

ABSTRACTS

PANEL ONE: FISCAL AND MONETARY POLICIES OF ENERGY EXPORTERS: THE CASE OF AZERBAIJAN

Mr. Kazim Kazimov, *Forecasting the term structure of interest rates. Necessary steps for analyzing the data in Azerbaijan*

The government securities markets in Azerbaijan are only rudimentary: the secondary market for government securities is practically nonexistent, the turnover is very low, and the investor spectrum is very narrow. However, the Ministry of Finance of Azerbaijan has been expressing interest in supporting the development of government securities markets. A recent establishment of the Public Debt Agency and strong cooperation with IMF's "Public Debt Management, Development of Government Securities Market and Improving Fiscal and Monetary Policy Coordination" project serve as a proof of this interest.

As markets take off and the volume of information coming in inflates, a need for faster ways to analyze this data will become more pressing. There are numerous works on the most effective ways in analyzing the term structure data. I will follow a recent work by Kazimov, Alper, and Akdemir (2007) (KAA) to give a perspective on the methods and their use. Based on the obstacles we faced while collecting the Turkish data, I intend to provide some guidelines on the best practices of data collection and characterization.

In KAA, we performed factor analysis on monthly yield curves estimated by Nelson-Siegel model using the Turkish secondary government securities market data. Monthly yield curves are characterized by three factors which are estimated using nominal volume-weighted average monthly zero-coupon yields. According to the loadings of each factor, we labeled the factors as level, slope and curvature. Next, we forecasted yield curves using AR-GARCH and random walk processes and compared their relative performance. Our results indicate that the three factor model has high explanatory power and that the AR-GARCH specification has superior forecasting power. I will provide detailed explanation how the same techniques can be used for the case of Azerbaijan as the data becomes available.

Dr. Fariz Huseynov, *The Determinants of Bank Interest Margins When Deposit Insurance is Tied to Interest Rates: Evidence from Azerbaijan*

This paper studies the determinants of bank interest margins in an oil-producing country when government insurance on deposits is tied to the refinancing rate set by the Central Bank. Until May 2009, only deposits that offered interest below 1.8 times the refinancing rate were insured in Azerbaijan. In a country where oil revenues are the main source of income, banks' risk taking behavior will be affected by them. When oil revenues increase (decrease), banks will be likely to take more (less) risks because of positive (negative) economic outlook. However because the government ties deposit insurance to the refinancing rates, when refinancing rate is lowered by the Central Bank, banks

should either lower the deposit rates to maintain state-provided insurance, or offer higher rates in order to compensate additional risk from the lack of protection.

When the refinancing rate is lowered (increased), the banks' deposit rates and cost of borrowing will decline (increase). Thus the interest margin should widen (decline). This suggests a negative relation between refinancing rate and interest margins. However, changes in the cost of funds may also affect banks' lending behavior such that lower (higher) cost of funds will encourage banks to take (avoid) additional risks and reduce (increase) lending rates. As a result, the interest margins will shrink (widen). This effect will be exacerbated with oil revenues flowing into economy. This suggests that the relationship between refinancing rate and interest margins should be positive.

We apply the Ho and Saunders (2001, JFQA) model with slight adjustments to the most recent data on the banks in Azerbaijan during the period 2006-2009. Our results suggest that the refinancing rate has a positive impact on interest margins: when interest rates increase one percent, net interest margins increase by 0.36 percent. The impact of refinancing rate on interest income is twice higher than that on expenses. This suggests that lending rates are more sensitive to refinancing rates than deposit rates. We also find that the higher the equity, the lower the interest margins. However, this effect is economically small. Another major finding of this study is that oil prices negatively affect interest margins. In other words, the higher the oil prices, the lower the interest margin. This can be interpreted as higher oil prices induce risk taking. Banks take more risks by lowering interest margin spread because higher oil prices strengthen their confidence in economy.

Dr. Elvin Afendi, *Fiscal Dominance in the Republic of Azerbaijan: Can the Game of Chicken be a Solution?*

In recent years the Republic of Azerbaijan highly benefits from oil revenues. For example, the share of the oil sector in GDP, state budget and export was 54%, 68% and 96% respectively in last year. However, several crucial problems follow these gains, too. The latest country report of the World Bank claims that a high degree of oil dependence, weaker diversification, 'unsustainability' of hard achieved targets in poverty reduction, weakness of market institutions are among the core challenges that the economy encounters. Moreover, the modernization in public administration was indicated as one of the most important measures in order to ensure sustainable development of the economy. Therefore, strengthening the coordination between economic policies, namely monetary and fiscal policies, was highly recommended in the report too.

