



# Azerbaijan in Transition

Jens Hölscher

## Abstract

Azerbaijan has been the fastest growing economy of the world and it increasingly attracts the interest of foreign investors. This paper analyses the Azerbaijani economy in transition from communism to capitalism over the past decade with a focus on investment climate. Facts and figures of the apparent economic miracle are presented and a number of political obstacles considered. Azerbaijan's transition towards a market economy has not gone very far and it is mainly slowed down by low levels of trust and high levels of corruption. There are also human rights issues and freedom of press is limited. Unless and until Azerbaijan deals with these problems, shadows will continue to loom over its economic miracle.

**Keywords:** *Azerbaijan economy / Economic transition / Foreign investments / Business climate / Corruption / Human rights*

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## Azerbaijan in Transition

by Jens Hölscher\*

### Introduction

Azerbaijan has an ancient history, sometimes referred to as “the land of fire”. In Greek mythology, Prometheus was chained to the Caucasus Mountains, as he stole the fire from the gods and brought it to human beings. Indeed, an abundance of gas and oil resources give rise to open fires in Azerbaijan, there where mankind struggled to discover fire elsewhere for a long time. These energy riches are the core of the economy of Azerbaijan. The purpose of this paper is to analyse the Azerbaijani economy in transition from communism to capitalism. The focus is on the investment climate, in particular the climate for foreign investment. After the fall of the Berlin Wall, Azerbaijan - like other parts of the former Soviet Union - became an independent state. This posed a huge challenge, as many state institutions, such as the central bank and the ministry of the economy, had to be created from scratch. In addition to the lack of institutions, the related forms of knowledge were absent. Building a market economy required building a new state.

Azerbaijan’s geopolitical location, at the crossroads between Europe and Asia complicated matters. Bordering with Iran has not only led to some disputes over gas and oil resources in the Caspian Sea, but also to political and religious tensions. Azerbaijan is a secular Muslim society, which stands in sharp contrast to the Islamic Republic of Iran. To the north is the border with Russia, and Azerbaijan’s close ties with the European Union and the United States are watched carefully by Moscow. The broader region territory has also witnessed violence and war (Chechnya, Abkhazia, South Ossetia, Nagorno-Karabakh), heightening further the risks for investment, particularly when it comes to the construction of pipelines.

Azerbaijan is a small open economy with a population of 9 million citizens and a territory of 87 thousand km. The capital Baku is a harbour town on the seafront of the Caspian Sea with regular ferry and also pipeline connections to Kazakhstan, another oil and gas rich country of a much larger size. The main ethnicity and official language is Azeri, but there are eight other ethnic minorities. The national currency, the Manat, is pegged to the US Dollar and has been stable over recent years.

Azerbaijan has been a fast growing economy until 2008 and the current slowdown is temporary and linked to technical problems in the oil industry. The current global economic slowdown particularly in Europe however presents some challenges for the Azerbaijani economy, as oil prices remain below their mid-2008 highs. Oil production has increased dramatically since 1997, when Azerbaijan signed the first production-

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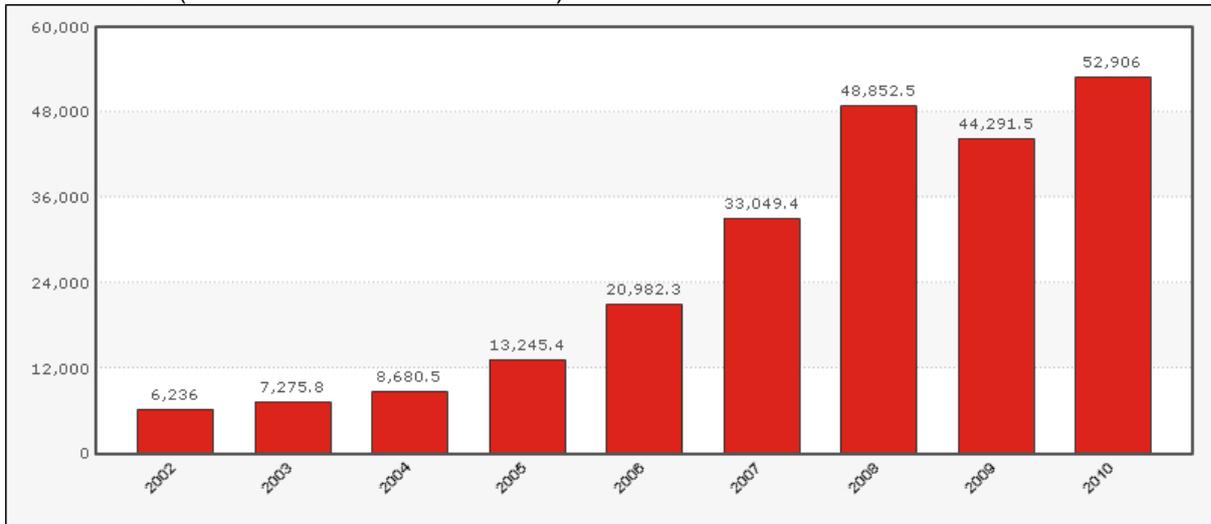
\* Jens Hölscher is Head of the Research Group Economic and Social Transition, University of Brighton.

