

## THE POLITICAL ECONOMY OF CONFLICT IN NAGORNO-KARABAKH

George Welton  
Bret Barrowman

### Introduction

Over the last few years, many commentators pointed out that it is increasingly inaccurate to describe Nagorno-Karabakh as a ‘frozen’ conflict when the tension and the body count have been rising every year. This concern was punctuated in April, with a military conflict that killed dozens and was quickly dubbed ‘the Four Day War’.

However, while oil wealth and changing resource prices, as well as the role of the Armenian diaspora, are regular reference points in the discussion of the region, the political economy of the Nagorno-Karabakh conflict is rarely considered explicitly and systematically. This paper seeks to fill this gap by explaining how the political economy of the Nagorno-Karabakh conflict affects the incentives facing parties to the conflict, and as a result, affects the likelihood of political settlement, maintenance of the status quo, and escalation.

Our analysis has two conclusions. First, the economic support of Nagorno-Karabakh from the Armenian government and diaspora has maintained a level of income in the region which is far higher than it would be otherwise, reducing incentives to push for peaceful resolution.

Second, we argue that recent economic changes in Azerbaijan, and changes in its relations with Russia, may have increased the likelihood of war by changing decision makers’ perceptions of the costs of conflict in three ways. First, Azerbaijan’s resource wealth allowed it to dramatically outpace Armenian military expenditure. This encouraged strong arguments from the Azerbaijanis that they would ultimately be able to take back the region by force. However, reduction in military budgets and an upgrade in capability on the Armenian side may encourage Azerbaijan to seize

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its advantage while it still can. Second, Azerbaijan may believe that Russia's security guarantee to Armenia is not strong enough it to act, particularly if the Azerbaijanis restrict themselves to small land-grabs on their own territory. Third, deteriorating economic conditions can increase the incentives for war but can also have the opposite effect. The lack of democracy and the weakening economy on both sides can create incentives for elites to engage in increasingly hostile and nationalistic rhetoric to distract from domestic crises. In turn, this rhetoric increases the perceived costs of inaction. That is, elites on both sides may have an incentive to follow up on threats if they perceive they will suffer a backlash in popularity for failing to act. On the other hand, diminishing economic resources may actually quell the desire to fight, as elites fear losses of revenue that can result from a war.

Therefore, while the shifts in the regional economic and political circumstances do not push in one direction, their impact on incentives is important. While the most recent outbreak of armed conflict has temporarily subsided, the fact that it happened seems to suggest that something has already shifted, and significant potential remains for the resumption of hostilities on a larger scale. It is therefore important to carefully

distinguish different explanations for why the conflict might resume. In particular, one must separate the possibility of 'accidental' escalation from deliberate escalation by political leaders. The current literature tends to emphasize the fact that increased weapons on the Line of Contact have created greater opportunity for accident and miscalculation. This is certainly true, but it is also possible that there has been a change in the motivations to escalate. This is important because the policy prescriptions to reduce the likelihood of accidental conflict are different from the policy prescriptions if changing incentives and perceptions of risk drive intentional escalation.

If the concern is accident, then better command and control, better communication and strategies for quickly responding to minor problems are key. If the problem is the structure of costs and benefits, then those need to be changed directly, by somehow making the costs and risks associated with war higher. Therefore, understanding the political economy of the situation is crucial to identifying the correct remedy to make the situation less vulnerable.

## EVIDENCE AND ANALYSIS

### **The political economy of the status quo. Supporting Nagorno-Karabakh**

This paper will look at how resource flows have worked to both undermine the motivation to resolve the dispute diplomatically, and the way in which the recent economic changes may increase the likelihood that Azerbaijan intentionally starts a major war. For the first part of the analysis, we look at the way that Armenian support for the Nagorno-Karabakh economy had helped to sustain the status quo and remove motivation for peaceful resolution of the conflict.

Although the Nagorno-Karabakh economy produces food and some industrial products for domestic consumption, it relies on imports, direct transfers, donations, and remittances. This support perpetuates the status quo because it allows the Karabakh people to enjoy a far better standard of living than they otherwise would, given their circumstances. This has helped to ensure that the de facto authorities have had no problem maintaining domestic support for a hardline position of independence.

