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### **AZERBAIJAN'S ROLE IN REGIONAL ENERGY SECURITY**

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A country's energy security reflects its ability to have continuing access to sufficient supplies of energy, oil and gas, either from its sources on its own territory or abroad, to allow it to develop. But for producing countries, like Russia and Azerbaijan, it also involves using its exports or its geographical location to promote its particular geopolitical interests, sometimes by denying other exporters the opportunity to make independent decisions as to the path their supplies will pass to reach ultimate consumers or even to the political arrangements they may make as to their domestic political system or broader foreign policy goals.

For most of the post-Soviet period, the Russian Federation has played the predominant role in using energy to promote its own security, but increasingly Azerbaijan is doing the same both because of its own supplies of oil and gas and because it has sponsored the creation of alternative transportation routes for that hydrocarbon. As a result, the strategic importance of Azerbaijan is growing rapidly.

Baku launched its independent energy strategy in 1994 when it signed the "Deal of the Century" with Western oil majors to develop the Azeri-Chirag-Guneshli fields. Despite the political instability resulting from the Karabakh conflict and Russia's objections, Azerbaijan was able to involve companies like BP, AMOCO, and Statoil to develop its enormous reserves of oil and gas. Since that time, the Azerbaijani authorities have signed 25 additional production sharing agreements. [1]

Among the most important of these supplemental accords was the 1996 agreement signed with BP to develop the Shahdeniz offshore fields, a site that BP reported in 1999 contained at least 1.2 trillion cubic meters of natural gas and that is especially important because it is closest to Europe and thus able to supply a major market more efficiently than Russian or Middle Eastern locations.

But identifying major fields and even signing accords with Western companies was not sufficient for Azerbaijan to be in a position to defend its energy security. It needed to develop its own pipeline routes westward, and in 1997, it favored the construction of the Baku-Supsa pipeline to supplement the flow through the Baku-Novorossiisk pipeline. That action represented the first time when a post-Soviet state was able to export oil or gas without going through Russia and thus being potentially subject to Moscow's control.

Azerbaijan however needed more routes in order to handle the expected oil production from the Azeri-Chirag-Guneshli field, especially because given present infrastructure arrangements, much of the oil would have to pass through the Bosphorus, another geopolitical chokepoint. And consequently, Baku decided to construct a new 1730 km pipeline via Tbilisi and Ceyhan as an alternative route. Since 2005, Azerbaijan has been able to use this pipeline to export oil to the Mediterranean and hence to Western markets. In addition, Azerbaijan was involved in building the Baku-Tbilisi-Erzurum gas pipeline to allow Baku to export gas to world markets.

Thanks to these pipelines, Azerbaijan has become the only country other than the Russian Federation and the Middle Eastern states supplying European countries with hydrocarbons directly, a situation that enhances its geopolitical standing both absolutely and in comparison with those countries forced to export their oil and gas through Russian territory.

The importance of this was underscored in 2006 when Russia dramatically increased the price of natural gas. At that time, Azerbaijan was not only able to stop purchasing Russian natural gas but to help Georgia by exporting Azerbaijani gas to Tbilisi. And since 2007, Azerbaijan has been exporting gas to Turkey and Greece and will soon send some of it to Italy as well.

Azerbaijan's ability to do so has enhanced its influence with Central Asian countries like Kazakhstan which are interested in sending their hydrocarbons out via routes that bypass Russia. And it has made Baku a major player in EU and US plans

to build the Nabucco gas pipeline that will carry not only Azerbaijan gas but also gas from Turkmenistan and Kazakhstan.

In addition and perhaps ultimately even more important, Azerbaijan is a major backer of the creation of a Baltic-Black Sea-Caspian energy space. At a summit in Kyiv in May 2008, the countries of these two regions, along with Ukraine and Poland agreed to establish the infrastructure necessary to guarantee energy security in Eastern Europe. Had Azerbaijan not agreed to participate, the other states involved could not have proceeded, one more indication of Baku's growing influence on questions of energy security.

#### Note

[1] See <http://www.socar.az/projects-az.html>.

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### **PIPELINE HARMONIZATION INSTEAD OF ALTERNATIVE PIPELINES: WHY THE PIPELINE "COLD WAR" NEEDS TO END**

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The countries of the European Union are now so dependent on Russian energy resources that this has given Moscow a highly effective tool to put political pressure not only on them but also on those countries like Belarus and Ukraine across which these resources flow to reach Europe. Not surprisingly, European Union countries have looked for other sources, including the Caspian basin states. But what is troubling is that these sources are inevitably modified by adjectives like "alternative," a conscious or unconscious reflection of a view that there is an inherent confrontation between Russia and the rest of the world on energy issues.