sharing arrangement (PSA) with the Azerbaijan International Operating Company. Although the economy depends almost exclusively on oil and gas, other non-export sectors like services and construction also experienced double digit growth.

## 1. The economic miracle in facts and figures

Azerbaijani growth over the last decade measured in absolute or relative terms is stunning. Table 1 shows GDP growth in absolute terms.

**Table 1.** GDP (in millions of current US dollars)



Source: World Bank, World Development Indicators<sup>1</sup>

From 2002 to 2006 income more than doubled and from 2006 to 2008 it more than tripled. There was a small dip post-2008 as a consequence of the global economic crisis, but the economy has recovered quickly. This observation is confirmed by looking at GDP per capita (table 2).

**Table 2.** GDP growth (%) and per capita (in US dollars)

2002	2003	2004	2005	2006	2007	2008	2009	2010
10.6	11.2	10.2	24.3	30.5	23.4	10.8	9.3	9.0
760.5	880.9	1,051	1,577	2,498	3,730	5,508	5,119	n.a.

Source: EBRD, Macro economic indicators<sup>2</sup>

The table also shows that Azerbaijan was a rather poor country before the boom began. 760.50 \$ per capita per year meant that the average Azerbaijani citizen had to make a living with \$2 per day, which is close to the poverty line. This change from a low income country (LIC) to a middle income country (MIC) came about very quickly

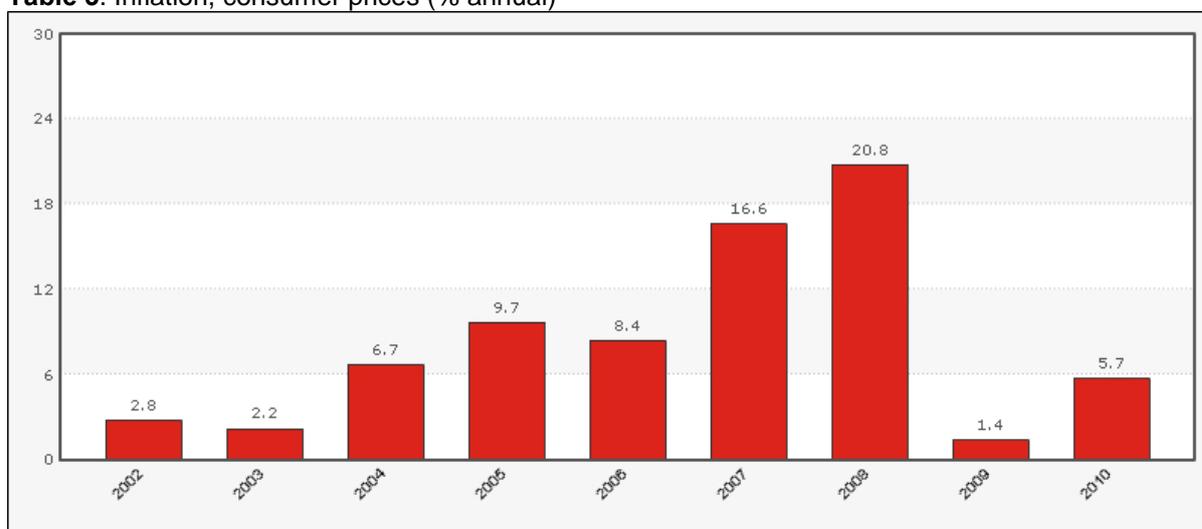
<sup>1</sup> World Bank, *World Development Indicators & Global Development Finance*, <http://databank.worldbank.org/ddp/home.do?Step=12&id=4&CNO=2>.