If one accepts the data provided by the National Statistical Service of the Nagorno-Karabakh de facto authority, then national income is surprisingly high. In 2014 they reported a GDP of approximately US \$454 million, and a per capita income of about \$3,050.<sup>1</sup> Of course, these figures need to be taken with a large element of caution, but if true they compare well to the region. Per capita GDP in Armenia is around \$3,500 and

Georgia is around \$3,600, and both of these economies are far more vibrant.

Whether or not this number is plausible, it is certainly the case that high levels of support from the outside mean that Nagorno-Karabakh has a far higher GDP and average national income now than it would without that support. The economy remains heavily dependent on Armenia and the Armenian diaspora for goods, financing, infrastructure development, and personal income. First, the economy is highly import-dependent. According to the National Statistical Service of the Nagorno-Karabakh Republic (NKR), the region imported approximately US \$301 million worth of products in 2014, but exported only \$64 million, with Armenia being by far the region's most important trade partner. Imports from Armenia constituted approximately 93% of Nagorno-Karabakh's total import volume in 2014, and Armenia was the destination of approximately 88% of the region's total export volume.<sup>2</sup>

In addition to relying on Armenia for goods for domestic consumption, Nagorno-Karabakh depends on the government of Armenia for budget financing. Lacking normal economic investment and development to generate taxable revenue, state budget revenues are insufficient to cover expenditures. In 2014, budget revenues were about \$78 million, with expenditures totaling \$190 million.<sup>3</sup> This shortfall is typically covered by annual subsidies from the Armenian government, officially called "interstate loans."<sup>4</sup> Notably,

therefore, Nagorno-Karabakh consistently depends on Armenia for more than half of its state budget.

In addition to budget financing from the Armenian government, Nagorno-Karabakh depends on charitable donations from the worldwide Armenian diaspora to perform essential state functions. Notably, NKR state expenditures do not include public goods and infrastructure spending, much of which is funded by the Armenian diaspora through charitable foundations like the Hayastan All-Armenia Fund, which combines donations from 25 countries. Foundation funding for these projects is considerable, relative to the state budget. According to one report, the fund received \$30 million in donations in 2011, mostly from the diaspora,<sup>5</sup> equivalent to slightly less than 10% of the reported 2011 GDP of Nagorno-Karabakh. Completed or ongoing projects in the region include water distribution, road networks, gas transit lines, schools, healthcare facilities, and residential buildings.

Finally, lacking a state capable of providing public goods, and an economy capable of producing surplus goods, residents of Nagorno-Karabakh depend heavily on remittances from Armenia for income. In the absence of significant Foreign Direct Investment, and with credit not readily available, this deficit has to be made up with a range of non-value adding transfers. The biggest financial element to cover this shortfall is remittances. Remittances from Armenia to Nagorno-Karabakh were estimated at 16% of Nagorno-Karabakh's GDP, or around \$60 million. Estimating remittances from Russia is difficult, but if

