleum sector.

Social polarization (inequality) is rather profound and continues to intensify. The indicators offered by international organizations do not always provide a correct reflection of its level, since they are calculated on the basis of local official statistics. For example, according to *The World Factbook*, the poorest 10% of households in Azerbaijan account for 2.8% of all the incomes (or consumption), and the richest 10% account for 27.8% (1995), while the *Gini coefficient* is equal to 36.5% (2001). In Georgia, this coefficient is equal to 36.9% (2001), and in Armenia to 37.9% (1998).[8] In this way, the differentiation coefficients are very close to the European (throughout the European Union, it is equal to 32%, in Great Britain to 36.8%, in Portugal to 38.5%, and in Greece to 35.1%)[9] and could very well be considered normal.

But in the Caucasus, the prosperity statistics distort reality. The rich mainly accrue wealth from illegal sources, primarily by corruption, which naturally the official figures do not reflect. It is also true that a significant percentage of the income of the poorly off strata of the population is not included in the statistics either, since it is provided by the informal economy. But the percentage of unofficial income of the rich is several-fold higher. So actual polarization is more profound than the official figures show.

The political result of the current economic situation is somewhat paradoxical. Theoretically, given the low material prosperity, high unemployment, and rather profound social polarization, the leftist-centrist political orientation should predominate, but in all the Central Caucasian states,

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[6] Compiled according to: *CIA—The World Factbook—2005,* available at [http://www.odci.gov/cia/publications/factbook]. We are talking only about those countries where the per capita GDP according to PPP does not exceed $15,000. The data on the poverty level in Azerbaijan relate to 2005.

[7] Endorsed by Presidential Decree of 11 February, 2004, available at [http://www.president.az/s22_decrees/_decrees_r.html]

[8] See: *CIA—The World Factbook—2005,* available at [http://www.cia.gov/cia/publications/factbook].

[9] See: Ibidem.

rightist-centrism is currently the prevailing political philosophy. In Azerbaijan, for example, politicians who are leftist by definition (let's say communists or social democrats) come forward with slogans characteristic of the rightists. Demands such as privatization of state property or tax reduction are universal. Disruption in the Central Caucasus of the normal correlation between the level of the economy and the political agenda is most likely related to the historical past of the region's countries: they came from the bowels of the most leftist economy in the world, and even the leftist politicians would like to move the economy of their countries further to the right (although not as far as the rightists), which of course requires specific economic reforms.

Economic reforms. Noticeable progress has been achieved here. The best criterion of the ultimate success of the reforms should of course be economic growth rates. But for several reasons (primarily "distortion of the picture" by the high percentage of oil and gas production in Azerbaijan), direct indicators of economic freedom are more precise in the Caucasus at present. The analysis conducted every year by the Heritage Foundation in cooperation with *The Wall Street Journal* is considered the most acceptable for making international comparisons in this area (see Table 2).[10]

Of course, these indicators are also provisional to a certain extent. Sometimes it even happens that two positive changes together produce a negative result. For example, the authors of the *Index of Economic Freedom* calculate the tax burden on the basis of the ratio of state spending to the GDP. In Azerbaijan, tax rates in the period under review dropped, which should have led to a reduction in the tax burden. But tax collection improved at the same time, which cancelled the benefits from the drop in tax rates and led to an increase in the percentage of state spending in the GDP and, correspondingly, to a drop in the end coefficient. This technically means that businessmen now pay more taxes, al-

Table 2

The Level of Economic Freedom

Indicators \ Countries	Azerbaijan	Georgia	Armenia
Trade	3.0	3.5	2.0
Tax burden	3.6	2.3	2.1
State interference in the economy	3.0	1.5	2.0
Monetary policy	2.0	2.0	2.0
Foreign investments	4.0	3.0	1.0
Banks and finances	4.0	2.0	1.0
Incomes and prices	3.0	3.0	2.0
Property rights	4.0	4.0	3.0
Economic regulation	4.0	4.0	4.0
Informal economy	4.5	4.5	3.5
Total score	3.51	2.98	2.26
Rank among 157 countries	123	69	27

[10] Compiled according to: *Index of Economic Freedom—2006*, calculated by *The Heritage Foundation* and *The Wall Street Journal,* available at [http://www.heritage.org/research/features/index/indexoffreedom.cfm].

though in actual fact the total sum of official taxes and "informal payments" (bribes) most likely decreased. So these indicators should be respected, but also taken with a grain of salt.

Nevertheless, the data presented confirm the fact that the Central Caucasian states must resolve several urgent problems, the most important of which are shrinking the size of the impermissibly "inflated" informal economy and ensuring the real guarantee of property rights.