Which factors mainly impede the economic policies to be mutually consistent and better coordinated in the country? So, this paper will first explore the core causes of the coordination problem in the Republic of Azerbaijan. Second, the existence of fiscal dominance will be approached as a main cause of inconsistent macroeconomic policy. Furthermore, the fiscal dominance will be quantitatively estimated and analyzed. Finally, in the paper 'the game of the chicken' will be treated as one of the strategies to ensure coordination between the policy agencies within the framework of specific nature of the problem that country face.

PANEL TWO: ENERGY ECONOMICS

Mr. Azar Abizada, *When too little is as good as nothing at all: Rationing of a disposable good among people with acceptance thresholds*

We study the problem of rationing a perfectly divisible social endowment among a group of people. Each person's preferences are characterized by an ideal amount that he would prefer to receive and a minimum amount that he will accept: he finds any amount less than this threshold to be just as good as receiving nothing at all.

We are interested in Pareto-efficiency, strategy-proofness, and fairness (envy-freeness). While the definitions of these axioms carry through, with minimal changes, from the more commonly studied problem without lower-bounds on consumption (Sprumont 1991), we show that these extensions are not compatible. We explore weaker versions of these axioms that are, in fact, compatible.

This model can be easily applied to energy (or some other resource) exports problem. Now think that resource that we want to distribute is energy, gas or oil that a given country (exporter) wants to export to other countries. And we can assume that every importing country has an ideal amount that they want to import and a minimum amount below which they would not willing to import (they will just find some other exporter).

Mr. Islam Rizvanoglu, *Optimal Dynamic Production with Random Timing of Backstop Technology*

This paper proposes an extension to Gao, Hartley and Sickles (2008) which models the profit-maximizing dynamic oil production from a large oil field in Saudi Arabia. Their novelty in the paper is use of engineering model of oil extraction. Although it gives important insights about the dynamics of oil production by examining and comparing different scenarios for exogenous variables, it assumes the perfect knowledge and foresight about the future. However, the production decision cannot be based on different scenarios, but the expectations about the future. Therefore, I propose to extend the model by incorporating uncertainty arose from a random arrival date of a new backstop technology that will enable the production of a perfect substitute for oil.

Following the literature (Nemet, 2006), I assume that the backstop technology will be competitive with conventional alternatives any time between 2040 and 2070. To capture this fact, I will introduce a probability distribution function for the arrival date of the backstop technology which will ensure that the technology is adopted at 2070 the latest, and it will not be available any time before 2040. Additionally, it will be increasing between these two dates. That will lead to a modification of the model presented in Gao, Hartley and Sickles (2008), where the producer will maximize the expected present value of profits.

PANEL THREE: ADDRESSING THE RESOURCE CURSE AND ENVIRONMENTAL CHALLENGES

Mr. Farrukh Irnazarov, *The Impact of the Dutch Disease on Transition Strategies of Kazakhstan and Uzbekistan*

Central Asia has been the focus of the world community since the collapse of the Soviet Union. On the one hand, natural resources, including such commodities as crude oil, natural gas and uranium, make the region attractive to investment by both local and foreign investors. On the other, a thorny path towards democracy, and reports of human rights abuse make the region appealing to many countries for research. Once a part of the Soviet empire, the region nowadays is full of paradoxes. For example, the two regional heavyweights – Kazakhstan and Uzbekistan have chosen different development strategies which have led to interesting and ambiguous results.

After gaining independence Kazakhstan chose to open up its economy, whilst the Uzbek government concentrated on political stability and a fully coordinated economy. In the early 1990s the Uzbek strategy appeared to be more reasonable and less painful, as Kazakhstan suffered from severe economic degradation during this time, however by the turn of the century the Kazakh economy significantly outperformed that of their neighbors. Many analysts came to an early conclusion that the reason for the Kazakh economic boom was entirely based on oil prices and the discovery of new crude oil deposits in Western Kazakhstan. However, such conclusions were rather superficial and one-sided, since Uzbekistan also possessed large natural gas deposits (although not as large as those of Kazakhstan) but did not experience such an economic boom.

