

# PERSPECTIVES OF DIVERTING TRANSNATIONAL CORPORATIONS ACTIVITIES TO THE DEVELOPMENT OF NON-OIL SECTOR IN AZERBAIJAN

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## Abstract

*After restoration of its independence in 1991, Azerbaijan became an important and active player in the region due to its oil and gas reserves and its geopolitical location. As it can be predicted, Azerbaijan soon attracted Transnational Corporations (TNCs) which were seeking natural resources. In 1994, the Contract of the Century (BTC) was signed between partner countries, and Azerbaijan got start towards a rapidly flourishing country. However, today there is an economic crisis since its economy mainly depends on oil and gas exports. The paper reviews three types of FDI, analysis which kind of FDI is beneficial for Azerbaijan and seeks for opportunities and possibilities to divert FDI inflows to the development of non-oil sector, such as agriculture, tourism and updating soviet ventures in industry.*

**Keywords:** Transnational Corporations, Oil-sector, non-oil sector, FDI, Azerbaijan, economic development, economic crisis, agriculture, tourism

## Introduction

Azerbaijan got its independence after the collapse of the USST after 71 years in 1991. Right after gaining independence, the young country found himself in a war with another young country Armenia Republic over Nagorno Karabakh conflict. Claiming possession of these lands, two countries made war for three years until 1994 official ceasefire. If we briefly

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describe the picture of that period of Azerbaijan, all industry stopped production because of financial and economic crisis, currency inflated, unemployment rose to the highest peak, poverty increased in all the regions, and most important that young country had more than one million refugees and IDPs departed from their homes and lands by Armenian troops. Within all this mess, the country had to take some urgent measures with its gas and oil reserves. Subsequently, Tbilisi- Baku- Jeyhan oil contract came to the agenda with Turkey and Georgia. With the consent of European countries and the USA, Azerbaijan started to build this huge pipeline with the sponsorship of its 11 partner Transnational Oil Corporations. After the ceasefire, as the stability was provided throughout the country, investors started to get interested in the country and made some investments. The peak of this kind of investment appealing process happened when "Contract of Century" Baku-Tbilisi-Jeyhan pipeline was signed between Azerbaijan Republic, Turkey and Georgia and their 11 transnational energy partners BP (UK), SOCAR (Azerbaijan), Chevron (US), Statoil (Norway), TPAO (Turkey), Eni (Italy), Total (France), Itochu (Japan), Inpex (Japan), ConocoPhillips (USA), Hess (USA). As BP is the operator of this consortium, it has 30.1% in this contract<sup>1</sup>. Taking into consideration of that hard and harsh period of Azerbaijan, this contract took the healing role for poor and torn economic and social life of Azerbaijan after Nagorno Karabakh war between Azerbaijan and Armenia in 1991-1994. It was the second largest pipeline in the former USSR area after Druzhba pipeline. Although the first oil was expected to be sent through the pipeline in 2006, economic and political consequences of this contract attracted many more foreign direct investments to Azerbaijan. Firstly, Azerbaijan had to make urgent ceasefire with Armenia and freeze the Nagorno Karabakh conflict in order to stabilize economic, political and social life inside the country, and start to build the pipeline. That stability also would attract foreign companies to come to Azerbaijan and invest here. It was obvious no TNC would spend money on the country, where there was war. One of the main conditions for TNCs to invest in foreign country is having stability and security there. Therefore, with that ceasefire in 1994, security was provided for TNC branches to invest in Azerbaijan. After a year of the pipeline

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<sup>1</sup> \*\*\*, "BTC Celebrates Full Commissioning"- press release,BP. 13 July 2006. Archived from the original on 2007-10-30.