Some commentators now speak of a "pipeline confrontation" or even of a "pipeline cold war," terms that have been linked to pipelines like Baku-Tbilisi-Supsa (BTS), Baku-Tbilisi-Ceyhan (BTC), and the South Caucasus Pipeline (SCP). But such commentators forget that these pipelines carry less than ten percent of the amount of oil that Russian pipelines do and less than five percent of the gas, figures that call into question their utility as "alternatives" to Russian pipelines.

Moscow is at least in part to blame for this situation. It has used its monopolistic position in this sector to promote a wide range of interests. Moreover, it has opposed the construction of "alternatives" lest its own position be somehow weakened. More than a decade ago, the Russian government opposed the BTC project, despite instability in the North Caucasus through which its own pipeline passed. And when common sense prevailed and the BTC project advanced, Moscow never acknowledged its error and continues to try to block the completion of other pipeline systems.

Now, given the world's thirst for hydrocarbons, the time has come to shift from the alternative pipelines paradigm to a new one of mutually supplementary pipelines or even pipeline harmonization. If that perspective is adopted, then analysts and governments can view the pipelines as a single whole with a single purpose: providing an uninterrupted and consistent supply of energy resources to their customers.

In terms of this paradigm, transportation of Caspian energy resources to the West should be viewed not as competitors to Russian routes but as supplements to them. Indeed, several important steps have been taken in this direction. In January 2007, Kazakhstan and those developing the Kashagan and Tengiz oil fields signed an MOU on the construction of a Kazakhstan-Caspian Transportation System intended to ensure the outflow of growing amounts of oil through the Caspian region. Oil is to be moved along the Eskene-Kurik-Baku-Tbilisi-Ceyhan route, something that will require the building of the Eskene-Kurik oil pipeline. And in March 2007, Russia, Bulgaria and Greece signed an intergovernmental agreement to build the Trans-Balkan Oil Pipeline, Burgas-Alexandropolis, which would begin in the Bulgarian Black Sea port of Burgas and end at Alexandroupolis on the Greek Aegean coast.

Harmonizing gas pipelines is even more important given that it is far from clear whether the Russian gas transport system will be sufficient to transport expanded volumes of Central Asian gas during the first part of the next decade. As far as the Trans-Caspian pipeline is concerned, it is far from clear just who will be involved and how various interests will be harmonized. It is associated in the minds of most with the Nabucco and the White Stream gas projects, a structure that will both complete and complement the South Stream gas pipeline Moscow hopes to run to Varna in Bulgaria and then further west.

If all the countries of the region and their customers recognize just how large the demand from the latter is likely to be, they should be able to cooperate rather than compete in the construction of pipelines and thus provide the best possible supplies of oil and gas to the Europeans.

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## **GEOPOLITICS AND VULNERABILITIES IN AZERBAIJAN'S ENERGY SECTOR**

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Geopolitical uncertainty has combined with oil and gas resources and the imperatives of geography to shape Azerbaijan's foreign policy. The country's current boom represents the coming together of instability in the Middle East and the isolation of Iran, Western efforts to limit Russian control of energy supplies to Europe, and infrastructure developments like the BTC and BTE pipelines. But even as Azerbaijan benefits from that, Baku has acknowledged the dangers of both the so-called Dutch disease and future declines in production at its major fields and adopted domestic policies designed to limit the impact of these developments.

But Azerbaijan is a small country surrounded by large neighbors and influenced by even larger powers, and as a result, geopolitics and the increasingly complex network of powers and institutions in the Caspian region are going to have

important, and not always complementary, roles relative to Azerbaijan. Responding to those challenges is a central task for Azerbaijan's foreign policy.

The Multiple Pipelines Policy pursued at the beginning of the Bush administration in 2001 confirmed what the previous Clinton administration had already revealed: The United States was prepared to act to undermine Russia's growing energy monopoly in Europe. Backing the construction of the BTC and BTE pipelines would lay an alternative route for Caspian oil and gas to traversing Russia, Azerbaijan's neighbor to the north. In a similar vein, building ties in the Caspian could undermine the growing threat the United States associated with the Islamic Republic of Iran, Azerbaijan's neighbor to the south.