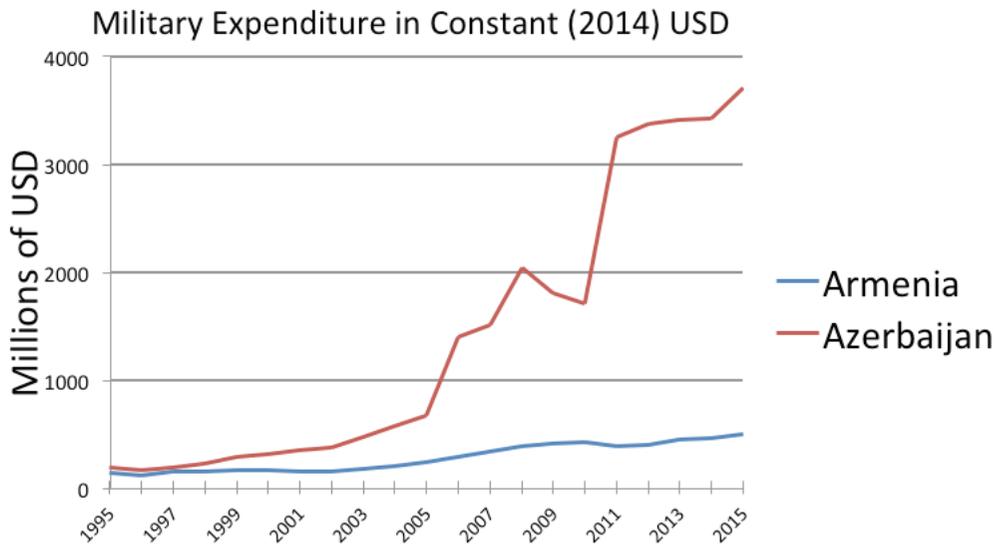
we assume that it is that same as Armenia, or around 20% of GDP, then that would suggest another \$70 million or so.

While there are efforts by the Nagorno-Karabakh de facto authorities to increase the level of foreign investment and to convince diaspora to settle in the region, and there are some reports of moderate economic growth, the political and economic development of Nagorno-Karabakh should expect to depend on Armenia and the worldwide Armenian diaspora for the foreseeable future. This helps to support a mutually reinforcing relationship between Nagorno-Karabakh and Armenia that avoids economic problems that might lead citizens in the region to look for routes to normalise political and economic relations.

#### **Changing military spending and its impact on incentives**

While a range of sources are used to support the Nagorno-Karabakh economy, the area where resource flows are most commonly a focus of the literature is military spending. Seen in basic spending terms, the picture is dramatic.

As one can see, the overall picture is a six times increase in Azerbaijani spending, in absolute terms, since 2005. Over the same time, Armenian spending has approximately doubled. As a result, while both have increased dramatically, Azerbaijan is now outspending Armenia by about 7.5 times.



Source: SIPRI Military Expenditure Database, 2015

Azerbaijan acquires military hardware through both international and domestic sources. It was the 28th ranked importer of weapons in the world over the period of 2005-2015, purchasing weapons from Russia, Israel, South Africa, Belarus, Ukraine, and Turkey.<sup>6</sup> Russia is by far Azerbaijan's largest supplier, accounting for about 80% of its imports between 2009 and 2013. Most

recently, in a 2012 arms deal, Baku agreed to buy \$4 billion-worth of equipment and weapons from Russia over three years. In the case of Azerbaijan, this growth has, of course, been driven by oil resources. Below, one can see the increase in oil and gas revenue over the time period when military expansion occurred.

Table 1: Azerbaijan Oil Revenue and State Oil Fund Revenue 2005-2014

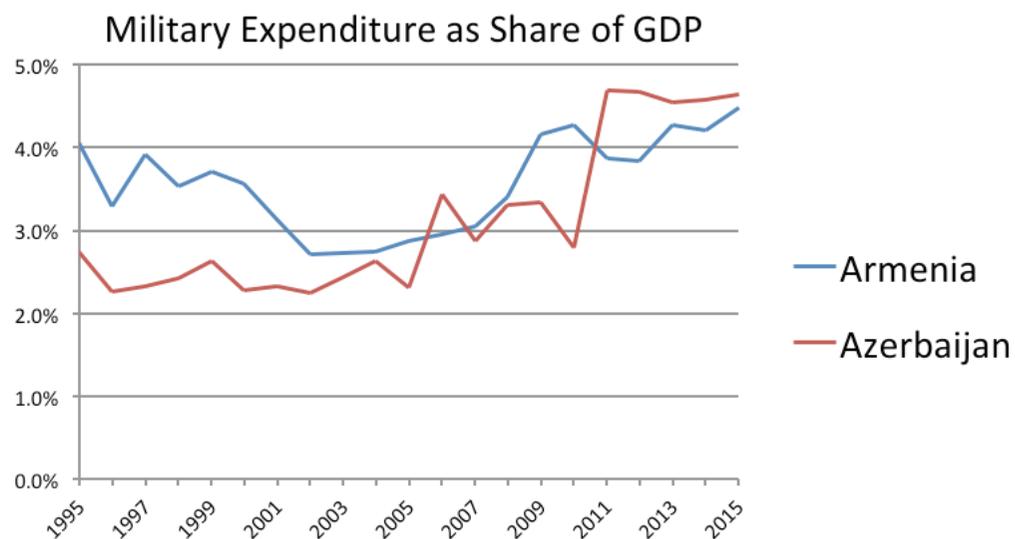
Year	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
<b>Oil revenue</b> Mln manat (Mln US\$)	1,221 (1,565)	2,667 (3,419)	4,305 (5,519)	14,600 (18,718)	9,461 (12,12)	14,323 (18,363)	17,422 (22,336)	16,231 (20,809)	16,065 (20,596)	16,714 (21,428)
<b>Oil Fund revenue</b> Mln manat (Mln US\$)	596 (764)	984 (1,262)	1,871 (2,399)	11,865 (15,212)	8,274 (10,608)	13,087 (16,778)	15,521 (19,899)	14,183 (18,183)	14,132 (18,118)	14,874 (19,069)