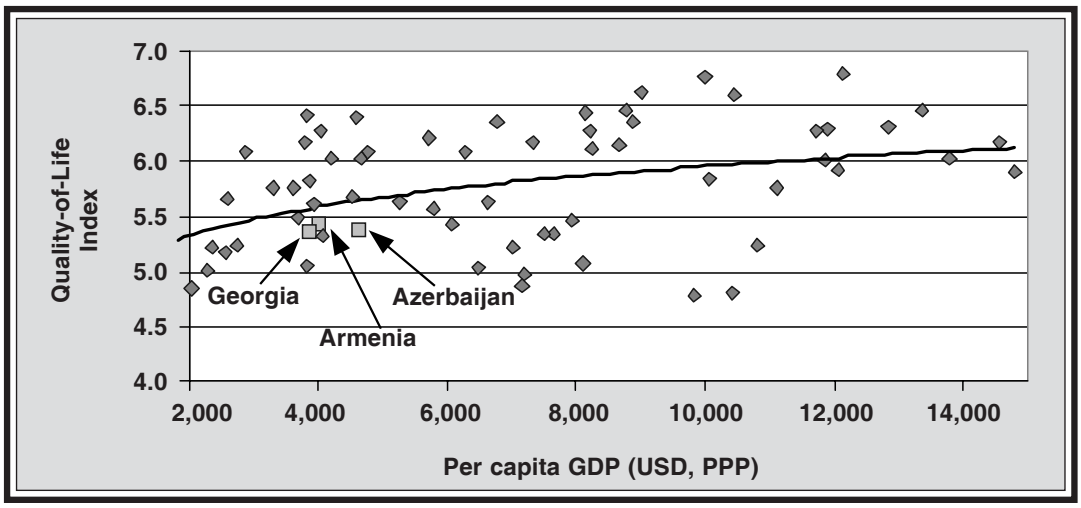
In this way, from the historical perspective, the Central Caucasian states' independence, as well as the important political and economic reforms they have carried out are indisputable achievements. Nevertheless, the Central Caucasus could make more efficient use of this historical opportunity. The main obstacles are expansionism and separatism. Regional conflicts are having a negative effect on the political and economic development of the Central Caucasian countries.

Political Stability and Economic Progress

The theoretical interdependence between these two concepts is obvious: they are reciprocal. The most authoritative source for measuring the correlation between them is the data published in *The Economist Intelligence Unit.* But it does not present a complete enough list of countries for which an assessment of the political stability risk is given; this list does not include Georgia and Armenia. Only those states are included on the rating list in which large investors are seriously interested.[11] The rating of countries in terms of quality of life is more complete. According to the methodology applied here, political freedom and security are the most significant (26.2%) components of the quality of life. Therefore, the correlation between per capita GDP and quality of life, although indirect, still reflects the interdependence between political stability and economic progress (Fig. 2).

Figure 2

Correlation between Per Capita GDP and Quality of Life[12]



[11] See: *Risk Briefing,* available at [http://viewswire.com].

[12] Compiled according to: *The EIU—Worldwide Quality-of-Life Index, 2005*, available at [http://www.economist.com/media/ pdf/QUALITY_OF_LIFE.pdf]. Countries are considered where the per capita GDP according to PPP is between $2,000 and $15,000.

In this figure, the quality-of-life indices are scattered quite far from the trend line, whereby this is true of both poor and relatively rich countries. This shows, among other things, that material prosperity in society's perception does not play as high a role as might be expected. Although perhaps it would be expedient to differentiate the percentage of factors depending on the level of per capita GDP and, as it increases, raise the percentage of material factors by decreasing the value of factors such as gender equality or social activity. From the analytical viewpoint, it might be productive to carry out a parallel compilation of ratings for groups of countries in which per capita GDP fluctuates within well-known limits.

Political instability is hindering economic progress for several reasons, the most important of which are as follows:

- the government cannot make the correct economic decisions, particularly if they threaten to be politically unpopular;
- domestic and, especially, foreign investments are dramatically slowing down, particularly in branches where the payback period is long (even oil investments were not made in Azerbaijan until the second half of the 1990s, although they are usually less subject to political risk than investments in other branches). A so-called *vicious circle of political instability* arises when the threat of political change and violation of property rights limit investments, which entails a drop in economic growth rates and an increase in poverty and social tension, creating, in turn, the threat of new political cataclysms;
- the outflow of capital from the country is increasing, whereby residents are also exporting it. The progressive difference between the volume of gross domestic savings and total domestic investment in favor of the first can be interpreted as one of its indicators;
- business is oriented toward "fast" profit, which can often take forms detrimental to the economy (in the Caucasus, the situation became absurd, when at the end of the 1980s-first half of the 1990s, dismantled railroad rails or power transmission lines were "exported" abroad essentially for a song);
- the monetary system is not withstanding political pressure, inflation is becoming difficult to control (the highest inflation was noted in Azerbaijan in 1994 at 1,800%, and an important role in this was played by political instability in 1993).