If geopolitical calculations and resource locations converged almost perfectly over the last decade to create the foundations for a period of unprecedented economic growth, supply-side vulnerabilities, including a decline in the production of its fields, almost certainly means that it will be forced into greater cooperation with its immediate neighbors whatever the preferences of its elites and of outside powers.

Moscow has recently demonstrated that it understands this trend and has been developing its own policies in ways consistent with it. In May 2007, for example, the Russian Federation reached an agreement with Turkmenistan, Kazakhstan and Uzbekistan on a new gas pipeline to Russia, a move potentially designed to undermine the viability of a Trans-Caspian gas pipeline to Azerbaijan (Leonard and Popescu 2007, p. 18). In a further indication that Russia will continue to buy Central Asian gas to augment its own supply and weaken prospects for a Trans-Caspian project, Russia agreed to pay 50% more for Turkmen gas in late 2007. [1] Turkey responded in early 2008 to this geopolitical challenge by arranging for the reopening of a Turkmenistan embassy in Baku (see Daly 2008).

With regard to oil, Moscow has moved in a similar way, this time with Kazakhstan. In contrast to Azerbaijan where the ACG fields are expected to decline in a few years, Kazakhstan's Kashagan project is expected to increase production for many years to come, with production in 2020 projected to be four million barrels a day, a four-fold increase from today's output (Nanay 2005, p. 142). Despite the presence of American firms in Kazakhstan like Exxon Mobil and Chevron, the Russians have aggressively pursued deals with Kazakhstan and made a requirement of production sharing agreements that oil extracted as part of a Russian-Kazakh partnership be shipped through the Russian pipeline system. One such arrangement, concluded in 2005, confirmed a production-sharing agreement on Kazakhstan's Kurmangazy offshore field, including ten years for exploration and 45 years for extraction (Socor 2005). Because development of the Kashagan field has predominantly Western investors, its oil would have been a likely target for Azerbaijan and a future Trans-Caspian link, although another delay in production here to 2011 combined with continued Russian pressure in favor of the Caspian Pipeline Consortium (CPC) through Russian territory leaves in doubt the fate of the Trans-Caspian oil pipeline, and the levels of Azerbaijani oil supply.

Consequently, Azerbaijan must also navigate an ever more complex challenge: geopolitical uncertainty. With Russia's strategy of linking its energy sector and foreign policy and Iran's isolation from the West, the geopolitical equation in the Caspian has been relatively stable over the past five years. But what would happen if that stability ended? On the one hand, growing Western demand coupled with a Russian triumph in gaining more control of oil and gas resources east of the Caspian

could force greater acceptance of Russia's dominance in this area, perhaps in a trade-off for greater liberalization of Russia's energy sector. That would alter Azerbaijan's role in the region significantly, as its geographic advantages would no longer be paramount. But on the other hand, similar demand-side considerations coupled with future political developments in Iraq could moderate the US position towards Iran, thereby undermining Azerbaijan's geographic advantages by providing an alternative route for Central Asian resources to the West.

To limit the impact of either of these developments, Azerbaijan should more aggressively support the proposed Nabucco pipeline. Backed by the US and EU as an alternative source to natural gas supply from Russia, Nabucco would connect the BTE pipeline in Ezurum, Turkey with Eastern Europe and Austria. Construction of this route would bolster EU ties to the Caspian as a source for natural gas and apply indirect pressure for a Trans-Caspian gas connection to augment supply from the second phase of Azerbaijan's Shah Deniz field. Despite enthusiasm from the US and EU, the Nabucco project has not gained the momentum many expected, at least in part because of Russia's greater success in pushing the South Stream gas pipeline, which in theory would compete directly with Nabucco and extend Russia's dominance as a gas supplier to the EU while lessening its dependency on Ukraine as a transit country.