<sup>2</sup> EBRD, *Macro economic indicators*, <http://www.ebrd.com/pages/research/economics/data/macro.shtml>.

with double digit growth rates at their peak in 2006 with 30 percent, which made Azerbaijan the fastest growing economy in the world. Interestingly, this high growth did not lead to high income inequality, as often occurs in developing countries and emerging economies. In 2008 the World Bank reported a Gini coefficient of 33.7<sup>3</sup>, which put Azerbaijan's income inequality in line with that of Latvia and below that of Russia or Turkey. However, table 2 also shows that there is still a long way to go before Azerbaijan catches up with high income countries.<sup>4</sup>

Such rapid growth normally causes rising prices and ultimately inflation. Not so in Azerbaijan, as table 3 shows.

**Table 3.** Inflation, consumer prices (% annual)



Source: World Bank, World Development Indicators

Given the high growth rates, inflation rates are modest. They peaked in 2008, but this was caused by a liquidity surge in order to fight the effects of the global crisis. The problem was only temporary and, as table 3 shows, was resolved quickly. This implies that monetary policy has been carried out effectively and the central bank has been in control of the money supply. Given the socialist legacies of the country, this is a remarkable achievement.

This economic miracle attracted remarkable foreign investments, which in turn boosted growth. Table 4 shows the quadrupled of this capital inflow over the last decade. Investments have come mainly from the United States, the United Kingdom and Turkey.<sup>5</sup>

<sup>3</sup> World Bank, *World Development Indicators*: GINI Index, <http://data.worldbank.org/indicator/SI.POV.GINI>.

<sup>4</sup> EU average income per capita is \$ 32.000 USD.

<sup>5</sup> Gerald Hübner, "Foreign Direct Investment in Azerbaijan: the Quality of Quantity", in *Caucasus Analytical Digest*, No. 28 (21 June 2011), p. 2-13, <http://www.css.ethz.ch/publications/pdfs/CAD-28-2-6.pdf>.

**Table 4.** Foreign investments (in millions of US dollars)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
<b>FDI inflows, % GDP</b>	22.3	45.1	41.0	12.7	-2.8	-14.4	0.0	1.1	1.1	2.3
<b>FDI inflows</b>	1,392.4	3,285.0	3,556.1	1,679.9	-584.0	-4,748.9	14.8	473.3	563.1	1,465.3
<b>FDI outflows</b>	325.6	464.5	1,163.6	1,221.0	705.0	285.6	554.8	326.1	231.9	532.7
<b>FDI net</b>	1,066.8	2,351.7	2,351.3	459.2	-1,289.5	-5,034.5	-540.8	147.2	331.2	932.6
<b>Total foreign inv.</b>	2,234.9	3,371.0	4,575.5	4,893.2	5,052.8	6,674.3	6,847.4	5,468.6	8,247.8	8,673.9

Source: World Bank, World Development Indicators; Azerbaijan Statistical Committee<sup>6</sup>

The main receiving industries are:

- Petroleum and natural gas
- Petroleum product
- Oilfield equipment
- Steel, iron ore, cement
- Chemical, petrochemicals, textiles
- Machinery, cotton, food

This picture might be misleading, as the industrial sector employs only 12 percent of the work force, whereas 40 percent of it still works in the agricultural sector. However, the service sector is highly developed with 50 percent employment share of the workforce.<sup>7</sup>

High investment inflows from the US and Europe have come with a strong relationship with both the US and the EU. Azerbaijan is currently part of the European Neighbourhood Policy and the Council of Europe. EU relations with Azerbaijan are governed by the EU-Azerbaijan Partnership and Cooperation Agreement, which was signed in 1996 and came into force in 1999. On the basis of bilateral priorities, a National Indicative Programme (NIP) has been adopted by the EU in agreement with the Azerbaijani authorities.<sup>8</sup> Through this programme the country became a large recipient of aid and infrastructure investment. In addition, also the World Bank provides funds for investment into infrastructure.

