

Brief Analysis of the Impact of the Russia-Ukraine Conflict on Azerbaijan's Oil and Gas Industry and Its Economy

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Abstract: Azerbaijan is rich in oil resources. As early as the Soviet era, Azerbaijan was designated as the oil and gas center of the Soviet Union's output. In the 1920s, Azerbaijan's oil production accounted for 95% of the entire Soviet Union. The export of abundant oil and gas resources has improved the living conditions of Azerbaijani citizens and maintained the rapid growth of Azerbaijan's economy. After the outbreak of the Russia-Ukraine conflict, Azerbaijan's oil and gas industry faced dual impacts: on the one hand, the increased demand for alternative energy in the international market brought opportunities for its oil exports; on the other hand, Azerbaijan's close economic ties with Russia made it difficult to remain unaffected, with Western sanctions against Russia indirectly affecting Azerbaijan's economy. Azerbaijan's economy is greatly affected by international political and economic fluctuations. This paper aims to deeply analyze the specific impact of the Russia-Ukraine conflict on Azerbaijan's oil and gas industry and the overall economy and explore the necessity and potential paths of the country's economic structure transformation to provide academic reference for its sustainable development.

Keywords: Russia-Ukraine conflict, Azerbaijan, international oil prices, source of energy.

1. Introduction

Azerbaijan, known as "Little Dubai", boasts rich oil and gas resources that undoubtedly serve as a key driver of its economic growth. However, as a country that does not occupy a major position in the global economic market, Azerbaijan's economic and trade system is vulnerable to the influence of international powers, especially regional powers. Azerbaijan's economy is highly specialized. Azerbaijan's economy relies almost entirely on its oil resources as a typical resource-based country. As an important economic partner of Azerbaijan, Russia is not only its largest source of imports, and the largest exporter of non-oil products but also its third-largest trading partner. However, despite their close economic ties, the two countries also compete in the field of energy exports. Azerbaijan is committed to cooperating with European countries, and this strategy has effectively weakened Russia's monopoly on the Caspian oil export market to Europe. In 2022, with the beginning and intensification of the Russia-Ukraine conflict, Azerbaijan's oil export industry has also been greatly affected. This paper aims to analyze the oil industry in Azerbaijan, discuss the impact of the Russia-Ukraine conflict on Azerbaijan's oil and gas industry and its economy through literature review, case analysis, and comparative study, and try to analyze the possibility of Azerbaijan's economic structure transformation.

2. Overview of Azerbaijan's Oil and Gas Industry

This paper will use Azerbaijan's Gross Domestic Product (GDP) to measure the country's macroeconomic performance while comparing global crude oil prices to provide a brief analysis of the profound impact of the oil and gas industry on Azerbaijan.

Azerbaijan's oil resources are vital to the country's economy. More than half of its total industrial output, more than 50% of its fiscal revenue, and more than 90% of its total exports are directly related to the oil industry [1]. Due to its abundant oil and gas resources, Azerbaijan's talent and capital have gravitated towards the energy sector. Azerbaijan not only directly invests in oil companies, but also develops extensive urban infrastructure and services centered around its needs. This has also led to a lack of financial and policy support for other industries in Azerbaijan. For example, the development of capital and talent-intensive science and technology industries has always lagged, creating certain difficulties for Azerbaijan's economic structural transformation. Figures 1 and Figure 2 show the degree of dependence of Azerbaijan's oil and gas industry and its economy.