Moreover, Baku should invest its capital to gain a stake in both upstream and downstream projects where a longer-term presence will grant leverage in decision-making around supply routes. The State Oil Company of Azerbaijan Republic (SOCAR) is a suitable vehicle for doing that and indeed has already started down this path. In addition to opening European offices in 2007, SOCAR has invested in renovated export facilities at the Georgian Black Sea port of Kulevi and participated in the privatization of the Georgian gas industry. Furthermore, SOCAR has extended its stake in the Turkish economy, obtaining a majority stake in the Turkish petrochemical firm Petkim. Strategic investments like this not only build a market for future Azerbaijani gas exports in transit countries like Turkey but they reinforce multilateral alliances like GUAM of which Azerbaijan is a member. For example, a recent meeting between Azerbaijan's Ilham Aliyev and Ukrainian President Viktor Yushchenko resulted in plans to construct a modern oil refinery in Ukraine. Developments like this coupled with possible SOCAR plans to build its refining capability in Central Europe could further reinforce ties with Georgia, Ukraine and Moldova, the other members of GUAM (Ismayilov 2008b). While there have been limited examples of SOCAR investments in Central Asia so far, these existing investments should serve a model for how SOCAR could approach a future stake in the region.

And finally, Azerbaijan should approach negotiations with Turkmenistan over the Caspian delimitation with Nabucco in mind and continue to consider ways that existing infrastructure from Shah Deniz can be employed to build Turkmenistan's stake in a Trans-Caspian link. In particular, reaching a resolution on ownership of the Kapaz / Serdar field would be a constructive step in the relations between the two countries, and, given its proximity to Azerbaijani fields with significant infrastructure, an opportunity for collaboration between the two (Ismayilov 2008a). Already, signs suggest greater alignment between the two countries; on the same day of Turkmen President Gurbanguly Berdimukhammedov's first official visit to Baku, SOCAR announced delivery of equipment to a Turkmennefgaz oil rig in a Turkmen-controlled section of the Caspian Sea (Ismayilov 2008a). Such improvements in political

relations should facilitate future collaboration between SOCAR and Turkmenistan's growing energy sector.

Maintaining strong ties to the United States and the EU will remain an overarching characteristic of Azerbaijan's foreign policy. Yet there is a downside to big power allies that they can limit a state's control to influence and shape geopolitical developments in its neighborhood. Acknowledging the long-term nature of ties to the EU and United States, Azerbaijan's ability to counter this geopolitical uncertainty is to pursue localized policies that reinforce the interests of both Azerbaijan and its larger Western allies. Following this direction, Azerbaijan increases the probability that longer-term developments will serve its interests, in addition to creating greater alignment between its foreign policy and that of its allies.

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### Note

[1] BBC News, "Turkmenistan Gas Price Rises 50%", November 28, 2007, available at: <http://news.bbc.co.uk/2/hi/europe/7116218.stm>, accessed 12 June 2008.

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**GIVING MOSCOW A TASTE OF ITS OWN MEDICINE:  
AZERBAIJAN'S STRATEGY ON RUSSIA**

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Russia has increasingly used its economic power to promote strategic foreign policy goals, an approach that has forced other countries to modify the way they conduct their relations. Azerbaijan is one of those countries, and it has responded by employing its own economic resources as a foreign policy tool, thus giving Moscow what might be called a taste of its own medicine. [1]

“Economization,” the term for the assignment of particular importance to economic priorities and instruments in foreign policy reflecting the heightened influence of business and economic actors in decision-making (Wallander 1997), has acquired special importance under President Vladimir Putin, but it has also been a part of Moscow's foreign policy in earlier periods, because the dissolution of the Soviet Union and the ensuing decay of Russia's military machinery left Russia with few other effective foreign policy tools. And that is particularly the case in Russia's policy toward the former Soviet republics: it is primarily through economic strength that Russia has been able to exercise a measure of indirect control in these states (Lo 2006, pp. 63-64).

Because Moscow views the "near abroad" as lying within Russia's undisputed sphere of interest, the Kremlin, according to Bobo Lo (2006, p. 62), has reserved to itself both the right and the duty to exploit every advantage at its disposal to promote Russian national interests. Among these advantages, the Russian government believes, are its economic strengths, and consequently “economic trumps serve not only commercial ends but also larger political and strategic aims” (Lo 2006, p. 63). Thus, for Moscow, the economization trend can be defined as “the use of economic tools to reach strategic aims,” a definition that calls attention to the distinction between Moscow's belief in the efficacy of this tool and its actual success in doing so.

The sector in which the Russian government has exerted its economic muscle for political gain most forcefully has been the energy sector, although it has employed trade embargoes and labour migration restrictions toward that end as well. Several former Soviet republics are totally dependent on Russia for their energy supplies, and this has allowed Moscow the chance to maintain economic and political leverage in what it sees as its legitimate sphere of influence. And even in those former republics which are net exporters of energy, Russia has used its control of transit routes and its market power to exert influence. Kazakhstan, for example, competes with Russia in the same oil markets, but it remains dependent on Russian pipelines, allowing Moscow to limit Kazakh export volumes (Dodsworth et al. 2002, p. 23).