**Table 5.** Main trade partners 2011 (millions of US dollars and % of country total)

Export			Import		
Italy	9,341.0	35.2	Italy	9,595.6	26.4
France	4,036.7	15.2	France	4,645.5	12.8
USA	1,804.7	6.8	Russia	2,828.5	7.8
Russia	1,187.4	4.5	USA	2,435.1	6.7
Indonesia	913.2	3.4	Turkey	1,758.2	4.8

Source: International Trade Statistics Yearbook; Azerbaijan Statistical Committee<sup>9</sup>

<sup>6</sup> World Bank, *World Development Indicators*, cit.; Azerbaijan Statistical Committee, "Finance and credit", in *Azerbaijan in Figures*, 2012, <http://www.azstat.org/publications/azfigures/2012/en/020en.shtml>.

<sup>7</sup> World Bank, *World Development Indicators*, cit.

<sup>8</sup> More information available in the EEAS website: <http://www.eeas.europa.eu/azerbaijan>.

<sup>9</sup> UN Dept of Economic and Social Affairs, "Country Trade Profiles", in *International Trade Statistics Yearbook 2011. Vol. I: Trade by Country*, June 2012,

As shown in table 6, since 2005 Azerbaijan has been producing a sound export surplus, which dipped in the aftermath of the 2008 crisis, but has quickly recovered.

**Table 6.** External balance (current account in millions of US dollars)

2002	2003	2004	2005	2006	2007	2008	2009	2010
-454	-1,713	-2,077	1,330	5,822	13,093	20,670	12,975	18,005

Source: World Bank, World Development Indicators

Azerbaijan's main export goods include:

- Gas and oil
- Machinery
- Cotton
- Foodstuffs

While its import are:

- Machinery and equipment
- Oil products
- Foodstuffs
- Metals
- Chemical

Notwithstanding Azerbaijan's economic miracle, there is still a long way to go in the transition to a market economy. In this respect the European Bank for Reconstruction and Development's (EBRD) assessment highlights the challenges ahead. The EBRD measures transition towards a market economy against the standards of industrialized market economies, while recognizing that there is neither a "pure" market economy nor a unique end-point for transition. The measurement scale for the indicators ranges from 1 to 4+, where 1 represents little or no change from a centrally planned economy and 4+ represents the standards of an industrialized market economy. Table 7 shows the scores for Azerbaijan.

**Table 7.** Transition indicators, 2011

Large scale privatisation	3.67	Small scale privatisation	4.00
Enterprise restructuring	2.33	Price liberalisation	4.33
Trade & Forex system	4.33	Competition Policy	2.33
Banking reform & interest rate liberalisation	2.67	Securities markets & non-bank financial institutions	2.33
Overall infrastructure reform	2.67	Telecommunications	3.00
Railways	2.33	Electric power	3.33
Roads	2.67	Water and waste water	2.33

Source: EBRD Transition indicators by country<sup>10</sup>

<http://comtrade.un.org/pb/FileFetch.aspx?docID=4324>; Azerbaijan Statistical Committee, "External trade", in *Azerbaijan in Figures*, 2012, <http://www.azstat.org/publications/azfigures/2012/en/018en.shtml>.

<sup>10</sup> EBRD Transition Indicators, 2011, <http://www.ebrd.com/pages/research/economics/data/macro.shtml#ti>.

The table clearly demonstrates that Azerbaijan's progress towards a market economy over the past 20 years has been very slow and that it has been late starter. Only with regards to trade and the foreign exchange system, price liberalization and privatization, Azerbaijan can be classified as a market economy. In sectors such as infrastructure, finance and enterprise, restructuring is still at the beginnings.

But overall, the prospects are encouraging. As the EBRD Office of the Chief Economist<sup>11</sup> put it: "After successfully weathering the financial crisis, Azerbaijan's economy has slowed as the pace of oil extraction decelerated. The oil output decline has been only partially offset by robust growth of the non-oil sector, stimulated by budget expenditures. Diversification of the economy remains an important objective as risks associated with high oil dependence became apparent during the crisis, when oil prices declined. Immediate macroeconomic risks continue to be mitigated by a very strong fiscal position, which has been acknowledged in recent sovereign rating upgrades<sup>12</sup> by international rating agencies." So, the future is bright - it seems.