The aim of this paper is to assess and analyze the scope and the depth of the Dutch disease in Kazakhstan and Uzbekistan.

Ms. Gulchohra Aliyeva, *Renewable energy – power for a sustainable future*

World total annual consumption of all forms of primary energy increased more than ten-fold during the 20th century and in the year 2002 reached an estimated 451 EJ, or some 10 800 MToe. At current consumption rates, proven world coal reserves should last for about 200 years, oil for approximately 40 years and natural gas for around 60 years (BP, 2003). However, world production of liquid fuels, including nonconventional as well as conventional sources, seems likely to reach a peak between 2005 and 2015. Peak production of natural gas is likely around 2030. From then on, although large quantities of oil and gas will remain, the overall resource will be in decline (Laherrere, 2001)

At the same time, apart of the depletion of natural resources, the society's current use of fossil and nuclear fuels has many adverse consequences such as air pollution, acid rain, the dangers of nuclear radiation and global climate change. To address above mentioned concerns EU adopted energy policy program to cut greenhouse gas emissions by 20%, produce 20% of its energy from renewable sources and increase energy efficiency by 20% – or "20/20/20 by 2020".

Renewable energy can be defined as “energy obtained from the continuous or repetitive currents of energy recurring in the natural environment” (Twidell and Weir, 1986). The paper describes the potentiality of renewable energy application in Azerbaijan, the main technologies to be involved, their cost and environment impact, the potential resources and their future prospects.

Dr. Farhad Mukhtarov, Integrated Water Resources Management: Links between Water and Energy in Turkey and Kazakhstan

Integrated Water Resources Management (IWRM) has come to prominence since the 1990s to become a conceptual solution to the complex problems of water management. Emerging evidence and historical performance suggest that IWRM has always been problematic as a scientific paradigm imposed on a complex social reality with intransigence on both sides. In spite of considerable evidence of dubious practical performance of IWRM, it has acquired a global hegemony as a single unifying mechanism for coordinated development and management of land and water resources. Understanding how IWRM has been politically constructed and acquired hegemony can be critically analyzed through the lens of policy translation and hegemony. Being proliferated through the processes of policy translation, IWRM morphs at national and local levels around the world and produces an overarching global discursive hegemony. We describe the process of IWRM translation from the global theory to national planning and local implementation using a comparative case study approach. An innovative notion of discursive, normative and practical stages of IWRM translation is introduced to illustrate the incremental nature of translation, whereas the three pillars of hegemony: material, discursive and organizational explicate the mechanisms of the hegemony. We conclude with linking the global hegemony of IWRM to the success of the national level policy translation, and indication of the relevance of the ideas formulated in this research to other environmental concepts and discourses.

PANEL FOUR: POLITICS OF ENERGY SUPPLY

Mr. Plamen Dimitrov, From Diversification of the Oil and Gas Routes to Multiple Vectors of Geopolitical Orientation – the cases of Azerbaijan, Kazakhstan and Turkmenistan

The export of petroleum and/or natural gas is the most important resource for the possible intensified economic development of Azerbaijan, Kazakhstan and Turkmenistan. This is why the energy factor is key for decoding the complex geopolitical positions of these countries.

In the beginning of the post-soviet era, the Caspian states inherited from the Soviet Union a system of transportation of oil and natural gas that did not allow them a direct access to foreign markets. Russia itself is among the leading producers and exporters of crude oil and natural gas. The markets for Russian and for Caspian energy resources nearly fully overlap. In this sense, it is logical for Azerbaijan, Kazakhstan, and Turkmenistan to seek less dependency on their main competitor in the energy export sector.

All export routes for Caspian energy resources could be divided into two major groups – vertical (from south to north) and horizontal (from east to west and lately from Caspian region to China). The first group consists of the Atyrau-Samara and the Baku-Novorossiysk oil routes and the Turkmenistan-Russia gas route. The group of horizontal routes includes the existing Tengiz-Novorossiysk, Baku-Tbilisi-Ceyhan, Baku-Supsa and the Kazakhstan-China oil pipeline plus Turkmenistan-China gas pipeline that is expected to be completed by December 2009 . The east-west group also include the trans-Caspian oil and gas pipeline projects and that of exporting via Georgian oil terminals in direction of the Black Sea states. Regarding natural gas the horizontal routes may also include the possible Turkmenistan-Baku and Turkmenistan-China pipelines as well as the one of Baku-Tbilisi-Ezurum as a part of the Nabucco Project.

