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Does Declining Oil Revenue Equal Less Security for Azerbaijan?

Declining oil revenues and a changing energy marketplace are placing Azerbaijan's social and economic development under strain. Worse still, observes Eric Eissler, the lost income might curtail the country's defense spending at a time when Baku needs it most.

By Eric Eissler for ISN

To say that Azerbaijan lives in a unique but troubled geopolitical location is perhaps an understatement. Flanked by assertive regional powers and embroiled in a 'frozen' [conflict with neighboring Armenia](#) (which still occupies 20% of Azerbaijani territory), Baku's diplomatic relations are undoubtedly complex. Nevertheless, this former Soviet republic has been able to utilize its hydrocarbon wealth to balance its regional ties and safeguard its overall security. But the veneer might be slowly starting to slip.

Rising from the Ashes

Upon gaining independence, Azerbaijan inherited a massive quantity of hydrocarbon reserves, estimated in 2012 to stand at 7 billion barrels of oil and 0.9 tcm of natural gas. Put another way, the country was effectively born with a ready-made source of income that could boost its social and economic development during a period of great uncertainty. In order to better capitalize upon this, Baku established the State Oil Fund of Azerbaijan Republic (SOFAZ) in December 2000. Since then, the revenues that it has pumped into Azerbaijan have formed the backbone of the country's development.

Indeed, the amount of hydrocarbons-based revenue that SOFAZ has injected into the country increased dramatically between 2000 and 2013. In 2007, for example, the fund invested \$686 million back into the country. By 2012, however, this figure increased to \$11.64 billion. In total, Azerbaijan has allocated an estimated \$49.73 billion for economic development and regeneration.

A major benefactor of this investment has been Azerbaijan's armed forces. In an address to a military parade in June 2013, President Ilham Aliyev laid bare the extent of his country's defense expenditure when he [declared](#):

"In 2003, our military budget was \$163 million. Last year [2012] this figure was \$3.6 billion, this year [2013] it has reached \$3.7 billion. This in itself shows that military buildup is the top priority, great funds are allocated from our budget for military buildup."

Increased defense expenditure has allowed Azerbaijan to gain the military upper hand against Russian-backed Armenia. Baku has invested heavily in purchases of combat and transport helicopters, combat aircraft and air defenses that can be deployed along the 'line of contact'. Moreover, by possessing the strongest armed forces among the South Caucasus states Azerbaijan has been able to keep Russia out of its domestic politics. This, in turn, has enabled Baku to develop close ties with the likes of Israel and the United States, thereby boosting its international profile in the process. In marked contrast, the only recent 'positive' in Russo-Azerbaijani relations was Vladimir Putin's visit to Baku in 2013 - the first official Russian delegation in seven years .

Trouble Ahead?

But the good times are possibly coming to an end, at least for Azerbaijan's elite, pro-government forces and the country's military. On December 3 2013, Baku gave the country's Tariff Council the green light to raise gas and petrol prices. As a result, petrol [prices](#) increased by up to 33% and natural gas prices almost doubled. This was effectively the beginning of the end of cheap gas and petrol prices for Azerbaijan's citizens.

Skyrocketing domestic fuel prices were quickly followed by an announcement that SOFAZ will reduce its transfers of oil revenues to state coffers in 2014. It has been estimated that SOFAZ's actions will lead to a 17-18% reduction in government spending. This, in turn, helps to explain why the government has dramatically hiked up the price of domestic fuel. Dr. Vugar Bayramov, the Chairman of the Board from the Center for Economic and Social Development (CESD) told the ISN:

"The government is attempting to compensate the budget with revenues from the non-oil sector. One of the main reasons for increasing the petrol tax rate was to compensate for this deficit."

But why has Azerbaijan taken such drastic measures? The answer to this question lies in declining oil production. Estimates suggest that Azerbaijan produced on average 872,000 barrels per day in 2012. By contrast, production stood at 1.02 million barrels per day in 2010. And while Azerbaijan is increasingly developing its natural gas exploration and production capabilities, gas alone will not be able to offset declining oil production. That's due in part to a decline in gas production from 17.24 bcm per annum in 2010 to 15.6 bcm per annum in 2013.

In addition, Azerbaijan's gas sector also faces a number of additional challenges. These include the United States' and the West's growing exploitation of unconventional resources such as shale oil and gas, as well as the vagaries of the oil and gas markets. While oil is sold on the global marketplace, gas tends to be traded regionally and is only sold on a global level as Liquefied Natural Gas (LNG). As a result, gas sales are not as consistent as oil purchases. Gas prices remain very much subject to current regional requirements and their respective markets.

Currently, Azerbaijan's economy is not yet diversified enough to cope with such a dramatic fall in oil revenues. This is also reflected by the fact that many Azerbaijanis continue to live below the breadline. While [relative poverty](#) has fallen in recent years, and Gross Domestic Product (GDP) per capita has risen from \$1,908 in 2002 to \$6,220 in 2012, many citizens living outside of the capital continue to struggle making a living. It's also difficult to see how Baku can make much-needed investment in education and further training against a backdrop of declining oil revenues.

Around the Neighborhood

Worse still, declining oil revenues casts further doubt over the sustainability of Azerbaijan's defense expenditure at a time when it arguably needs it most. Like many other former Soviet states,

Azerbaijan is undoubtedly viewing the events unfolding in Ukraine with a sense of unease. The region as a whole is also likely to be unnerved by popular demands in Russia for Putin to go after other 'lost' territories, such as Belarus and Kazakhstan. Yet, while there is no suggestion that Azerbaijan is under immediate threat, the fact Moscow has Russian troops based in neighboring Armenia might become too close for comfort for Baku in the coming years.

Yet it could have been so different for Azerbaijan and its citizens. While SOFAZ did a good job in terms of transferring the country's oil revenues, it has done little in the way of improving economic conditions for the generations to come. In 2012, for example, SOFAZ made significant purchases of gold, only for the price of gold to fall dramatically after the purchase. The same can also be said of its investments in Turkish Lira, especially given that this currency plummeted to all-time lows against the Dollar and the Euro in the opening weeks of 2014.

Consequently, if Baku wants to continue lavishing its military with substantial defense expenditure *and* improve social and economic conditions for the majority of the population, it needs to keep a tight rein on long-term planning and asset management. As it currently stands, Azerbaijan is unable to meet both requirements. Bearing in mind the neighborhood and times that it finds itself in, these are lessons that the country needs to learn – fast.

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