Azerbaijan was subject to the same kind of pressures until the BTC pipeline from Baku via Tbilisi to Ceyhan went online in 2005 and broke the Russian monopoly on the transit of Caspian petroleum. But demonstrating that other countries can make use of economic power to promote political ends and reflecting the fact that Russia no longer can block its oil flows, Azerbaijan has exploited this new situation to

position itself as an increasingly powerful and independent actor in the South Caucasus.

In the first instance, this means that Azerbaijan need not defer to Russian pressure to survive, be that in the form of transit blockade or stops in Russian gas deliveries. When Gazprom in 2006 sought a steep price increase for the gas it delivered to Azerbaijan, Baku was in a position to respond by simply stopping the import. And in pursuit of its own political goals, Azerbaijan supported Georgia during the latter's 2006 gas feud with Russia, something Baku was able to do without suffering any reprisals from the Russian side. [2]

Unlike Russian relations with Baku, the relationship pattern between Russia and Georgia provides a clear example of the consequences of energy dependence if one is not sufficiently accommodating. After a troublesome year in Georgian–Russian relations in 2006, Gazprom demanded a more than twofold increase in gas prices (from USD 110 to 235 per 1000 m<sup>3</sup>) from both Georgia and Azerbaijan. Azerbaijan's response was not only to cut the Russian gas import but also to offer Georgia gas at only USD 120 per 1000 m<sup>3</sup>, thereby helping its neighbour out of a tight situation. [3]

In doing so, Azerbaijan managed to strike a balance between maintaining good working relations with Georgia, an important partner due to the transit of Azerbaijani oil through its territories, and accommodating Russia, a central actor in the negotiations over Nagorno-Karabakh. That Azerbaijan chose to support Georgia through the crisis points up the new possibilities available to Baku now that it is no longer dependent on Russia for transit. But in contrast to Georgian rhetoric on this issue, Azerbaijan has struck a more conciliatory tone, thus showing both skill and caution in its own use of economic leverage.

Despite this, there is still the risk that Azerbaijan's energy interests and ambitions may collide with the Russian ambitions and interests in the future. Discussions concerning the possible construction of a Trans-Caspian Pipeline that would provide BTC with Central Asian oil after the expected peak in Azerbaijani production already have become a source of tension with Russia, which wants to monopolize the transit of Central Asian petroleum to Western markets.

At the same time, Russia, its weakened economic sanctions opportunities toward Azerbaijan notwithstanding, still holds a rather strong hand in the economic sector. On the one hand, the large Azerbaijani diaspora working in Russia, one whose members send remittances home, may become subject to Russian pressure, just as the Georgian one was in 2006. And on the other, Moscow's status as a Minsk Group co-chair means that it plays a key role in the policy area of greatest concern to Azerbaijan, thus reducing Baku's ability to ignore Russian demands. Indeed, Russia's leverage in this area may be one of the most important reasons for Baku's decision to build up its military capacity, something that could give it more independence in that area as well.

The military build-up and an independent energy policy are only few of several ways Azerbaijan is employing its economic strength to reduce Russia's influence. And it is striking that, at least in comparison to the other post-Soviet states, Azerbaijan has shown that it is ready, willing and to a large extent able to give Russia a taste of its own medicine by pursuing an economic-centric foreign policy.

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## Notes

[1] This article draws upon my previous work, in which I analyzed Azerbaijani elite perceptions of the operations of two Russian companies in Azerbaijan (Lukoil and RAO UES), as a proxy for the Azerbaijani response to the economization trends in Russian foreign policy (Kjærnet 2007).

[2] Azerbaijan had the opportunity to choose between continued import from Russia for domestic consumption and export of its own Shah Deniz gas to Western markets, or meeting its own demands with the Shah Deniz gas and postponing the export of the gas. Azerbaijan has thus taken the cost of losing the possible revenues from gas export.

[3] One could perhaps go so far as to argue that Azerbaijan has undertaken the cost of subsidizing Georgia, with all the implications this could have for political influence.