## 2. Obstacles for economic transition

According to Amnesty International, there are severe human rights problems in Azerbaijan.<sup>13</sup> From April 2011 to June 17 people in jail were regarded as political prisoners due to their opposition to the ruling regime. During the Eurovision Song Contest in May 2012, peaceful protests were dispersed under the eyes of the international media.<sup>14</sup> The internal freedom of press is ranked at place 162 (out of 179) in the world, which puts Azerbaijan behind countries like Pakistan, Afghanistan or Iraq<sup>15</sup>.

The 2011 *Corruption Perceptions Index* compiled by Transparency International also reveals important problems of corruption<sup>16</sup>. No region or country in the world is immune to corruption, and the vast majority of the 182 countries and territories assessed score below five on a scale of 0 (highly corrupt) to 10 (very clean). Azerbaijan hovers towards the bottom of the ranking, at place 143 and its assessment score is 2.4. In comparison with neighbouring Turkey, which is ranked 61 and scores 4.2, this assessment is worrying. The *Corruption Perceptions Index* ranks countries and territories according to the perceived levels of public sector corruption. It is an aggregate indicator that combines different sources of information about corruption, making it possible to compare countries. The 2011 index draws on assessments and opinion surveys carried out by independent institutions. These surveys and assessments include questions related to the bribery of public officials, kickbacks in public procurement, embezzlement

<sup>11</sup> EBRD, *Regional Economic Prospects in EBRD Countries of Operations: May 2012*, 18 May 2012, p. 11, <http://www.ebrd.com/downloads/research/REP/regional-economic-prospects1205.pdf>.

<sup>12</sup> By one notch to Baa3 from Ba1.

<sup>13</sup> See Amnesty International, *Report 2012: The State of the World's Human Rights*, 24 May 2012, p. 69-70, [http://files.amnesty.org/air12/air\\_2012\\_full\\_en.pdf](http://files.amnesty.org/air12/air_2012_full_en.pdf).

<sup>14</sup> See Azerbaijan page in Amnesty International website: <http://www.amnesty.org/en/region/azerbaijan>.

<sup>15</sup> Reporters Without Borders, *Worldwide press freedom index 2011-2012*, <http://en.rsf.org/press-freedom-index-2011-2012,1043.html> <http://en.rsf.org/press-freedom-index-2011-2012,1043.html>.

<sup>16</sup> Transparency International, *Corruption Perceptions Index 2011*, <http://cpi.transparency.org/cpi2011/results>.

of public funds, and the effectiveness of public sector anti-corruption efforts. Perceptions are used because corruption is to a great extent a hidden phenomenon that is difficult to measure. Over time, perceptions have proved to be a reliable estimate of corruption.

It is therefore no surprise that according to the second EBRD-World Bank's *Life in Transition* survey, only 40 percent of the Azerbaijani population is satisfied with overall life.<sup>17</sup> They share this feeling with the other Caucasus countries and this is mainly attributed to the presence of war and conflict. Table 8 shows the satisfaction with public services. The level of perceived corruption is extraordinary and twice as high as in the next ranked transition country, Kyrgyzstan, which report levels around 30 to 50 percent.

**Table 8.** Reported prevalence of unofficial payments

Sector	Per cent of respondents that report unofficial payments are usually or always needed
Public health system	72
Primary/Secondary education	65
Traffic police	66
Official documents	60
Vocational education	65
Social security benefits	63
Unemployment benefits	65
Civil courts	61

Source: EBRD and World Bank, *Life in Transition*, 2011, p. 32

The problem of high corruption levels is also reported by the *Economic Freedom index*<sup>18</sup>. Table 9 shows that in Azerbaijan the rule of law is ranked very low. The judicial system is non-transparent and subject to government interference. Property rights are highly regulated and score only 20 per cent. Also due to the high levels of corruption the freedom from corruption scores just 24 per cent. The Heritage Foundation ranks Azerbaijan overall at 58.9 per cent, which makes it the 91st freest economy in 2012.