launch, GDP in Azerbaijan boosted to the record level with 35% in 2007<sup>2</sup>. It is understandable for that described situation to attract resource-seeking FDI, since Azerbaijan did not have capability in terms of capital and necessary technology to extract oil and gas from the depth of the Caspian Sea in 1990s. After war with Armenia, Azerbaijan economy was torn into pieces, unemployment was high, USSR factories and plants were closed, military force was weakened, and internal and external security was not in the sufficient level. Therefore, as a transition country or former soviet state, FDI was vital for economy. However, today Azerbaijan has become a leader country in the Caucasus region, has accumulated huge capital from the revenues of oil and gas, and has got stronger army and sustainable economy. Appropriately, it matters now what kind of FDI is flowing to the country. Since J.H. Dunning has determined mainly three types, resource seeking, market seeking and efficiency seeking FDI.<sup>3</sup> Commonwealth Independent States (CIS) including Azerbaijan need to pay more attention to the type of FDI. The focus of the paper is doing research to answer to some questions. What type of FDI does Azerbaijan need? How can Azerbaijan divert TNCs investments to the non-oil sector? What are the perspectives for TNCs to invest in non-oil sectors like tourism and agriculture?

### **Resource seeking and market seeking FDI**

"FDI in the CIS up to the early 2000s were related to the extraction of natural resources, to the construction of pipelines transporting these energy resources, large privatizations, and to debt/equity swaps to pay for energy supplies. The disappointing level of FDI at that time reflected weak investment climate in the region, particularly because of incomplete structural reforms."<sup>4</sup> A big portion of TNCs are dealing with natural resources and get revenue from them in developing countries by processing, transferring and producing goods from them. Therefore, raw

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<sup>2</sup> "Republic of Azerbaijan – Concluding Statement of the IMF Mission". International Monetary Fund. 2007-09-06. Retrieved 2007-12-30.

<sup>3</sup> Dunning, J.H. (1993), *Multinational enterprises and the global economy*. Workingham.: Addison-Wesley.

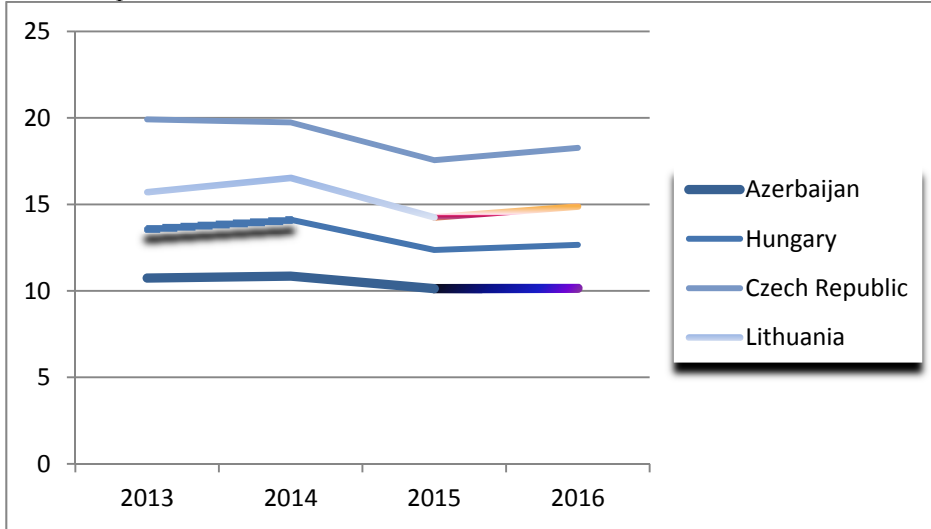
<sup>4</sup> The Motives and Impediments to FDI in the CIS Alina Kudina & Malgorzata Jakubiak, VII Global Forum on International Investment, 27-28 March, 2008, page 4

materials and natural resources are crucial for their operations. Today, “the prime foreign investment motive in Azerbaijan is resource seeking. This is in contrast to many other transition countries in CEE, where the majority of foreign direct investment has been of market and efficiency seeking nature”.<sup>5</sup> Undoubtedly, this tendency has some reasons. During 1990s, Azerbaijan had 7 million populations with low GDP, which means there was not big market or high consumer society to attract market seeking TNCs or their FDIs. However, market-seeking FDI usually depends on the internal factors and growth rates of the country. “Market-seeking investment is attracted by factors like host country market size, per capita income and market growth. For firms, new markets provide a chance to stay competitive and grow within the industry as well as achieve scale and scope economies.”<sup>6</sup> However, from natural resources TNCs can earn huge amounts of revenue. Therefore, small markets with low GDP do not attract market-seeking investors. If we look at comparative GDPs of different countries where market-seeking investments are high, then the picture would be more clearly. While, GDP per capita in Azerbaijan has been around 10.000 dollars, it has been around 13.000, 15.000 and 19.000 dollars in Hungary, Czech Republic and Lithuania, although all of these states have passed transition periods after the collapse of the USSR. Of course, there are some other factors that cause and attract relatively higher GDP in those countries, like geographic location, natural resources, distribution of social wealth, stability, rule of law, effective governing and economic reforms.