All vertical routes cross Russian territory while all horizontal ones, with one exception, bypass it. This exception is the Tengiz-Novorossiysk Pipeline that passes through Russian territory but also has Russia as a minority shareholder. From a political point of view, all the vertical routes plus the horizontal Tengiz-Novorossiysk Pipeline could be defined as “Russian”, while the horizontal routes may be called “non-Russian”. The realisation of all the potential projects for export of Caspian oil and natural gas should lead to the development of a system, inventively described by Robert Barylski as: “an energy hub with many pipelines like spokes on a wheel”. An even distribution of the spokes would provide stability for the Caspian energy wheel and would allow it roll successfully towards the global markets.

The development of new export routes, leads to a reduced dependency of the Caspian states on Russia and inevitably reflect on the geo-political positions of Azerbaijan, Kazakhstan and Turkmenistan. Caspian energy resources have become one of the main factors for the USA in achieving their goal and establishing geopolitical pluralism in the post-Soviet space. The main goal of Azerbaijan, Kazakhstan and Turkmenistan is to keep all energy export options open and in the best case scenario – operational. It means that previous dependence on Russia will not be replaced by the same type dependence on the West. On the contrary - the Caspian former USSR republics prefer the multiple vectors of geopolitical orientation.

Mr. Parviz Soltanov, *Obsolescent Bargaining Theory: the case of Sakhalin II in Russia*

Based on Obsolescent Bargaining Theory (OBT hereon), this paper attempts to explain the case of Sakhalin II in Russia: why and how Russian state was able to renegotiate the terms of these contracts? OBT argues that although host states have potential bargaining power once Multinational Corporations (MNC hereon) invest in them; it is difficult to turn this into an actual power because of the lack of capital, know-how, and domestic and international political costs of such acts. There is enough empirical data to support OBT's this argument in the form of failed nationalization attempts ranging from Mosaddeq's Iran (1951-53) to some Latin American countries' attempt to nationalize the assets of the United Fruit Company. In this sense the case of Sakhalin II is interesting deviation, because the Russian state has been able to renegotiate the terms of original contracts for these projects and get big shares of the projects back (the controlling share in this particular project). What helped this success of the Russian state?

Interestingly, obsolescent bargaining power of host states (in these cases Russia) played an important role in this success. What is OBT and what exactly does it argue? Vernon (1971), who played a big role in advancement of OBT explains that this theory is about foreign direct investment (FDI) by MNCs in host countries. When a MNC and a host government sit behind negotiations table in order to decide about the terms and conditions of FDI, then the host governments does not have too much bargaining power, while MNC does. The reason is the MNC has the money in hand, and if the host government will not give heavy concessions in the form of tax cuts and other favorable conditions, MNC will go and invest somewhere else. Therefore, in the initial stage of attracting FDI host country has to make these sacrifices, because MNC has the bargaining power. However, once the big investments are made, the bargaining power shifts to the host states, which can renegotiate the terms of previous contracts and get back some or all of the concessions given to MNC in one way or another, including confiscation of its property, getting back some shares in different projects, etc. However, the important point to understand about OBT is that it is talking about the potential, not actual, power of host states. Whether the host states are willing or will be able to turn this potential bargaining power to actual power to get something solid is a different issue.

Why is the Russian case of Sakhalin II so interesting? The reason is this is one of the few non-ideological cases where a host state was successful in renegotiating the terms of a contract in its favor once MNCs heavily invested in the project: in other words, Russia was able to turn potential bargaining power into actual bargaining power in this case. According to Tarzi (2000), this is a difficult task because host state usually is not brave enough to do that, given such circumstances as the lack of capital, know-how, and domestic and international political costs of such acts. This paper tries to find out under what circumstances and how Russia did it with the Sakhalin II project, how this particular case similar or different from the majority of other cases, and whether we can reach some hypotheses that could be tested with large-N studies.