Interestingly, fiscal freedom is ranked highest with 84.9 per cent. This reflects the low tax burden imposed on businesses with a top corporate tax rate of 20 per cent. The top individual income tax is 30 per cent. This obviously creates an investment friendly environment. Although this indicates limited government as such, one should bear in mind that President Ilham Aliyev's New Azerbaijan Party won the November 2010 parliamentary elections, but - according to the Heritage Foundation - questions of electoral fairness and legitimacy persist. A constitutional amendment to abolish presidential term limits, passed by national referendum in 2009, will allow Aliyev to seek a third term in 2013. Restraints on the media have included suspension of some foreign radio broadcast licenses.

<sup>17</sup> EBRD and World Bank, *Life in Transition. After the Crisis*, June 2011, p. 62, [http://www.ebrd.com/downloads/research/surveys/LiTS2e\\_web.pdf](http://www.ebrd.com/downloads/research/surveys/LiTS2e_web.pdf). Compared with the first survey (2006), Azerbaijan has witnessed a rise in life satisfaction.

<sup>18</sup> Heritage Foundation, *Index of Economic Freedom 2012*, December 2011, p. 95-96, <http://www.heritage.org/index/pdf/2012/countries/azerbaijan.pdf>.

Economic freedom for business is ranked high at 77.2 per cent, but table 13 shows that actually starting up a business still faces obstacles.

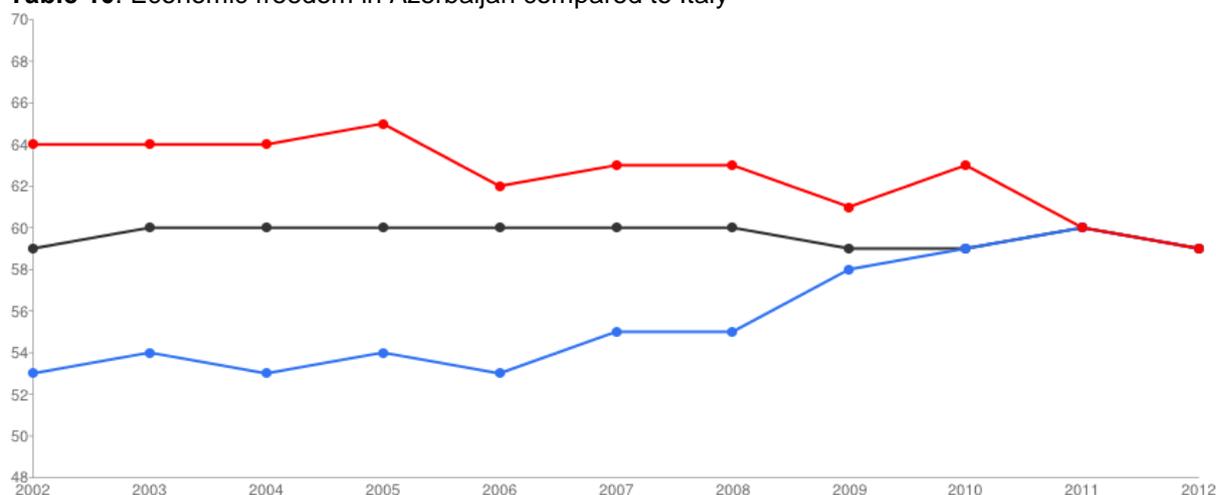
**Table 9.** Economic freedom index

Sector	Economic Freedom	Score (out of 100)
Rule of law	Property Rights	20.0
	Freedom From Corruption	24.0
Limited government	Government Spending	63.7
	Fiscal Freedom	84.9
Regulatory efficiency	Business Freedom	68.6
	Labour Freedom	81.6
	Monetary Freedom	74.5
Open markets	Business Freedom	77.2
	Labour Freedom	55.0
	Monetary Freedom	40.0

Source: Heritage Foundation, Index of Economic Freedom 2012, p. 95-96

All these considerations regarding economic freedom can be put in perspective, when comparing Azerbaijan with one of its major trading partners, Italy, where Azerbaijan emerges in a rather positive light.