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<sup>5</sup> Jutta Günther, Björn Jindra, *Investment (FDI) Policy for Azerbaijan Final report*, Halle Institute for Economic Research, 2009, p. 8.

<sup>6</sup> Alina Kudina, Malgorzata Jakubiak, “The Motives and Impediments to FDI in the CIS”, *VII Global Forum on International Investment*, 27-28 March, 2008, p. 4.

**Table 1.** Comparative Gross Domestic Product per capita in Azerbaijan, Hungary, Czech Republic and Lithuania

Source: World Bank, [www.data.worldbank.org](http://www.data.worldbank.org)

As we can see from the graph, during last four years GDP per capita was lower than other developing countries. Therefore, market-seeking investment is higher in these countries. Besides GDP, number of population also attracts market-seeking investment. If there is small population, then consuming rate will also be low. Of course, this argument does not apply to the above-mentioned countries, since Hungary, Czech Republic and Azerbaijan have similar population around 10 million, and Lithuania have almost 3 million people. But for example, if we take into account the countries with huge populations like Turkey (80 million), China (1.5 billion), then we can easily imagine how big market and consuming society stands in front of investors. In China, there are a lot of brands and goods that they do not need to go to the world market, since Chinese population is enough for their targeted sales. A beverage company Jianlibao, sport apparel company Li Ning, Xiaomi, Haier and Hisence have seen consumer boom in China, so very few of them have looked beyond the Chinese borders. For such sales companies, having big market is sometimes can be enough to attract large investments.

In a nutshell, currently Azerbaijan is not an appealing country for market seeker investors, since population is small, and consumer society is not in the high level due to lower GDP. Vice versa, as Azerbaijan owns abundant oil and gas reserves, right now it is more attractive for resource seekers. The paper is going to analyze how the government would divert the attractiveness from resources to non-oil sector.

### **Efficiency seeking FDI**

Such kind of investment happens when there is an effective institutional arrangement, economic system and active cross-border activities. Some countries can attract such FDI, as they have large number of cheap labor, which is ideal for efficiency-seekers. However, "there is a lack of efficiency-seeking investment that poses further concern about the nature of FDI in the region."<sup>7</sup> Although, all three Caucasus states have labor-productivity advantage, some negative cases such as corruption, gaps in the legislation, volatile rule of law and other factors hinder increasing of efficiency-seeking FDI. Moreover, efficiency seekers will wish to export their produced goods in the region and for that they need low transportation costs, low customs taxes and flexible border rules. However, in this situation Azerbaijan is in the war condition with Armenia and subsequently borders are closed. Another point here is that Azerbaijan is not the member of World Trade Organization, although membership negotiations have started for a long time. Decision has not been made due to the lack of border, legislation and trade reforms and adaptation of the rules to European standards. Therefore, currently the main motivator for investors is resource -seeking. Caucasus region does not attract efficiency seekers due to the above-mentioned problems.

Throughout our research, we determined that most of the FDI flowing to Azerbaijan is resource-seeking which is not positive trend right now. Since Azerbaijan needs to diversify its economy, government needs to seek for remedies to divert FDI to non-oil sector. In this case, what can be perspectives for investors to direct their investments to other sectors and how Azerbaijan can attract them.

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<sup>7</sup> *Ibidem*, p. 2.