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## **USING OIL REVENUES EFFECTIVELY IN AZERBAIJAN**

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The rapid increase in oil production and the rise in prices for this oil have ensured that Azerbaijan has posted the sixth consecutive year of double-digit growth. GDP expanded by a record 34.5 percent in real terms in 2006 (the last year for which complete data are available), the highest growth rate in the world for the second year in a row. Although oil and gas are responsible for most of this growth, non-hydrocarbon sectors of the economy are still growing fast as well, by 11.2 percent in the same year.

Moreover, the medium-term outlook for the economy is positive, with GDP growth expected to continue to be at the double-digit level for the next few years, even though foreign direct investment is expected to decline as major oil and gas projects move into less intensive stages of development. At least some of that decline, the Azerbaijan government plans to compensate for by increasing its spending on the economy. But many in Baku are concerned that Azerbaijan's dependence on oil and gas sales could put the country at risk. And they argue that Baku must develop the non-oil sector even more rapidly than it has done up to now.

The challenge for Baku is to find a way to make use of the revenues from the sale of hydrocarbons to develop other parts of the economy, a challenge that until the post-1991 period Azerbaijan had little experience in dealing with. The country now has an Oil Fund which collects much of the revenue and oversees its disbursement. But deciding how to do so, and especially how to balance short-term versus long-term investments is one of the most difficult policy choices Azerbaijani officials now face.

This fund was established eight years ago, but even now, there are no transparent resource management principles to ensure that the fund's managers serve the needs of the economy as a whole. There is no general strategy and no criteria to measure the effectiveness of its investments. That has led some to suggest that the Oil Fund should be disbanded because theoretically what it does could be done by others. The central issue is whether the fund can give a privileged status to certain revenues and investments or whether some other agency might perform that function more effectively. But many believe that the primary virtue of the fund is its ability to serve as a single institution that can at least partly sterilize the economy from the oil money and thus help the country avoid what some have called the oil curse, a problem that the Azerbaijan government has officially acknowledged.

Just how important that is can be seen from the amounts of income and expenditure projected over the next six years, the period when Azerbaijani oil and gas production is likely to peak (Table 1).

**Table 1.** Oil Fund Balance and non-oil economy thru years, mIn AZN

<b>Year</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>
Oil Fund assets [1]	2659.98	11063.79	23112.32	34799.1	45293.56	66025
Oil Fund expenditures [2]	1107	767	705	705d	655	655
Return from Fund assets [3]	106	443	924	1392	1812	2264
Oil Fund balance	-1001	-324	219	687	1157	1609
Non-oil GDP [4]	10366	12755	14859	17038	19513	22346
Fund returns/non-oil GDP	1	3	6	8	9	10

*Sources:* 1. IMF projections (2007-2008 baseline scenario; 2009-2012 sustainable scenario); 2. Ministry of Finance projections; 3. With 4% return rate as estimated with Pension Fund in Norway; and 4. IMF projections.

Thus, it is clear that oil and gas are short-term assets while the fund itself is a long-term one. And consequently, the fund should behave as if there is no oil at all. That is what the Norwegian Pension Fund has done, and Azerbaijan's Oil Fund must

be at least as efficient in isolating oil revenues from society and using them efficiently at the same time. *Why at least?* Because, the fund may also generate money and that money can be partially accumulated in the fund. Were there no Oil Fund, the economy would survive but not do nearly as well as it could with fund investments.

The Fund's basic challenges are to decide whether to transfer money to the budget and how to use the money that it does not transfer. The principles of the modern finance can be applied to develop the best investment strategy. Diversity, of course, is the best way to lessen risks, but it works only if there is a realistic and prudent approach for each investment decision. In addition, non-transparent management is likely to lead to satisfying behavior and inefficient decisions. All of these principles can be derived from the experience of other oil and gas exporting countries.

Table 2 compares the growth of expenditures in several countries. "After the boom" is a relative terminology, since the countries in the list still produce oil, and here the boom refers to the rise in the production, but not to the production itself.

**Table 2.** Average annual growth of budget expenditures (in %)

<b>Country</b>	<b>Prior to the boom</b>	<b>Oil boom period</b>	<b>After the boom</b>
Azerbaijan	12.9	46.2	-
Saudi Arabia	27.5	112.5	30
Nigeria	29.6	70	-3.0
Norway	12.7	32	17.2

Source: IMF (2006), International Financial Statistics.