**Table 10.** Economic freedom in Azerbaijan compared to Italy



**Country** Italy: red, overall score: 62  
Azerbaijan: blue, overall score 61  
World average: black

**Range** 80-100: free  
70-80: mostly free  
60-70: moderately free  
50-60: mostly unfree  
< 50: repressed

Source: Heritage Foundation, Index of Economic Freedom 2012 (data)<sup>19</sup>

<sup>19</sup> Heritage Foundation, *Index of Economic Freedom 2012*, online database, <http://www.heritage.org/index/country/azerbaijan>.

Recent data by the EBRD<sup>20</sup> show that life satisfaction has improved, as one would expect given the stunning growth of income rates. But the level of trust in others is very low (see table 11), very few people think that corruption levels have improved, and many are very concerned about climate change, probably because this will affect the water level of the Caspian Sea. There is strong support for the market economy and democracy. The latter needs some further thought however, as less than half of the population believes that the elections were fair. Given the oil and gas dependence of the country it is not surprising that most households feel affected by the post 2008 crisis. This was also confirmed by the macro data.

**Table 11.** Main results from the 2010 Life in Transition Survey (LiTS)

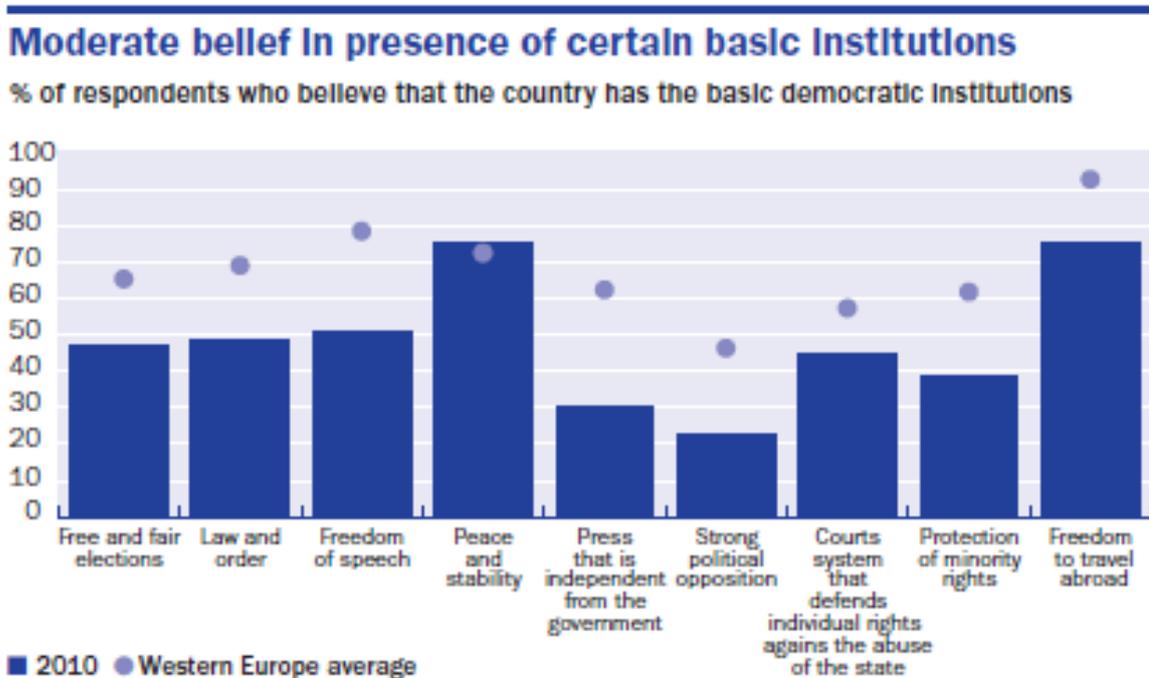
Key findings (% , weighted)	Azerbaijan	Transition region	Western Europe
Satisfied with life	42	43	72
Trust in others	24	34	42
Perceive less corruption than four years ago	18	21	9
Concerned about climate change	73	54	54
Support both market economy and democracy	50	34	42
Households affected by the crisis	55	49	31

Source: EBRD and World Bank, *Life in Transition*, 2011, p. 62

As reported above, public trust levels are very low in Azerbaijan, deserving further analysis (see table 12). Trust in basic institutions is weak. Only with regards to peace and stability Azerbaijan is at par with Western European levels. Given the past conflicts, this comes as a surprise, but it reveals the general trust Azerbaijanis feel towards the presidency and the military. People feel safe. Only 25 per cent believe that there is a strong opposition, which is half of the Western European level.