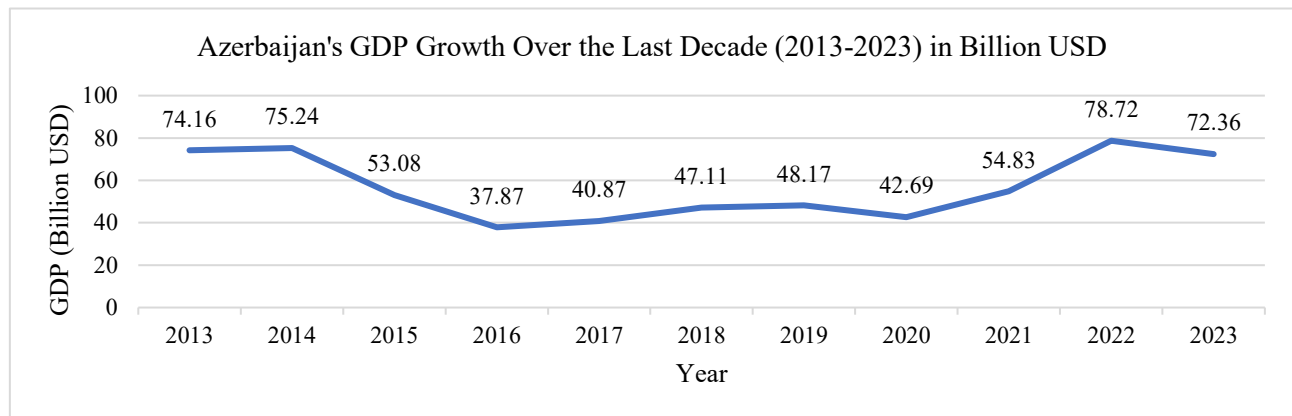


Figure 1: Azerbaijan's GDP growth over the last decade (2013-2023) in billion USD

Data from: <https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?locations=AZ>

As shown by the data in Figure 1, Azerbaijan's GDP experienced significant fluctuations from 2013 to 2023. The overall economy has been heavily dependent on oil exports, which are influenced by crude oil prices. Azerbaijan's GDP showed a downward trend from 2014 to 2016. From 2016 to 2022, despite a temporary decline in 2020 due to COVID-19, Azerbaijan's economy was largely on an upward trajectory. In 2022, with the easing of the pandemic and the onset of the Russia-Ukraine conflict, Azerbaijan's economy saw a substantial increase.

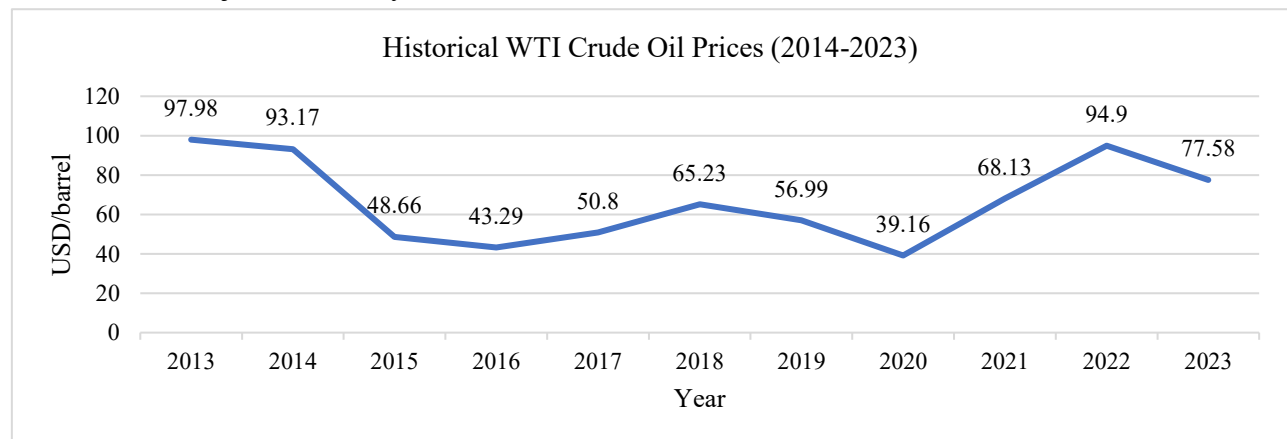


Figure 2: Historical WTI crude oil prices (2014-2023)