Sources: Oil and gas data: BP Statistical Review of World Energy 2015; Oil revenue and Oil Fund (SOFAZ) revenue: IMF Republic of Azerbaijan Article IV Consultation reports, presidential decrees on SOFAZ budget execution

The Azerbaijani government has used its advantage in military spending as part of increasingly bullish rhetoric. For instance, in a June 2012 address, Azerbaijani president Ilham Aliyev famously declared: “Military expenditure is our biggest budget item. Over the past few years our military spending has increased more than 20 times and is 50 percent more than Armenia’s total expenditure.”<sup>7</sup> Since this address, Aliyev has repeatedly emphasized this spending gap, offering it as proof that Azerbaijan’s superior military capability would allow it to retake Nagorno-Karabakh.<sup>8</sup> As late as 2015, the Finance Minister of Azerbaijan, Samir Sharifov, projected more growth in defense spending despite falling oil prices, and again invoked the Karabakh conflict, emphasizing military spending eclipsed Armenia’s

budget.<sup>9</sup> Some analysts even believe Azerbaijan actually overstates the budget gap with the goal of extracting concessions from Armenia over Karabakh.<sup>10</sup>

Azerbaijan’s resource-fueled military expenditures have been accompanied by an increase in military expenditures by Armenia. Curiously, in spite of Azerbaijan’s dramatic advantage in absolute military expenditure, both sides have come into approximate alignment so that military expenditure in both countries constitutes about 5% of GDP, and both spend a similar percentage of the state budget on the military.<sup>11</sup>



Source: SIPRI Military Expenditure Database, 2015

The Armenian purchases in recent years have, of course, been aimed at negating Azerbaijan's offensive advantage. Azerbaijan advantages derive from a combination of air superiority guaranteed by helicopter brigades and advanced anti-aircraft batteries, with tactical battlefield superiority provided by its T-90 tank brigades and artillery systems. Armenia's most recent purchase of weapons from Russia, which had not been delivered as of the April 2016 offensive, included systems to specifically negate these advantages, including the Igla-S surface to air MANPADS systems, and anti-tank systems including the 9M113 anti-tank missiles.<sup>12</sup> Furthermore, Armenia recently announced its intention to move to a more active deterrence posture, perhaps by targeting Azerbaijan's oil and gas infrastructure with Iskander cruise missiles obtained from Russia.<sup>13</sup>

There is little doubt, therefore, that Azerbaijan maintains a large quantitative advantage in military capability. However, it is unclear whether this translates into a decisive enough advantage for Azerbaijan to take the risk of war. For a start, it is unclear that all of this spending has generated the operational improvements one would expect. Military experts believe that, "rising oil revenues have provided the financial headroom for acquisitions, including the S-300 SAM system, but it is unclear whether the potential benefits brought by these modern systems have been felt in terms of operational capability."<sup>14</sup> Also, while the Azerbaijani special forces who took part in the 'Four Day War' seem to have acquitted themselves well, it is unclear if the Azerbaijani conscript army would be effective. Finally,

the nature of the weapons systems and the timing of their delivery could be decisive in any decision about if and when to go to war.