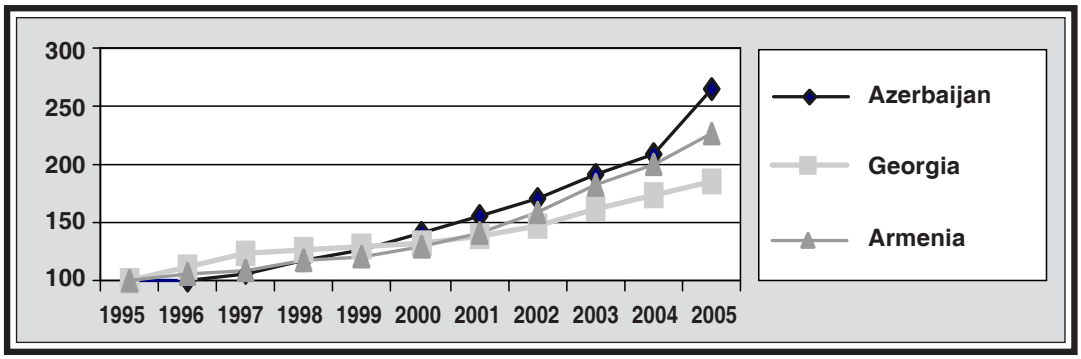
But it stands to reason that political stability in itself does not guarantee economic progress. This is at least evidenced by the differences in rates and quality of economic growth in countries which are generally recognized to be politically stable.

Dependence of economic development on political stability in the states of the Central Caucasus. At the end of the 1980s-beginning of the 1990s, the economy of the region's countries fell under the destructive influence of political instability, both internal and external. After Azerbaijan and Armenia signed a cease-fire agreement on 12 May, 1994, relative political stability was established in them, which was expressed, with a certain time lag, in accelerated economic growth. Domestic political instability in Georgia was retained at a higher level, which apparently was one of the reasons for the less dynamic economic growth compared with Armenia and particularly with Azerbaijan (see Fig. 3 on p. 118).

Armenia overcame its overall political instability, objectively caused by the war, at a faster rate than Azerbaijan. War in itself is undoubtedly the highest (extreme) form of breakdown in stable social development. The war ended favorably for Armenia and did not have domestic political repercussions, rather vice versa. In Azerbaijan, on the other hand, domestic political instability, which was one of the most important reasons for the military failures, became even more aggravated because of the latter. The country needed more time to gear up to normal economic progress, since the time lag itself needed for this began later. The coincidence of the curves of the volume of GDP in Azerbaijan and Armenia until 1998 is explained by the mass foreign investments made after signing the first oil contract in 1994.

Figure 3

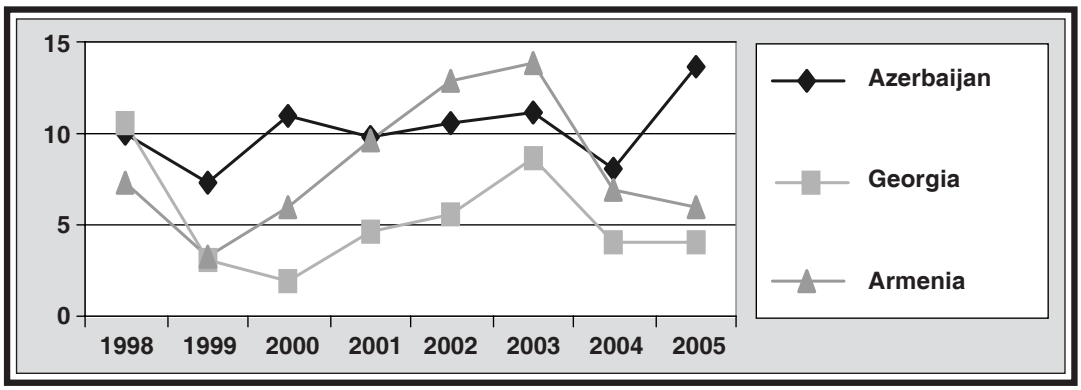
GDP Volume Indices (*at constant prices, 1995 = 100*)[13]



The dynamics of real GDP reveal the more subtle correlation between political stability and economic progress (Fig. 4).

Figure 4

Growth in Real GDP (*in %*)[14]



Here a certain anomaly is clearly seen, which is expressed in a slowdown in real GDP in Azerbaijan in 2002-2003, although growth was maintained above the 10% level, which in itself is quite a high index. This slowdown, which was somehow contradictory to the dynamic acceleration that began in the previous years, was caused, among other things, by the political uncertainty resulting from the deterioration in President Heydar Aliev's health.

Political expectations had an effect on the economic behavior not only of local, but also of foreign businessmen. After the presidential election at the end of 2003, and subduing of the unrest that followed it, political stability in the country was quickly restored, which was soon reflected in an increase in economic growth rates. This process continued throughout 2004. According to the forecasts, the growth in Azerbaijan's real GDP will not fall below the 20% mark in the next few years, thus competing with the most dynamically developing economies of the world.