Mr. Roya Babayev, Comparative study analysing consideration of the European energy supply security strategy in the member states national energy policies

J. Hay (2008) defines the “energy security” term as concern about “ensuring the continuing availability of energy to satisfy domestic demand at reasonably stable prices”(Hay, 2008). A similar definition of the energy security is given by W.Nuttall and D.Manz (2008) for whom it means “consistent availability of sufficient energy in various forms at affordable prices”. The interruption of the energy supply has been identified by many as the primary threat that faces energy security (Nuttall et al., 2008:2). For example Weisser (2007) referring to the International Energy Agency statement (2004) argue that the energy security is an important concern for every country as “projected high dependence of power generation on imported gas might create a domino effect on the power sector in case of energy supply interruption”.

The EU Commission calls the member states to mutual support and integration of the common European interests to their national energy policies. This research work has for objective to analyze and compare how far the EU member states integrate the European common interests in their national energy policies.

The hypothesis of this study is focused on an analysis of the proposition that the consideration of the European energy security interests vary from one country to another based upon policy approach, market liberalization, energy infrastructure, energy

mix and in dependence is not adapted to the realities of the global world and that this could damage in medium and long term the competitive environment of the country.

The comparative study covers national energy supply security policies in France, the United Kingdom and Poland. In order to test the hypothesis first of all the study will present an overview of the member states' energy sector and forecast their dependence on the imported sources of energy. Second, the study will evaluate existing and potential risks for the member states security of energy supply. It will also analyze how satisfactory undertaken and planned measures will be to minimize the impact of those risks. Thirdly, since there is no "successful" approach to deal with security of energy supply issues the study will contrast the member states approaches (economic liberalism vis-à-vis policies of "economic nationalism") with policies practiced by other global leading economies. Finally, the research highlights the liberalization of the European energy market seen as a way of ensuring greater supply security.

Mr. Alexandros Petersen, *Eurasia's Changing Energy Dynamics*

Energy geopolitics in Eurasia are on the cusp of a number of major shifts that will fundamentally alter the relationships between European Union consumers and Russian and Caspian producers. While Russia's Nord Stream pipeline will begin construction in early 2010, its sister South Stream pipeline is increasingly being revealed as a phantom project. Slow-motion progress on the EU's Southern Corridor, as well as the long-running dispute between Ankara and Baku about natural gas transit revenues has compelled Azerbaijani decision-makers to contemplate gas exports to China across the Caspian. The EU's strategic Nabucco pipeline is being reoriented as a Middle East-centered project, not a Caspian one. Finally, unconventional gas production, which has already revolutionized the North American market, is set to take off within the EU. Coupled with increased LNG flows to Europe and East Asia, due to disappearing demand in North America, unconventional gas development could drastically decrease the need for expensive and political unwieldy pipeline projects in Eurasia, both from Russia and the Caspian. The old rules of pipeline politics no longer apply. It is time for a major reassessment of energy strategies on the part of EU consumers and Caspian producers.

ROUNDTABLE DISCUSSION ON EUROPEAN ENERGY CHARTER AND INTERNATIONAL LAW

Mr. Rashad Ibadov, *Energy Exporters: Rights and Responsibilities of States under European Energy Charter Treaty and Dispute Settlement Procedures*

The European Energy Charter Treaty, established in 1994 on the principles of the European Energy Charter, is a legally-binding multilateral instrument for international energy cooperation, aimed to strengthen the rule of law on energy issues, including investment, transit and trade, to develop the energy potential of central and Eastern European countries, to promote cooperation in the field of energy efficiency and to ensure the security of energy supply for the European Union.

Accordingly, the Protocol on energy efficiency and related environmental aspects intends to promote energy efficiency policies that are compatible with sustainable

development, to encourage more efficient and sound use of energy and to promote cooperation in the field of energy efficiency.

All parties undertake to ensure that the provisions on the transit of energy materials and products and the use of energy transit equipment treat energy materials and products in transit in a manner that is no less favorable than that regarding materials and products originating in their area, save where otherwise provided in an international agreement.

The Treaty provides for strict procedures for settling disputes either between countries or between private investors and the state in which the investment has been made. In the case of a dispute between an investor and a country, the investor may decide to submit the dispute to international arbitration. In the case of a dispute between countries, and if diplomacy is unsuccessful, an ad hoc arbitration tribunal may be set up. The settlement solutions provided by these mechanisms are binding.