### **Azerbaijan's declining resources and the impact on military spending**

In Azerbaijan, until recently, little thought was given to the long-term challenge that increases in spending on arms may create. However, Azerbaijan's economic crisis, in particular the drop in oil prices, has forced a sharp contraction in public spending, including military spending. Azerbaijan's state budget is financed to a large extent through transfers from the State Oil Fund, which constituted over half of state budget revenues from 2009-2014, peaking at 58% in 2013.<sup>15</sup> However, in 2014 transfers from the fund began to contract, and in 2015 constituted 47% of state revenues.

The drop in oil prices and the subsequent decrease in transfers from the state oil fund had immediate consequences for Azerbaijan's military expenditures. After projecting more growth in military expenditure in 2014 to almost \$5 billion, the Azerbaijani government sharply slashed its military budget for 2016 to just \$1.2 billion, accompanying a cut in total state expenditures of about 23%.<sup>16</sup> In the final section, we will discuss how these changes might influence Azerbaijan's incentives to engage in military activity in Nagorno-Karabakh.

### **The role of Russia**

Russia plays a range of roles in the Nagorno-Karabakh dispute, but in assessing the likelihood of military escalation there are two crucial elements. First, it has long been

Table 2: Azerbaijan State Oil Fund assets, 2001-2014 (in billion USD)<sup>17</sup>

Year	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Amount	0.49	0.69	0.82	0.96	1.39	1.45	2.48	11.22	14.90	22.77	29.80	34.13	35.88	37.10	33.6

Source: SOFAZ Annual Report 2015

assumed that Russia was strongly aligned with Armenia, particularly in providing a security guarantee in the event of an outright war with Azerbaijan.

Russia has a well-developed security relationship with Armenia. Military cooperation between Russia and Armenia occurs within the framework of a 1995 treaty that granted Russian army and air forces access to the military base at Gyumri, currently the location of the 102nd Russian military base, part of the Southern Military District. The agreement was “upgraded” after talks between Dmitri Medvedev and Armenian President Serzh Sargsyan in 2010 that extended the lease of the base at Gyumri from 2020 to 2044.<sup>18</sup>

Russia also subsidizes arms sales to Armenia both by selling weapons at Russian domestic prices, and through low-interest loans. In 2015, Nikolay Bordyuzha, the General Secretary of the Collective Security Treaty Organization (CSTO), confirmed that Russia provides weapons to CSTO allies, including Armenia, at subsidized prices. Bordyuzha noted that the amount of subsidies to CSTO members exceeded US \$500 million.<sup>19</sup> Russia also provides low interest loans to Armenia for the purposes of purchasing weapons from Russia. Most recently, in February 2016, Russia concluded a US \$200 million

loan to Armenia at a 3% annual interest rate over 13 years, with a three year grace period, to be used to modernize Armenia’s army.<sup>20</sup>

However, in recent years, in spite of this well-developed security alliance with Armenia, Russia has also sold a significant volume of arms to Azerbaijan. Russia’s exact logic in providing weapons to both sides is unclear. There is almost certainly a commercial dimension, since Azerbaijan has large cash resources and Russian weapons manufacturers would see it as a large and natural market for them to fill. Part of the Russian calculation may simply be that since the Azerbaijanis are going to buy from somewhere, they might as well buy from them.

In addition, the strategic implications of these arms sales may have been intended to strengthen Moscow’s position in the region by trying to improve relations with Azerbaijan and intimidate Armenia. Most obviously, the arms sales were concluded at around the same time that Russian President Vladimir Putin, along with a number of other senior Russian Government officials, visited Baku in the summer of 2013. This occurred after Russian-Azerbaijani relations had seen significant material decline with the Russians being forced to abandon the Gabala Radio Station, and with the

termination of an oil transit agreement between the two countries.