Norway's approach is generally considered to have been the most successful in making use of oil money to develop the entire economy. It established the Petroleum Fund, the prototype of the Oil Fund in Azerbaijan in which Oslo accumulated all the oil money. This money was then invested in bonds and corporate equities to generate the more stable income independent on the rate of the current oil production in the country. Later the fund's functions were integrated with the national insurance scheme, and the fund continued to function as the Pension Fund. But even after this change in name, Oslo's strategy of sterilizing the economy from oil money remained in place.

Most studies conclude that the budget in the oil-producing countries depend on the oil prices in the international market, thus the Oil Fund needs to include the stabilization function, i.e. filling the budget deficiencies in the recession years. This paper argues, however, that it is not the oil price but overall oil revenues that matter (the latter includes many other factors, such as the amount of oil production) for the decisions between the budget and the fund, and that it is not the budget but overall income that depends on oil revenues; budget often as a result of political processes and decisions is linked to short-time oil revenues, but the fund can eliminate that link and make it dependent on the long-term and secure incomes.

If that is recognized then it becomes obvious that the Oil Fund needs to develop instructions, guidelines and standards for portfolio investments and for transfers to the state budget. Such a strategy will improve management, prevent

the rise of populist policies, and reduce corruption. And at the same time, this commitment to transparency will guarantee that the fund will help promote the sense of ownership among the broader population that will help to support the rise of democratic forms of governance.

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## **A CHRONOLOGY OF AZERBAIJAN'S FOREIGN POLICY**

### **I. Key Government Statements on Azerbaijan's Foreign Policy**

President Ilham Aliyev says on June 3 that Azerbaijan is prepared to liberate the occupied territories at any moment ([www.anspress.com/index.php?nid=75618](http://www.anspress.com/index.php?nid=75618)).

Hafiz Pashayev, deputy foreign minister and former Azerbaijani ambassador in Washington, says that he would not take very seriously "the pro-Armenian comments" of American presidential candidates ([www.day.az/news/politics/121026.html](http://www.day.az/news/politics/121026.html)).

### **II. Key Statements by Others about Azerbaijan**

Vafa Guluzade, former national security advisor to President Heydar Aliyev, says that Russia will continue to punish Azerbaijan over Karabakh because of Baku's pro-Western orientation ([www.day.az/news/politics/120514.html](http://www.day.az/news/politics/120514.html)).

Aleksei Vlasov, the head of the Moscow Information-Analytic Center for the Study of the Post-Soviet Space, says that the OSCE Minsk Group has failed and that the sides should first deal with the withdrawal of Armenian forces from Azerbaijani territories beyond the borders of Karabakh ([www.anspress.com/index.php?nid=75633](http://www.anspress.com/index.php?nid=75633)).

Matthew Bryza, U.S. deputy assistant secretary of state, says the danger of war will diminish if Armenia withdraws from the seven districts of Azerbaijan beyond the borders of Karabakh ([www.anspress.com/index.php?nid=75990](http://www.anspress.com/index.php?nid=75990)).

The European Union is concerned that an entire generation of Azerbaijanis and Armenians have grown up without contact with the other, Peter Semneby, the EU special representative for the South Caucasus, says ([www.day.az/news/politics/120106.html](http://www.day.az/news/politics/120106.html)).

Peter Semneby, the EU special representative for the South Caucasus, says that Azerbaijanis are a unique nation who combine European values and Asiatic traditions (<http://www.day.az/news/politics/120379.html>).

Alirezah Sheikh Ettar, Iran's deputy foreign minister, says in Baku that Tehran is prepared to work as an intermediary to help resolve the Karabakh dispute ([www.day.az/news/politics/120371.html](http://www.day.az/news/politics/120371.html)).

Matthew Bryza, U.S. deputy assistant secretary of state, says that the status quo between Azerbaijan and Armenia is "dangerous" ([www.day.az/news/politics/120120.html](http://www.day.az/news/politics/120120.html)).

### **III. A Chronology of Azerbaijan's Foreign Policy**

15 June

Azerbaijan marks 15<sup>th</sup> Day of National Salvation in honor of the time when Heydar Aliyev returned to take power in the country ([www.day.az/news/politics/121342.html](http://www.day.az/news/politics/121342.html)).

13 June

President Ilham Aliyev receives former Belgian prime minister Jean-Luc Dean.

President Ilham Aliyev issues a decree on protecting the Caspian Sea ([http://www.president.az/articles.php?sec\\_id=30&item\\_id=20080614103917253](http://www.president.az/articles.php?sec_id=30&item_id=20080614103917253)).