There is apparently a correlation between Georgia's Rose Revolution in November 2003 and the slight slowdown in GDP growth in 2004-2005: any revolutionary change gives rise to a certain

[13] Calculated on the basis of data of the CIS Interstate Statistics Committee, available at [http://www.cisstat.com/rus/index.htm].

[14] Compiled according to IMF statistics; data for 2004 and 2005—estimated (see: *Recent Policies and Performance of the Low-Income CIS Countries*, April 2004, available at [http://www.imf.org/external/np/oth/042304.pdf]).

amount of political uncertainty and instability initially. But if it remains in a strategically correct development vector and promotes systemic stability, a revolution can create prerequisites for economic stability too, that is, stabilization of economic progress rates at a specific, "economically normal" level. If Georgia can cope with its foreign and domestic political problems (i.e. normalize relations with Russia, on the one hand, and overcome internal separatism, on the other) while retaining political stability, in the next few years, economic growth will stabilize at the level of 6-7%.

It would of course be a great mistake to explain the economic growth curves by means of political factors alone, including by the presence or absence of stability. In particular, it is unlikely that the noticeable slowdown in real GDP growth in Armenia in 2004-2005 has direct political undertones. It most likely returned to its "economically normal" level observed right up until 2000.[15]

Conditions under which political stability can work toward long-term stable economic growth. There are two mandatory conditions.

- ***First***, it (political stability) should be systemic, that is, ensured by the very political structure of society, its formal and real political-legal system, as opposed to stability, which rests primarily on the political authority of the head of state (or on repressive state machinery, or on both at the same time). If the second is also possible in authoritative systems of governance (including in dictatorships), the first is characteristic only of the democratic social system. The second form is always temporary, while the first is long-term. Authoritative political stability may become a launching pad for creating systemic stability, but this requires that it be aimed at conducting intensive political reforms.

  Consequently, for the states of the Central Caucasus, a fundamental condition of economic progress is not political stability as such, but as democratic development within the framework of this stability. Here they have serious problems, particularly with respect to forming (changing) power by peaceful and democratic means. Even the last change of power in Georgia, which the outside world perceived as the most democratic in the Caucasus, was in fact not a result of election, but only legitimized by it.

- ***Second,*** within the framework of systemic political stability (or in the process of its formation), an efficient system of economic motivations must be formed, the starting point of which is macroeconomic stability.[16] Without it, it is impossible to optimize the correlation between the private and state sectors, lowering the tax burden and implementing social programs, free foreign trade and protection of the domestic market, and so on in each time segment. In this sense, that is, in the sphere of efficient state regulation of the market economy, serious problems exist in the region, which however are beyond the scope of this article.

Dependence of political stability on economic progress. We all know that the more dynamically the economy develops, the stronger the government will be, all other things being equal. The thing is that political stability, understood as stability of the government, is very much tied to most of society's perception of its own socioeconomic prosperity, particularly in poor countries. In this sense, Azerbaijan differs dramatically from the other Caucasian states, since petrodollars allow the government to raise social prosperity even without conducting reforms that are adequate to the demands of the economy and stimulate business activity.

A principled condition of the positive influence of economic progress on political stability is the fair distribution of social benefits. Otherwise, it not only fails to strengthen, but, on the contrary, threat-

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[15] The normal economic growth rate for each stage of social development is determined by a large number of factors put into play by the political confrontation of supporters and adversaries of expanding (or reducing) state interference in the economy (see: N. Imanov, "Pravye i levye v ekonomike: Vsegda li seredina zolotaia?" in: *Ekonomicheskie etiudy.* Baku, 1999).

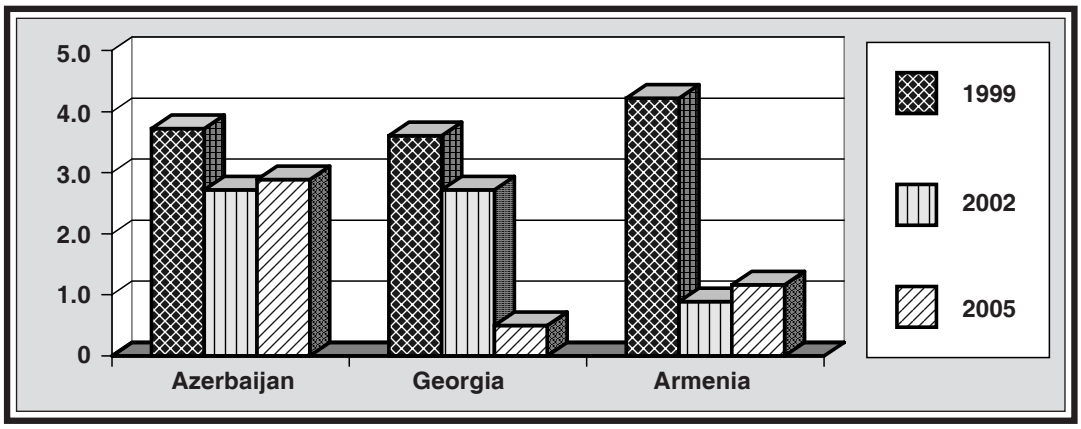
[16] For more details on the necessary and sufficient conditions of macroeconomic stability and degree to which they are satisfied by the Caucasian states, see: N. Imanov, "Political and Economic Development: Correlation in Southern Caucasus," in: *Towards Social Stability and Democratic Governance in Central Eurasia,* ed. by I. Morozova, IOS Press, Amsterdam, 2005, pp. 231-243.