Data from: <https://www.eia.gov/dnav/pet/hist/LeafHandler.ashx?n=PET&s=RWTC&f=A>

Comparing the two sets of data above, the trend of Azerbaijan's GDP closely mirrors the rise and fall of crude oil prices. Therefore, by comparing the two pictures, the trend of Azerbaijan's economic development and the trend of oil prices are relatively related. It can also analyze the instability and unsustainability of Azerbaijan's economic development: once the international political and economic situation changes and international oil prices fluctuate, it will directly affect Azerbaijan's economic growth. Russia, as a regional power with a significant impact on Azerbaijan's economy, has largely altered Azerbaijan's economic environment due to the Russia-Ukraine conflict.

3. Impact of the Russia-Ukraine Conflict on Azerbaijan's Oil and Gas Industry

Since the collapse of the Soviet Union, Russia has actively wooed other former Soviet countries and influenced their economies through remittances, trade, and foreign direct investment. It wields considerable geopolitical influence in the South Caucasus region. After the Russia-Ukraine conflict, the sanctions imposed by Western countries had a significant impact on Russia's economy. Sanctions restrict Russia's economic exchanges with other countries and have dealt a heavy blow to the Russian economy to a large extent. In 2021, the EU relied on Russia for 45% of its natural gas, 46% of its coal, and 27% of its oil imports, while more than half of Russia's energy revenue came from the EU [2]. In the short and medium term, Russia may give up 14.80% of its real GDP. The withdrawal of foreign direct investment from allies is a key driver of Russia's real GDP loss. In addition, Russia's total imports will decrease by 50.7% and its exports will decrease by 22.6% [3]. Therefore, in the case of an escalation of the Russia-Ukraine conflict, the economic impact of sanctions on former Soviet countries, including Azerbaijan, is obvious.

When discussing the impact of the Russia-Ukraine conflict on Azerbaijan, the academic community presents a variety of perspectives. Valiyev believes that the conflict provides Azerbaijan with economic and political opportunities, enabling it to supply more oil and gas resources to Europe and establish itself as an alternative to Russian energy exports. The Ukrainian crisis and concerns about gas supply disruptions have prompted the EU to refocus on an alternative transportation system to transport gas from the Caspian region to European countries [4]. However, some scholars believe that the Russia-Ukraine conflict has harmed Azerbaijan's economy. Huseyngulu S. Baghirov pointed out that in times of geopolitical turmoil, the Azerbaijani government urgently needs to develop human capital resources to improve high-value production sectors [5]. In other words, if the problem of Azerbaijan's economic structure being heavily dependent on oil is not resolved, Azerbaijan will experience the "natural resource curse" phenomenon. The government needs to put human capital development and structural policies on the agenda, otherwise Azerbaijan's food security and stable non-oil product export trade may suffer greater losses.

3.1. Foreign Trade

3.1.1. Trade with Russia

Russia is Azerbaijan's largest source of imports, largest exporter of non-oil products, and third largest trading partner. Azerbaijan is not only dependent on imports from Russia, which provides Azerbaijan with a variety of key commodities and resources, but its economy is also dependent on trade in non-oil products exported to Russia. The negative impact of sanctions on Azerbaijan's non-oil exports is inevitable. As a result of sanctions, the purchasing power of Russians will decline, and the Azerbaijani manat (AZN) is likely to appreciate against the Russian ruble. In addition, Russia's exclusion from SWIFT has a serious impact on international trade and may cause problems such as increased costs. Finally, Azerbaijan has some regions that specialize in exporting to the Russian market, and sanctions may seriously affect the well-being of these regions. Azerbaijan can use sanctions to develop export-oriented industries to replace non-Russian imports from Russia.