Baku court in closed session convicts five Azerbaijanis of spying for the Russian Federation.

12 June

President Ilham Aliyev receives a delegation from the Islamic Development Bank.

President Ilham Aliyev receives Britain's Prince Andrew, the duke of York.

President Ilham Aliyev receives Faruq Nafiz Osaka, Turkey's minister of architecture and urban planning.

Azerbaijani Foreign Minister Elmar Mammadyarov begins a two-day official visit to Poland. An earlier scheduled visit to Belarus was postponed.

11 June

President Ilham Aliyev receives Ekmeleddin Ihsanoglu, the secretary general of the Islamic Conference.

President Ilham Aliyev expresses his sympathies to the family of Chingiz Aitmatov on the death of the Kyrgyz writer.

First Lady Mehriban Aliyeva, already a goodwill ambassador for UNESCO and ISESKO, becomes one for the Organization of the Islamic Conference.

Yagub Eyubov, Azerbaijan's first deputy prime minister, leads a government delegation to Makhachkala for a working visit.

An International Atomic Energy Agency delegation arrives in Baku for three days of consultations.

9 June

President Ilham Aliyev receives Sergei Shoigu, the Russian Federation's civil defense and disaster response minister.

Araz Azimov, deputy foreign minister, says that Armenia would receive definite economic benefits from Azerbaijan if it withdraws from the occupied territories ([www.day.az/news/politics/120730.html](http://www.day.az/news/politics/120730.html)).

Oktay Asadov, the speaker of the Azerbaijani parliament, is in Athens to attend the 31<sup>st</sup> meeting of speakers of the members of the Organization of Black Sea Economic Cooperation.

8 June

Congress of Azerbaijanis of the World (KAM) adopts a resolution calling for the liberation of the occupied territories ([www.day.az/news/society/120582.html](http://www.day.az/news/society/120582.html)).

6 June

President Ilham Aliyev meets with Armenian President Serzh Sarkisian in St. Petersburg. The two agree to continue consultations.

President Ilham Aliyev meets with Russian Federation President Dmitry Medvedev in St. Petersburg.

5 June

President Ilham Aliyev receives Alirezah Sheikh Ettar, Iran's deputy foreign minister, who says that Tehran is prepared to work as an intermediary to help resolve the Karabakh dispute.

President Ilham Aliyev receives Digby Johns, Great Britain's minister for trade and investment.

Congresswoman Allison Swartz joins the Working Group on Azerbaijan bringing its membership to 41.

4 June

President Ilham Aliyev receives Turkish Prime Minister Recep Tayyip Erdogan in Nakhchivan.

Azerbaijan purchases ten pilotless drones from Israel, of the kind Georgia has used over Abkhazia.

Vasily Istratov, Russian ambassador in Baku, says that the status of the two villages in northern Azerbaijan whose population largely consists of Russian citizens should be determined by Azerbaijani law in a way that reflects the interests of all concerned.

Matthew Bryza, U.S. deputy assistant secretary of state, says that the status quo between Azerbaijan and Armenia is "dangerous."

### 3 June

Prime Minister Artur Rasizade says that Azerbaijan must continue to build up its military forces in order to be in a position to liberate the occupied territories.

Kyrgyzstan names Raimkul Attakurov as its ambassador to Azerbaijan. Amb. Attakurov who will be based in Moscow also serves as Kyrgyzstan's ambassador to Armenia and Georgia.

OSCE conducts monitoring of ceasefire line between Azerbaijan and Armenian forces.

### 2 June

President Ilham Aliyev receives Yuri Yekhanurov, Ukraine's minister of defense.

President Ilham Aliyev receives Benjamin ben Eliezer, Israel's minister of national infrastructure.

President Ilham Aliyev receives Liv Monika Stabholt, Norway's state secretary and deputy minister of oil and energy.

President Ilham Aliyev receives Peter Semneby, the European Union's special representative for the Southern Caucasus.

President Ilham Aliyev receives Stephen Mann, U.S. State Department coordinator for Eurasian energy diplomacy.

Two new monuments are erected in Kazakhstan dedicated to Azerbaijanis who suffered there under Stalin.

### 1 June

Mexican academic suggests his country is interested in being associated with GUAM (<http://www.day.az/news/politics/119816.html>).

### **Note to Readers**

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