In strategic terms it was generally, therefore, seen as an attempt to both bully and charm the Azerbaijani government, and stress the country's importance to Russia. This potential détente worried Yerevan. This fact was not lost on analysts who also saw the trip as a signal to Armenia not to take the Russia security relationship for granted. And, in fact, a month after Putin's visit to Azerbaijan, the Armenian government dropped its plans to sign an EU Association Agreement and instead decided to join the Russia-lead Eurasia Customs Union.

Of course, it is ultimately difficult to interpret Russia's final motives. Russia's willingness or ability to resolve the dispute, and the terms on which that might happen, is clearly a matter of dispute in the literature. Nonetheless, there is a consensus in the policy literature that Russia has little interest in seeing the resumption of large-scale hostilities in Nagorno-Karabakh, and that to some extent, they do engage in 'balancing' activities, intended to help mitigate the prospects of actual war. An actual large-scale conflict would put Russia in an untenable position of siding with Armenia, which would be very risky. However, if Russia failed to live up to its commitment to Armenia, its security guarantees would be entirely undermined in the future.<sup>21</sup>

Some have even argued the Russian weapon sales to Azerbaijan are themselves a kind of 'balancing', as the world market prices offered to Azerbaijan effectively provided the resources to allow the Russians to sell

weapons to the Armenians at a discount.<sup>22</sup> This seems a stretch since the scale of arms sales on both sides is so wildly divergent, but it cannot be entirely discounted.

### **The impact of shifting resource flows**

In the discussion above, we have outlined some of the ways in which the political economy, resource flows, and economic and security relationships underlying the military situation surrounding Nagorno-Karabakh have been changing in the last few years. First this resulted from the massive increase in spending. Then the situation changed again with decline in spending precipitated by the regional economic crisis. Finally, changes in patterns of military support and perceived support between Russia and the other players have also created uncertainty. In this section, we will highlight the way in which these changes impact the likelihood of escalation.

Generally, there is a strong agreement that increasing numbers of weapons on both sides of Line of Contact enhances the likelihood of accidental escalation. However, there still seems to be a strong belief that neither side has an interest in intentionally starting a war. We argue in this final section that more serious consideration should be given to how changing circumstances might actually motivate Azerbaijan to engage in a major military offensive. In particular, we consider how changes in resource flows and international relations discussed earlier affect the real or perceived costs of war and peace.

First, one central motivation for escalation might be the perception, based on

declining oil prices, military expenditures, and Armenia's weapons purchases, that Azerbaijan could lose its military advantage if it does not act soon. This is made worse by suggestions that the Armenians may try and adopt a more deterrence-oriented posture. Indeed, shifts in deterrence strategies are particularly unstable if deterrence capability is not yet in place, as it creates an incentive for an adversary to strike before it can be deterred.

Second, facing a difficult economy and declining popularity, the cost of inaction for the government of Azerbaijan may be a nationalist backlash. Conversely, the benefit of action, even if it does not generate immediate results, may be to shore up support. A large academic literature on regime type, resource wealth, and armed conflict explores the political-economic incentives for elites to engage in interstate conflict. In particular, instigating or intensifying existing disputes may produce a temporary popularity boost, and therefore is an attractive option for elites facing domestic crises.<sup>23</sup> This dynamic may be compounded in resource-rich states like Azerbaijan, which tend to be more bellicose in general than states with economies not centered on natural resources.<sup>24</sup> This dynamic is further exacerbated in authoritarian states in which elites do not rely on elections for legitimacy. As a result, elites in both Armenia and Azerbaijan have an interest in using the Karabakh conflict to distract attention from domestic problems.

Both Armenia and Azerbaijan have increasingly been facing domestic crises since 2013. In Armenia, the government

has faced a series of popular protests since 2013, over joining the Eurasian Customs Union, pensions, and culminating in the Electric Yerevan protests in 2015, which were dispersed by force.<sup>25</sup> In Azerbaijan, domestic crisis has been driven less by overt displays of dissatisfaction than by economic conditions. Plummeting oil prices and a significantly devalued currency have restricted Azerbaijan's public spending, critical to maintaining public support in the absence of legitimate elections. In turn, inflation and contraction of social spending have prompted some popular protests.<sup>26</sup> Furthermore, incumbents in both countries continue suffer problems of legitimacy stemming from allegations of corruption. All this suggests an increasing likelihood that political leaders may be tempted to intentionally start a war.