## Agriculture

Agriculture sector for TNCs might be rather appealing for foreign investors, since Azerbaijan has vast lands which have not been planted or used by peasants in the regions. "For many years, oil sector has been pillar of economy of Azerbaijan, while agriculture and service have not been developed adequately."<sup>8</sup> As we can see from the Agricultural country report of 2015, we can see that FDI inflow to oil sector is more than agriculture sector for many times. The situation was worse in 2010-2011, and then we see increase up to 12 million Azn, however it is again very very lower than FDI in oil sector. We believe, this situation can be diverted to the favor of agriculture, if government conducts several reforms and make this sector more attractive for investors.

**Table 2.** FDI flows to oil and agriculture sector in Azerbaijan Republic<sup>9</sup>

FDI	2009	2010	2011	2012	2013
Oil sector (million dollar)	752.7	777.6	999.5	1001.2	1107.2
Agriculture sector	9.7	1.0	0.5	5.7	12.3

There is good opportunity for building irrigation system from Kura and Araz river and other small seasonal rivers. "Sustainability of Azerbaijani economy will require shift towards technologically advanced and innovation friendly production with balanced approach to agriculture."<sup>10</sup> Today, Azerbaijan is not able to supply demand of its 10 million population with needed internal agricultural goods. Neglected agriculture sector can be attractive sector to invest for TNCs and with increased productivity with the help of modern technological machines, they can earn huge amounts of revenue. If Azerbaijan makes efforts to

<sup>8</sup> Fikrat M. Pashayev, „Investment policies and competitiveness of Azerbaijani economy“, in *Khazar Journal of Humanities and Social Sciences*, Khazar University, Baku, Azerbaijan, 2013, p. 26.

<sup>9</sup> H. Khalilov et al., *Country Report Azerbaijan*, Research Institute of Agricultural Economics, 2015, p. 9.

<sup>10</sup> Fikrat M. Pashayev, *op.cit.*, p. 31.

divert FDI to agriculture sector, the regions which have stayed under development in the comparison with Baku will start to show development signs, rural income will increase and rural people living in these areas will get employed in the fields. As a result of it, Azerbaijan will be able to supply the internal demand in the market, will not be depend on the import and social welfare, employability, and development in the regions out of Baku will get better and better. FDI can be diverted mainly to grains, fresh fruit, vegetables, tea, tobacco and cotton.

### **Transition of Soviet enterprises into the up-to-date ventures**

The role of the government in diversification policy is undeniably important especially in the case of Azerbaijan. Diversification of the economy will not happen without carrying on removing artificial barriers and demotivating factors in the market. First of all, the focusing on reforms, rebuilding effective institutions, infrastructure, and human services is the most significant step to the forward. Secondly, focusing an industrial policy on a few target sectors will help Azerbaijan both build institutions and work collaboratively with business world inside and outside. The question arises how to conduct industrial policy if the state does not own modern technology and ventures. According to Linear Growth Model which has been developed by Rostow in 1960s, states pass five stages in terms of economic development: 1. Traditional society; 2. Transitional stage; 3. Take off; 4. Drive to maturity; 5. High mass Consumption;

Rostow showed that development requires substantial investment in capital. He was arguing that if the country has reached stage 2, then substantial investments are needed in order to develop and pass to stage 3. Because in stage 2, specialization and infrastructure are built and it is easy to invest in existing infrastructure. In stage 3, industrialization, growing investment and regional growth happen already and Azerbaijan is in between Stage 2 and 3. As we know, Azerbaijan inherited several plants, factories with soviet type technology and ventures during 71 years of union, and when the USSR collapsed these factories and plants were mostly closed due to financial shortage, war and following economic crisis. Another way to divert FDI to non-oil sector would be reopen, reconstruct and reform these factories, modernize the buildings and technology



inherited from the soviet and develop industry sector. If the government conducts such an industrial and privatization policy, investors will be more interested to invest in non-oil sector privatizing such ventures. Transition of Soviet enterprises into the up-to-date ventures will also create new job places and will increase employability.