ens political equilibrium. The societies of the Central Caucasian states must, first, "digest" and adopt a market conception of justice new to them; and second, believe in the possibility of getting rich by entirely legal means, without the protection of the power elite. It is extremely important to continue reform of the civil service, since anyone's involvement in state governance is essentially tantamount now to his corruption, which is another form of unfair distribution of material and, partially, spiritual benefits.

At present, ***the fight against corruption*** is ultimately the best way for economic progress to have a positive impact on political stability. According to the studies of *Transparency International*, in 2005, Azerbaijan and Georgia improved their *Corruption Perceptions Index*, while in Armenia it dropped slightly, although there this index is still the lowest in the Caucasus.[17] A joint EBRD and WB business environment and enterprise performance survey (*BEEPS*) showed that in the past few years, the frequency of bribes paid by companies in Azerbaijan and Armenia significantly decreased, while in Georgia, it grew slightly.[18] Nevertheless, corruption is still one of the main (if not the main) factors hindering economic development of the region's countries, which is shown in particular by the results of the latest business environment survey conducted by EBRD and WB (Fig. 5). In 2002-2005, the bribes paid by companies in Azerbaijan and Armenia in relative terms (as a percent of annual sales) even rose slightly, while Georgia managed to achieve impressive results in decreasing them.

Figure 5

Bribes Paid by Companies (*in % of annual sales*)[19]



Intra-Country Correlation Between Political Democracy and Economic Progress

The global trend is seen rather clearly. A comparison between the indices characterizing political rights and civil freedoms and marcoeconomic indicators reveals a certain dependence between them (see Table 3). Most rich countries (79%), where per capita GNI is higher than 6,000 dollars, are among the free ones, and most poor countries (84%) are among the not free or partially free. Only 46% of all countries are considered free, whereby approximately 44% of the world population lives in them. However, they produce about 90% of the world GDP, while the other 54% produce only 10%.

[17] See: *Corruption Perceptions Index 2004 and 2005*, available at [http://www.transparency.org].

[18] See: *Recent Policies and Performance of the Low-Income CIS Countries*, April 2004, p. 26, available at [http://www.imf.org/external/np/oth/042304.pdf].

[19] Compiled according to: *Azerbaijan (…Georgia, Armenia) BEEPS-at-a-Glance, The WB—2005*, available at [http://siteresources.worldbank.org/INTECAREGTOPANTCOR/Resources/BAAGREV20060208Azerbaijan.pdf].

Table 3

Democracy and Economic Development

Groups of countries \ Category	Free	Partially free	Not free
Poor countries **(per capita GNI less than 1,500 dollars)**	**15** ***(16%)***	**39** ***(43%)***	**37** ***(41%)***
Average countries **(per capita GNI between 1,500 and 6,000 dollars)**	**35** ***(66%)***	**11** ***(21%)***	**7** ***(13%)***
Rich countries **(per capita GNI more than 6,000 dollars)**	**38** ***(79%)***	**5** ***(10%)***	**5** ***(10%)***

Source: *Freedom in the World 2004* (Freedom House's Annual Global Survey), available at [http://www.freedomhouse.org/template.cfm?page=130&year=2004].

Individual level. Here the dependence is caused by the fact that economic freedom of the individual is the most important of individual freedoms and, in a certain sense, even forms their foundation. There were and are examples in world practice of individuals enjoying a certain level of economic freedom while their basic political freedoms were strictly limited. The best illustration of this is China during the last ten years. But individual political freedom is impossible by definition without economic freedom, since the second is perhaps the most important of political rights.

Applying this idea to the countries of the Central Caucasus gives rise to certain hopes: here the level of economic freedom surpasses the level of political development almost everywhere, but the distance from theoretical economic freedom to the actual thing is rather long. Along the way are all kinds of factors hindering the development of business, including informal monopolism, dishonest competition, inefficient courts, and insufficient information, etc.