Third, given Russian overtures and weapons sales to Azerbaijan, the Azerbaijanis may predict that in the event of a conflict, the Russians would consider Azerbaijan to be a more strategically important ally than Armenia. This conclusion may be supported by other lines of reasoning that focus on Russia's recent entanglements, particularly if it expects limited benefits of involvement. This could be particularly true if Azerbaijan limited its military goals to retaking small strategic territories within Azerbaijan.

These three changes should be a cause for concern. However, the case for avoiding such a conflict would seem, from the outside, to be far greater. While Azerbaijan may have a huge quantitative advantage, Armenia is dug in, and Azerbaijan's offensive advantage may be diminished.

The Azerbaijani conscript army also has yet to demonstrate its capabilities in this kind of scenario.

Also, the logic of resource curse politics is contradictory in relation to conflict. While oil sales finance weapons and provide incentives for warmongering rhetoric, these resources may discourage elites from starting a war, which could disrupt the source of financing on which they depend. More recent research has also suggested that oil-rich countries may tend to be less bellicose as oil prices drop. This may be because they simply lack the resources to fight a war, or because elites are more sensitive to losses of resource revenue in times of financial difficulty.<sup>27</sup> Under these circumstances, Armenia's deterrent of targeting Azerbaijan's resource infrastructure could be more effective. Low oil and gas prices may therefore discourage escalation and support the status quo.

However, if on balance it seems unlikely

that Azerbaijan would intentionally start a war, these changes could still produce that possibility. This likelihood of escalation also seems to have increased because the April hostilities may persuade both sides that it is possible to revise the Line of Contact, while avoiding a larger war. According to Sergey Markedonov, Azerbaijan may feel motivated to increase its gains, and Armenia may believe that it can return the Line of Contact to its pre-April 2016 arrangement.<sup>28</sup> To that extent, there may be a strong feeling that there is no longer a status quo.

Therefore, either side could start what they consider to be a limited conflict. In addition, one can easily imagine a scenario where either side might decide to go 'all in' if political elites or their constituents feel that they are losing more territory than they consider acceptable. In these situations, particularly since there would almost certainly be no shortage of optimistic military advisors, one can see wishful thinking working into the logic of political leaders.

## POLICY IMPLICATIONS AND RECOMMENDATIONS

To conclude, the structure of political-economic incentives facing the major parties to the Nagorno-Karabakh conflict are important to understanding how they may think about potential outcomes—either resolution of the dispute, or escalation of the military conflict. For a start, the Armenian government and Armenian diaspora support of Nagorno-Karabakh has helped to ensure that the population of the region have higher incomes than they would have otherwise, lessening any indigenous

pressure for a peaceful settlement.

There is also a strong consensus in the literature that the resource wealth of Azerbaijan has made the situation more unstable, by increasing the belief that unilateral military settlement may be possible, by encouraging nationalist rhetoric and by buying more weaponry, and so creating a greater chance for dramatic miscalculation or accident on the ground.

However, we further argue in this

paper, that changing political-economic incentives not only makes it more likely that mistakes will happen, but also make it more likely that senior politicians may be encouraged to military adventurism.

Three factors are particularly important. First, diminished military spending in Azerbaijan and Armenia upgrading some of its current equipment with a more clearly defined logic of deterrence, may create a sense that the window for tactical advantage for Azerbaijan is closing. This could encourage military activity before the advantage diminishes or as a precursor to negotiations. This is perhaps what we saw in April and, now that a precedent of revising the status quo without an all-out war has been set, it might be tempting for both sides to try and change it again.