### **Tourism sector**

“Many developing countries are looking to tourism as a potentially promising avenue for economic and human development. This is a relatively new position for some countries, and reflects the rapid increase in tourism in terms of both numbers of arrivals and revenues for several economies in recent years.”<sup>11</sup> Tourism was usually considered less important than manufacturing or agriculture, as it was not supposed as a crucial or profitable source of development. Therefore, there is little research on the overall impact of FDI on tourism sector in developing countries, while “today, a “quiet but significant reappraisal” is taking place, which values tourism as a potential means of earning export revenues, generating large numbers of jobs – including for young people and women – promoting economic diversification and a more services-oriented economy, helping to revive declining urban areas and cultural activities, and opening up remote rural areas. For example, there is now growing research on what is called “pro-poor tourism” that is gaining mainstream support through the donor and development assistance communities.”<sup>12</sup> Attracting FDI to tourism sector will involve a lot of new constructions of hotels, resorts, recreation sites, museums, entertainment centers and trade centers which will have great job creating effect. Azerbaijan regions have such opportunity as it has 11 climate zones in the country, various types of lands such as mountainous or plain and hot lands. Azerbaijan regions have suitable conditions for winter tourism as well, which have made several efforts to develop it in Shahdag winter resort and Qabala Tufandagh winter resort. These places are ideal for summer resorts as well. Moreover, some regions have some medical water

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<sup>11</sup> *United Nations Conference on Trade and Development*, FDI in Tourism: The Development Dimension, United Nations, New York and Geneva, 2007, p. 11.

<sup>12</sup> *Ibidem*.

or mud, which is extracted from the ground and in these places, investors can develop huge medical resorts and cure people with kidney or heart diseases with this mud baths and sulfur water. Naftalan, Istisu and Duzdag in Nakhcevan regions, there are such potential places for investors. Currently, some small hotels and resorts have been built and are used in a nationwide. However, if these places attract TNCs and in case huge five starred medical resorts are introduced to these places, for sure they will attract many health-seeker tourists from overseas. After all, both TNCs and local SMEs will gain, region will develop, people will get employed and consequently social welfare and GDP will increase. Tourism in itself also means export of currency. As Azerbaijan manat has been devaluated against dollar, foreign currencies are very expensive right now and economic crisis is deepening more every day. Governmental steps towards diverting FDI to tourism sector would have great effect on the struggle with economic crisis and overall social welfare. For instance, Indonesia government is encouraging TNCs to develop their resorts in Bali for holiday makers, and especially offer great all-inclusive honeymoon trips for newly married couples. FDIs are usually playing as the main mean of funding such projects in the country. Next, it also helped the government to build better roads, bridges and develop the region in order to transfer it to a better destination from all over the world. Tourists after all have made Bali a flourished economy with the help of governmental reforms. In a nutshell, in case Azerbaijan eases taxes and registration procedures for TNCs, they might have incentives to invest in tourism sector. If we take into consideration that Azerbaijan really has beautiful, ancient and historical places as sight-seeing, it will motivate tourists to travel to a Caucasus with unique culture.

## **Conclusion**

To sum up, in Azerbaijan, there are many opportunities and sectors that can be very beneficial and attractive for investors, if just some governmental reforms are conducted efficiently by effective institutions. As a young country, there are a wide range of goods and services that Azerbaijan still export them since there is not production of particular goods or they are not enough supply or the quality of goods are not high.

In all three conditions, for investors there are massive opportunities and chances to use effectively and occupy all these gaps in economy. For example, Azerbaijan has fantastic regions with historical places and wonderful nature that very few tourists visit there and even by locals these places are not widely known and visited. However, in touristic countries, such places are considered as "touristic traps" and by promotion widely, thousands of tourists are attracted there. Both local people get employed, regions develop, and export of currency happen in the country. Updating soviet ventures might be another way of developing country by foreign investments. Azerbaijan has got a lot of factories and plants that have been locked after the collapse of the USSR. By renewing them with expert engineers, these places can be returned to productive economic life. Another non-oil sector is of course agriculture sector that vast fertile lands of the country give huge promises to investors. Looking at some statistical figures, we also witnessed that how enormous differences there are between the investment inflow to oil sector and agriculture sector. By promoting this sector to investors and reforming conditions in Azerbaijan, agriculture can revive and provide the country with necessary wheat, vegetables and fresh fruit.

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