

EURASIA: COULD KAZAKHSTAN AND AZERBAIJAN FOLLOW UKRAINE'S PATH?

The conflict in Ukraine has shown that political instability in the post-Soviet space remains a potent threat to investors, and the two largest non-Russian oil producers in the Commonwealth of Independent States (CIS) are not immune to internal and external destabilizing factors of their own: In Kazakhstan, uncertain presidential succession and Russian pressure could heighten security risks in the near-to-medium term; Azerbaijan, meanwhile, is plagued by poor governance and a dangerously unbalanced economy. And though the oil-fuelled economies of both countries have allowed their regimes to maintain power up to now, public protests in recent years suggest certain frailties as well. Moreover, government crackdowns on demonstrators and other critics in both countries have led to human rights violations that could present reputational risks to companies operating in Kazakhstan or Azerbaijan.

KAZAKHSTAN: IMPENDING SUCCESSION

To date, the regime of President Nursultan Nazarbayev has maintained Kazakhstan's political stability thanks to relatively inclusive economic growth, but the country faces some serious internal and external challenges in the near term. Its leadership will have to manage the succession of 74-year-old Nazarbayev, who has not yet designated a successor. If he dies before doing so, the political establishment in Kazakhstan could be subject to infighting and have difficulty soothing social tensions in the country's restive regions.

In 2011, violent protests broke out in the western province of Mangistau, a desolate region that produces much of the country's oil but whose residents feel they have been neglected by the government. Many disenfranchised youths in Mangistau have increasingly turned to Islam as a means of political expression, which could further destabilize the region. In February 2014, smaller protests erupted in response to the government's decision to devalue the tenge by 19 percent, causing sudden price increases for imported goods.

Kazakhstani authorities have cracked down on these protests with brutal and sometimes deadly force, drawing scrutiny for human rights violations and creating reputation risks for companies with operations in the country. Still, demonstrations are rare in Kazakhstan and are unlikely to occur with greater frequency, as Nazarbayev has prioritized economic growth by reappointing Karim Massimov as prime minister; Massimov occupied that post between 2007 and 2012 and steered Kazakhstan clear of a recession during the global economic crisis.

If Kazakhstan has remained relatively stable over the past two decades, it is largely thanks to the government's success in improving the living standards of its citizens. Kazakhstan is now an upper-middle-income country, poverty rates have declined, and life expectancy has increased. And, while oil remains the country's primary economic driver, the government has diversified its economy enough that those outside the oil sector have benefited as well.

Regarding its foreign policy, Kazakhstan currently has no choice but to maintain its strategic alignment with the Kremlin. As the Ukrainian crisis has shown, the West and other countries are not willing to risk a military confrontation with Russia in the CIS, least of all for an authoritarian regime. And though Astana has been somewhat successful in tempering its dependence on Russia by establishing decent relations with China and the West, these relations will not be enough to mitigate the many risks facing foreign investors emanating from the country's uncertain presidential succession and potential future interference from Russia.

AZERBAIJAN: INCREASING FRAGILITY

Azerbaijan is somewhat more vulnerable to internal and external threats. If global oil prices continue to decline, political stability in the country could be threatened despite its economic growth and improved living standards in recent years, as those are the very factors that have ensured Azerbaijan's stability. An over-reliance on oil revenues coupled with Azerbaijan's difficulties in managing its external relationships could therefore weaken the regime's international standing and lead to internal domestic strife.

In the long term, Azerbaijan faces significant economic challenges. The government's budget overwhelmingly relies on oil and gas revenues, but oil production has peaked and is now in decline. Future revenues will thus come almost exclusively from gas, but they will not be enough to compensate for the declining oil output. Oil revenues have helped to diversify the economy and reduce poverty; however, this has only been achieved because the State Oil Fund, which is supposed to save money for the future, has instead retained just 30 percent of the country's oil revenues for the past few years. In other words, Azerbaijan is currently experiencing a bubble economy, and over time, the regime will be less able to meet the economic expectations of its citizens and could face growing unrest as a result.

Demonstrations occur with some frequency due to a strong sense of social injustice and frustration with the country's leadership. The regime has chosen to respond with ongoing and increasingly brutal actions against all forms of dissent, hoping that the West will overlook its human rights violations due to Azerbaijan's geopolitical significance. While that gamble has not yet had any serious repercussions for the country's president, Ilham Aliyev, Azerbaijan's worsening human rights record has damaged its relationships with Western countries and poses reputational risks to companies with operations there.

Compromised relations with the West could also render Azerbaijan more vulnerable to Russian influence, about which the Azerbaijani government has become increasingly concerned. Such concern is warranted: Russia has begun interfering in Azerbaijani politics more aggressively than at any point in the past, most notably in the 2013 presidential elections, when the Russian film director Rustam Ibragimbekov was announced as a candidate by the Kremlin in an apparent attempt to scare Aliyev.

The greatest immediate concern, however, regards the long-simmering conflict between Azerbaijan and Armenia over Nagorno-Karabakh, which is legally part of Azerbaijan but inhabited and controlled by ethnic Armenians. Observers worry that the government will intentionally stoke the conflict to distract its citizens from the country's domestic problems. While openly hostile actions in the near future are unlikely, such developments should not be ruled out, and they would pose significant reputational and economic risks to any foreign investor with operations in Azerbaijan.

Social unrest and difficult relationships with Armenia, Russia, and the West pose certain threats to Azerbaijan's stability; however, the country's economic growth should ensure the Aliyev regime's ability to maintain its power in the near and medium terms – provided oil prices do not plummet more precipitously than they already have. Long-term prospects, meanwhile, warrant a much higher degree of caution and scrutiny.

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