<sup>20</sup> EBRD and World Bank, *Life in Transition*, cit., p. 62.

Table 12. Trust in basic institutions



Source: EBRD and World Bank, *Life in Transition*, 2011, p. 63

Finally, let us turn to the ease of doing business in Azerbaijan (see table 13). The *Doing Business 2012* report<sup>21</sup> assesses regulations affecting domestic firms in 183 economies and ranks the economies in 10 areas of business regulation, such as starting a business, resolving insolvency and trading across borders. Report data cover regulations measured from June 2010 through May 2011. The report rankings on the ease of doing business have expanded to include indicators on getting electricity. The report finds that getting an electrical connection is most efficient in Iceland and Germany, but still is an obstacle in Azerbaijan. For a country so rich in energy resources this is ironic. Also dealing with construction permits and trading across borders is relative difficult. Once the construction permit has been granted however, registration is rather quick. Investor protection is ranked high and contracts are easy to enforce. Access to finance is not a major problem, although this study found further need to deregulate the financial sector. Taxpayer's moral could improve.

<sup>21</sup> *Doing Business, Doing Business 2012: Doing Business in a More Transparent World*, October 2011, <http://www.doingbusiness.org/reports/global-reports/doing-business-2012>.

**Table 13.** Ease of doing business in Azerbaijan

Economy Overview		Doing Business 2012 Rank	Doing Business 2011 Rank	Change in Rank
Income Category	Upper middle income	<b>66</b>	<b>69</b>	<b>3</b>
Population	8.883.200			
GNI Per Capita (US\$)	5.180,00			
Topic Rankings		Doing Business 2012 Rank	Doing Business 2011 Rank	Change in Rank
Starting a Business		18	16	-2
Dealing with Construction Permits		172	172	No change
Getting Electricity		173	173	No change
Registering Property		9	9	No change
Getting Credit		48	45	-3
Protecting Investors		24	21	-3
Paying Taxes		81	105	24
Trading Across Borders		170	169	-1
Enforcing Contracts		25	25	No change
Resolving Insolvency		95	93	-2

Source: Doing Business 2012<sup>22</sup>

### Concluding remarks

Azerbaijan is under the spotlight of the international media. The latest example of this was the Eurovision Song Contest, which was used to put on a glitzy show to impress the world. The show was a great success, but there were shadows, when groups of peaceful human rights protestors were dispersed under the eyes of international media representatives. Also a small alternative festival was staged, which enjoyed the attention by the media as well.<sup>23</sup> The winner of Baku's Eurovision spoke out against Azerbaijan's record of violation of gay rights publicly as well.<sup>24</sup> Although homosexuality is not illegal since 2001, homosexuals do not enjoy the same legal protection as opposite sex partnerships.

Another international showcase was one of the latest James Bond thrillers, which had Baku as one of the scenes of action. Although it put Azerbaijan under the spotlight, the movie was reminiscent of Cold War times, putting the issue of distrust at the centre of the story.

<sup>22</sup> Doing Business, *Doing Business 2012*, online database, <http://www.doingbusiness.org/data/exploreeconomies/azerbaijan>

<sup>23</sup> In fact those protestors supported the official festival due to the international attention they enjoyed.

<sup>24</sup> Mina Muradova, "Swedish Eurovision Winner Meets Azerbaijani Activists", in CACI Analyst, 30 May 2012, <http://www.cacianalyst.org/?q=node/5788>. Swedish Eurovision 2012 Finalist Loreen Interview about Human Rights in Azerbaijan, Youtube, 21 May 2012, <http://www.youtube.com/watch?v=MBpGiMpBrT8>.

These examples illustrate Azerbaijan's current predicament: The glitz of the economic growth story at times conceals pending problems of corruption and distrust. Unless and until Azerbaijan deals with these problems, shadows will continue to loom over its economic miracle.

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**Istituto Affari Internazionali**  
Via Angelo Brunetti, 9 00186 Roma  
Tel.: +39/06/3224360 Fax: + 39/06/3224363  
E-mail: [iai@iai.it](mailto:iai@iai.it) - website: <http://www.iai.it>  
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