Hypothesis on the economic corridor of political activity. Political freedoms, which in their totality form the democratic system, are some of the highest demands and acquire practical urgency (social value) only after so-called basic demands are satisfied. So social activity aimed at democratization as a rule comes into play after the country has achieved a certain level of economic development and, correspondingly, prosperity (meaning democratic movement initiated "from below" and not "from above"). Apparently, there is a certain limit to economic development, after which this movement loses its social urgency. This is because fundamental political and civil rights have already been acquired, without which this level of economic progress would have been impossible.

Thus it can be presumed that there is a certain segment (economic corridor) in the growth of economic prosperity, which best stimulates political activity. Political passivity is characteristic both of the time before a certain minimum is achieved, and after most of the population has passed a certain peak of prosperity. The periods of revolutionary activity aroused by social motives "before the corridor," just as outbursts in defense of democracy "after," are probably not the norm, but a deviation from it. The corridor of optimality depends on many different (primarily culturological) factors and, of course, is specific for each country.

Judging by the level and intensity of the democratic movement, the Caucasian states have already reached a stage of economic progress that effectively stimulates society's striving for political development.

Exception to the rule. The argument that economic development stimulates political reforms after a certain level is reached is general in nature. There are of course exceptions. And there are both political and economic factors causing these exceptions. War is the most serious political factor, while a surplus of natural resources is the most detrimental economic element.

Researchers have long noticed that there is a certain contradiction between surplus resources and democratic development. In most countries rich in natural resources, difficult problems arise in the field of democracy and human rights.[20] It can easily be seen that in the world rating almost all the resource-producing countries occupy higher places in terms of per capita GDP than in terms of quality-of-life index, that is, their relatively low social activity and political freedom indicators pull them down.[21]

In Azerbaijan, some signs of this contradiction have already appeared. The almost automatic rise in prosperity, which is intensified by the high price of oil on the world market (such a level was not forecast when the contracts were signed), is weakening society's striving for political and, to a certain extent, even economic reforms. This is apparently one of the reasons for the weakness of the political opposition, which today is not only failing to define the political agenda, but is not even capable of having any serious influence on it. In so doing, both local and foreign experts believe that society's internal readiness for a democratic system is quite high. Many democratic values and standards, such as religious or national-ethnic tolerance, for example, are internally inherent in present-day Azerbaijani society.

In Armenia and Georgia, this contradiction is manifested in a different way. The thing is that not only surplus natural riches hinder democratic development, but also any other financial resources, seeming windfalls. In Armenia, this takes the form of continuous financial assistance from the diaspora. Most of these funds are spent on social needs by the government and create an effect similar to that caused by petrodollars in Azerbaijan, only to a lesser extent. In Georgia, the same role is played by large-scale financial and material assistance rendered the country by Western state and international organizations.[22] The difference is that these funds are being granted for specific purposes related, as a rule, to anti-corruption activity, increasing the efficiency of state administration, and developing democratic institutions. This gives Georgia an important advantage over its neighbors.

It can be concluded that factors hindering the stimulating influence of economic progress on the processes of democratic development are in effect in all the Central Caucasian countries. In the short term, Georgia will be the state with the most favorable conditions from this viewpoint, and Azerbaijan the least favorable.

Political conditions of the economic reforms. The global trend presented at the beginning of this section clearly shows that in the long term, democratic countries have immeasurably greater potential for economic development. This is because only a democratic political system makes it possible for the market stimulators of economic growth (the inviolability of private property, competition, and so on) to manifest their full creative force.

It is a well-known fact that authoritative regimes usually prefer to steer clear of liberal economic reforms, since a centralized economy is an important background prerequisite for preserving the regime. But when the carrying out of economic reforms becomes a goal, authoritative regimes, as world practice shows, have some advantages here. The thing is that they possess much greater resources for suppressing the social discontent caused by the consequences of liberal reforms, which are not always popular at first. Admittedly, these changes—after a certain critical level is eventually reached—also generate the need for political liberalization.

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[20] See, for example: K. Terry, *The Paradox of Plenty: Oil Booms and Petro-States,* University of California Press, Berkeley, 1997.

[21] See: *The EIU—Worldwide Quality-of-Life Index…*

[22] Right before the Rose Revolution and immediately after it, the amount of financial aid granted Georgia grew in leaps and bounds. The U.S., Japan, Germany, Italy, and Switzerland rendered it tangible support, and in June several leading Western states and international organizations adopted a joint decision to grant Georgia financial aid totaling one billion dollars in the next two years, that is, we are talking about figures comparable to the size of the Georgian economy (see, for example: Electronic newspaper *Day Az*, 3 December, 2003, available at [http://www.day.az/news/georgia/2455.html]; 2 March, 2004, at [http://www.day.az/news/georgia/4881.html]; 13 May, 2004, at [http://www.day.az/news/georgia/7549.html]; 15 June, 2004, at [http://www.day.az/news/georgia/8931.html], etc.