3.1.2. Trade with Other Countries

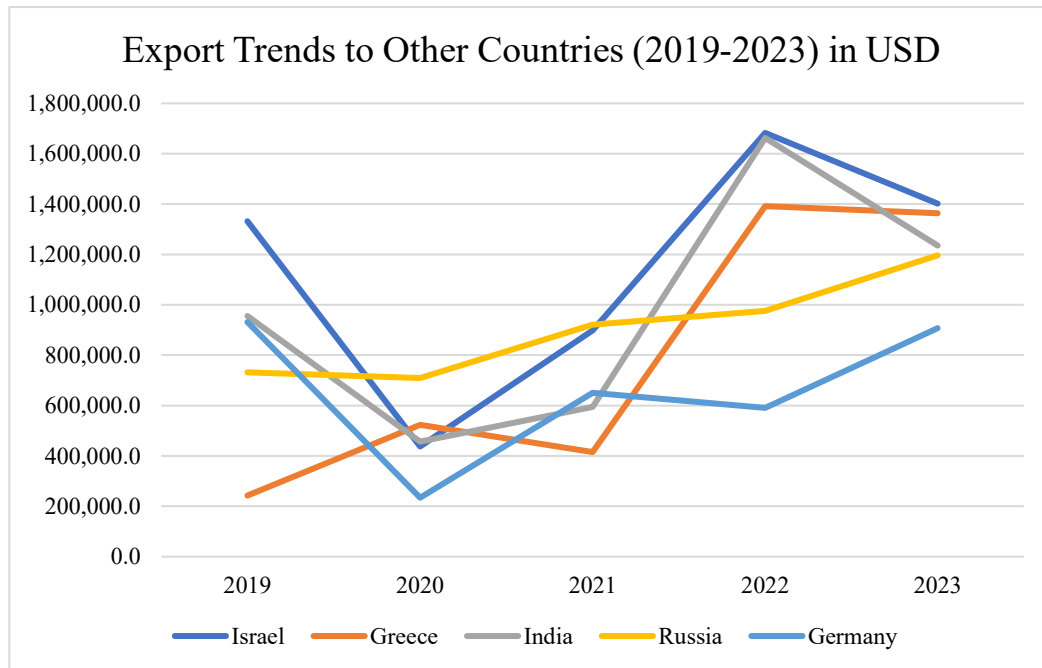


Figure 3: Export Trends to Other Countries (2019-2023) in USD
Data from: <https://www.azstat.gov.az/portal/tblInfo/TblInfoList.do#>

From the figure3, it can seen the trend of Azerbaijan's foreign trade and the impact of the Russia-Ukraine conflict on different countries. In 2020, affected by the pandemic, Azerbaijan's exports to almost all countries showed a large decline and increased in 2021. At the beginning of 2022, due to the beginning of the Russia-Ukraine conflict, Azerbaijan's exports to Israel, Greece, India, and other places increased sharply, while the exports to Russia and Germany, which were greatly affected by the Russia-Ukraine conflict, did not recover until a year later.

3.2. Service Industry

3.2.1. Financial Industry

Russia is excluded from the SWIFT system, so its financial transactions are severely disrupted due to sanctions. Financial relations between Russia and Azerbaijan have always been close. Therefore, Azerbaijan's financial and trade system is also in a precarious situation. According to the Declaration on Allied Interaction between the Republic of Azerbaijan and the Russian Federation in 2022, the two countries agreed to actively use national currencies in mutual settlements. The International Bank of Azerbaijan (IBA) and Roseximbank, one of the leading banks of Russia, signed a Memorandum of Cooperation. According to the agreement, both banks will participate in trade relations between Azerbaijan and Russia [6]. However, Russia's financial system has not yet been integrated and a complete system has not yet emerged to deal with sanctions, which has brought great changes to Russian-Azerbaijani trade. Azerbaijani experts have repeatedly suggested that a more advanced payment system be added to the Russian payment system. Otherwise, the black-market remittances that prevailed in the 1990s will reappear.