Regional Political Stability and Regional Economic Integration

Joint interest in regional economic cooperation is obvious. This stems from the inviolable fact that not one of the Central Caucasian states is economically self-sufficient today, nor will be in the future, and this even without taking into account that, during globalization, the concept of economic self-sufficiency will apparently become totally obsolete in the next twenty-five years.

Azerbaijan is needed by its neighbors primarily as a supplier of energy resources. Oil "sells itself," so no problems are anticipated with its sale. Nevertheless, it needs relatively free sales markets of non-petroleum products, the export of which the country must significantly expand in order to improve the branch structure of the economy as a whole, and of export in particular. What is more, in the next 15-20 years, the inevitable surplus of capital will prompt Azerbaijan to look for ways to efficiently spend it abroad (to ease the pressure of petrodollars on the domestic financial market). Georgia and Armenia, with their unsatisfied demand for investments, are the best places for this.

Georgia is just as interested as Azerbaijan in regional economic cooperation. First, this country could create an economic foundation for its territorial integrity in this way, and second, it could obtain good dividends by acting as a mediator between Azeri and Armenian business circles. This is particularly true, since after renewing their economic contacts, these two countries will find it difficult to cooperate with each other directly: it will take time to overcome their if not mutual hatred, at least psychological discomfort.

And, finally, Armenia is interested in regional economic cooperation, probably even more so than its neighbors. Azerbaijan is doing its best to exclude Armenia from major regional projects, particularly communication ones, which will have long-term negative consequences for its economy. The arms race requires a continuous increase in military spending. What is more, Armenia will find it impossible to realize the strategic economic goals it has set itself[23] without regional cooperation.

The current state of regional economic integration falls far behind the potential, primarily due to the existing political restrictions: there are simply no official economic relations between Azerbaijan and Armenia. As for Georgia, it engages in a certain amount of foreign trade cooperation with both neighbors, but it is still unable to ensure its own domestic economic unity.

The statistics of the Central Caucasian countries are unfortunately presenting slightly differing data on the volumes of export-import operations among these republics. Each of them artificially raises its export and lowers its import (see Table 4 on p. 124), whereby the difference in statistical indices is extremely large. For example, the Azerbaijani index of export to Georgia is higher than the Georgian import index from Azerbaijan by 16.5% of the first and 19.9% of the second. The difference between Georgia's export index to Azerbaijan and Azerbaijan's import index from Georgia is simply indecent—42.7% of the first and 74.5% of the second. The difference between Georgia's export index to Armenia and Armenia's import index from Georgia amounts to 11% of the first and 12.4% of the second. These discrepancies, which can in no way be written off as "statistical errors," prompt disturbing thoughts about the dimensions of corruption.

It remains a fact that the volume of inter-Caucasian economic cooperation falls far short of the potential.

Can the Central Caucasus, under current political conditions, become a single economic space? Armenia continuously insists that economic cooperation is a prerequisite for resolving political conflicts. Azerbaijan believes that these statements are in fact aimed not at peaceful settlement, but are for propagandist purposes. Under the current circumstances, Armenia's calls for economic integration with Azerbaijan are essentially utopian. The cease-fire, which both countries are observing, a priori presumes that the war is not over. It is difficult to conceive of anything more illogical than economic cooperation between two fighting states, one of which is occupying a fifth of the other.

[23] See, for example: *"Armenia 2020." Sbornik stsenariev*, Erevan, 2004.

Table 4

Export-Import Operations Among the Central Caucasian Countries in 2004 with Deviations in Statistics (*million USD*)

		to/from Azerbaijan		to/from Georgia		to/from Armenia	
			difference		*difference*		*difference*
Azerbaijan	**Export**			**188.9**	***+ 31.2***	**0**	**0**
	Import			**14.5**	***– 10.8***	**0**	**0**
Georgia	**Export**	**25.3**	***+ 10.8***			**54.5**	***+ 6.0***
	Import	**157.7**	***– 31.2***			**25.4**	***– 3.7***
Armenia	**Export**	**0**	**0**	**29.1**	***+ 3.7***		
	Export	**0**	**0**	**48.5**	***– 6.0***		

Compiled according to: *Statistical Yearbook of Azerbaijan—2005*, "Sada" PH, Baku, 2005, p. 716; *Statistical Yearbook of Georgia—2005*, p. 292, available at [http://www.statistics.ge/index_eng.htm]; *Statistical Yearbook of Armenia—2005*, p. 487, available at [http://www.armstat.am/StatData/taregirq_05/index.html].

This is one of the few questions on which complete consensus has been established in Azerbaijan: the government, and the opposition, and the country's public opinion as a whole believe that establishing economic ties with Armenia is not simply undesirable, it is also impermissible. Economic relations with Armenia would work toward freezing and even aggravating the conflict, rather than toward settling it. The question is simple: is Armenia willing to cease occupation of Azerbaijani territory and recognize its territorial integrity within the borders accepted by the world community, if economic cooperation between the two countries is restored? The answer is unequivocally in the negative.

As for Georgia, it is interested in expanding economic cooperation both with Azerbaijan and with Armenia. It hopes to use these bilateral relations to become the center of attraction in the Caucasus. It is even more interested in economic relations with Abkhazia and South Ossetia (although not as independent states), since economic integrity is the foundation of restoring the state's political sovereignty over all of its territory. But Abkhazia and South Ossetia are categorically against this, that is, establishing economic (or any other) relations with Georgia in keeping with the "region-center" principle.

Reverse correlation. There is definitely a correlation between regional political and economic progress, but it also works in reverse. The settlement of political conflicts comes first, with the Karabakh conflict being the primary one in terms of size and significance for economic integration of the Caucasus. It is utterly clear that settlement of political problems is the key to building a single economic space, and not vice versa.

Metamorphosis of the objectives of economic development. When talking about economic progress, the Caucasians, as a rule, do not mean regional integration, but economic development of their own country and, what is particularly important, mainly for political purposes.

The opinion prevails in Azerbaijan that the country should multiply its own economic might to restore its territorial integrity in the future and, as a priority task, strengthen its armed forces. Among the social and political objectives of economic growth, it is the second that is becoming the top priority, which cannot help but have an impact on the structure of economic development, in particular, government spending. In essentially all of his speeches on the Nagorno-Karabakh conflict, Azerbaijani President Ilham Aliev confirms his adherence to intensive economic development as a prerequi-

site for strengthening the country's military, emphasizing in so doing, that in the near future, Azerbaijan's military spending will be higher than Armenia's entire state budget.[24]

Identical approaches also prevail in Armenia and Georgia: in the first case, a strong economy is needed to create a strong army capable of "defending" Karabakh, and in the second, again to create a strong army capable of ensuring the country's territorial integrity. For example, shortly after becoming head of state, Georgian President Mikhail Saakashvili said that a strong economy is the main prerequisite for restoring the country's control over Abkhazia.[25]

Thanks to its oil and gas resources, Azerbaijan has an indisputable starting advantage in this economic competition. Beginning in 1994, the country signed approximately 30 production and production sharing agreements with the largest world companies. Work on building oil and gas pipelines for delivering the raw materials to the world markets is close to completion. The currency reserves of the State Oil Fund of Azerbaijan currently (as of 1 January, 2006) reach $1.4 billion[26] and, according to the forecasts, in 2010, they will be three-fold higher than the country's state budget. In 2006, spending from the Oil Fund, in correspondence with its budget approved at the end of last year, will be more than $1 billion. Approximately 10% of this amount will be spent on forming the statutory capital of the new State Investment Company.[27] Azerbaijan views the revenues from energy resource exports only as a starting boost for the non-petroleum economy, the development of which will remain a priority.

From the viewpoint of our subject a noteworthy metamorphosis is that the Central Caucasian states do not so much consider an increase in social prosperity to be the objective of economic development, which would be normal, as the settlement of political problems by concentrating forces: economic on the whole, and military in particular. This is understandable. No one in the Caucasus is declaring that they are preparing for war. Technically, military-economic might is evaluated as an additional, and possibly the most efficient argument at the talks, although it is well known than ***the concentration and demonstration of force have the habit of developing into the use of force after a certain level is reached.***

Prospects

The development of the Central Caucasus as an integral region has unfortunately not even begun yet, but this does not mean that even greater destruction of its political and economic integrity is inevitable: both positive and negative changes are possible. Positive changes are possible if the countries and autonomies of the region refuse to forcibly change the state borders. The settlement of the Karabakh problem within the framework of Azerbaijan's internationally recognized borders is the pivotal issue, after which restoration of Georgia's territorial integrity would largely be a technical matter.

Settlement of these political problems would open up greater prospects for regional economic development, since economic integration in the Caucasus is derived from political integration, and not vice versa.

The decisive role of the Caucasian people in overcoming their own political and economic problems in no way excludes external involvement. What is more, without it, as the practice of the past decade shows, it will be extremely difficult, if not impossible, to achieve major progress without renewing the hostilities.

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[24] See, for example: *Speech by President Ilham Aliev at the 2nd Congress of Azerbaijanis of the World, 16 March, 2006*, available at [http://www.president.az/s09_speeches/_speech_r.html].

[25] See: Electronic newspaper *Day.Az*, 8 March, 2004, available at [http://www.day.az/news/georgia/5084.html].

[26] See: *SOFAZ Revenue and Expenditure Statement for 2005*, available at [http://www.oilfund.az/inside.php?nID=131].

[27] See: *SOFAZ 2006 Budget Approved*, available at [http://www.oilfund.az/inside.php?nID=122].