3.2.2. Transportation and oil and gas exports

In terms of oil and gas transportation, the impact of sanctions on Azerbaijan's economy has shown a positive effect. Russia's weakening position in the European and Western markets has provided market opportunities for Azerbaijan. As early as the 1990s, Azerbaijan had demonstrated its foresight and flexibility in geopolitical layout. In September 1994, the Azerbaijani government signed the "Contract of the Century" for the development of Azerbaijan's oil fields with several major energy companies in the United States and Europe. In November 1999, with the promotion of the United States, the presidents of Azerbaijan, Georgia, and Turkey signed a package agreement on the Baku-Tbilisi-Ceyhan (BTC) oil pipeline, which can export Caspian oil to Europe without passing through Russian and Iranian pipelines [7]. This move further reduced Russia's control over Azerbaijan.

In 2022, sanctions further increased Azerbaijan's attractiveness as a source of national energy for the European Union. In 2022, during Ursula von der Leyen's visit to Azerbaijan, the EU and Azerbaijan signed new agreements and contracts to increase EU gas imports from Azerbaijan. This is a new opportunity for Azerbaijan to benefit from the Russia-Ukraine conflict. However, due to the close economic cooperation between Azerbaijan and Russia, some foreign experts called for the extension of sanctions on Azerbaijan. This casts a shadow on the Azerbaijani economy.

4. Azerbaijan's Efforts Towards Economic Structural Transformation

To mitigate the unsustainable impact of the oil and gas industry on Azerbaijan, the country has introduced various policies and established legal entities aimed at increasing revenue in other sectors.

Following the instructions of the President of Azerbaijan in 2016, Azerbaijan established the Food Procurement and Supply Joint Stock Company. To increase the country's total agricultural production, the government plans to build multiple agricultural parks in 24 regions to provide hardware support for increasing agricultural production [8]. The agricultural field accounts for about one-third of the 173 investment projects in Azerbaijan that have received financial allocations from the Azerbaijan government. It reflects the importance that the Azerbaijani government attaches to the development of domestic agriculture.

In October 2016, Azerbaijan introduced policies aimed at stimulating the export of non-oil products. To a certain extent, it promotes the export of Azerbaijan's non-oil products. Judging from the actual effect, this policy adjustment has had a positive impact on the agricultural sector, and agricultural exports have achieved significant growth.

Azerbaijan is strategically located in the central corridor of the network of trade routes that connected the East and West. Its capital, Baku, is at the crossroads of east-west and north-south transportation and plays a decisive role in the central corridor. The government attaches great importance to the country's transportation infrastructure and strives to build the country into an important node connecting the Eurasian continent. The whole country has developed a domestic transportation network of considerable scale.

5. Conclusion

To sum up, the sanctions in the Russia-Ukraine conflict have had a positive or negative impact on Azerbaijan. However, from the point of view of Azerbaijan's GDP growth and increase in exports, the sanctions against Russia have had an overall positive impact on Azerbaijan.

However, to ensure long-term economic stability and sustainable development, Azerbaijan must focus on economic diversification and reduce its over-dependence on oil resources and exports. Therefore, accelerating the structural transformation of the economy has become a top priority to prepare for the possible shortage of oil reserves in the future.

To improve the transformation, Azerbaijan needs to address existing corruption and inefficiencies in government institutions. Improving transparency and administrative efficiency will be key to driving economic reforms. Azerbaijan's 122nd place in the global ranking of clean countries highlights the need to address existing problems in government institutions.

In addition, Azerbaijan should focus on improving the overall business environment and infrastructure construction to promote the development of non-oil industries. Strengthening higher education, increasing investment in human capital, and modernizing the telecommunications sector are all key steps. For example, in 2017, only 2.1 percent of the country's \$1.2 billion education budget was devoted to higher education, indicating insufficient efforts to develop more talent people. While the road to economic transformation will be challenging, it is achievable with targeted reforms.

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