Second, both governments are facing sustained challenges to their legitimacy and popularity and have recently used nationalist rhetoric as a mechanism for shoring up support. This crisis has been particularly bad for Azerbaijan with a slump in oil prices and inflation. Under these circumstances, the government may either feel significant benefit exists in escalating the Nagorno-Karabakh conflict, or may be prone to over-reaction if faced with losses.

Finally, Azerbaijan may feel that Russia is no longer as committed to supporting Armenia as it once was, particularly if facing modest military conflict that stays largely contained on Azerbaijan's soil.

Against these dynamics, the usual rational reasons exist that discourage either side from intentionally precipitating military conflict. Armenia has little to gain, as the 1994 ceasefire gave it most of what it wanted. Azerbaijan may have a strong incentive to engage in conflict, but face an enemy dug in to strategically valuable territory, with equipment which may be able to much of Azerbaijan's military advantage. Worse still, Armenia may be able to target strategic pipeline assets, particularly if supported by Russia. Furthermore, the weakening economic situation may even have reduced the likelihood of war as it may have increased the sensitivity of political elites to revenue disruption.

It is hard to be clear about exactly how these shifting incentives will play out. However, it is important to realise that these dynamics are changing. As a result, in addition to miscalculation and wishful thinking, there are pressures in the underlying political economy that may help make sense of why the April military action occurred. If the April events were indeed a deliberate escalation in response to changing political-economic incentives, then unless something is done to correct or balance these changing incentives in the fairly short-term, more conflict is likely.

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Dr. George Welton and Bret Barrowman, Geowel Research (Tbilisi, Georgia),  
George.welton@googlemail.com, bbarrowm@gmail.com

### Endnotes

<sup>1</sup> For clarity, this brief reports figures in US dollars where possible, with conversions made using the average annual exchange rate reported by the World Bank World Development Indicators for the year in question.

<sup>2</sup> "External Economic Activity," *Statistical Yearbook of the Nagorno-Karabakh Republic, 2008-2014*, National Statistical Service of the Nagorno-Karabakh Republic. [[http://stat-nkr.am/files/yearbooks/2008-2014/31\\_Artar\\_287-304+.pdf](http://stat-nkr.am/files/yearbooks/2008-2014/31_Artar_287-304+.pdf)]. Accessed 1 July 2016.

<sup>3</sup> "Finances and Credit," *Statistical Yearbook of the Nagorno-Karabakh Republic, 2008-2014*, National Statistical Service of the Nagorno-Karabakh Republic. [<http://stat-nkr.am/files/yearbooks/2008-2014/26%20finans%20ev%20nerdrum%20225-269.pdf>]. Accessed 1 July 2016.

<sup>4</sup> "Nagorno-Karabakh Region Predicts Strong Growth in 2012," Radio Free Europe/Radio Liberty. 29 December 2011. [[http://www.rferl.org/content/nagorno\\_karabakh\\_region\\_predicts\\_strong\\_growth\\_in\\_2012/24437527.html](http://www.rferl.org/content/nagorno_karabakh_region_predicts_strong_growth_in_2012/24437527.html)]. Accessed 1 July 2016.

<sup>5</sup> Ibid.

<sup>6</sup> Stockholm International Peace Research Institute (SIPRI) Arms Transfers. [[http://armstrade.sipri.org/armstrade/html/export\\_toplist.php](http://armstrade.sipri.org/armstrade/html/export_toplist.php)] Accessed 1 July 2016.

<sup>7</sup> Quoted in Shahla Sultanova, "Azerbaijan bring in the big guns", Transitions Online, 12 July 2012. [<http://www.tol.org/client/article/23254-azerbaijan-military-spending.html>]. Accessed 1 July 2016.

<sup>8</sup> "Azerbaijan Plans More Modest Defense Budget In 2016," 2016. Radio Free Europe/Radio Liberty. [<http://www.azatutyun.am/a/27453992.html>]. Accessed 2 July 2016.

<sup>9</sup> Ibid.

<sup>10</sup> Ibid.

<sup>11</sup> For 2015 military expenditures constituted 16.4% of government spending for Armenia, and 13.5% for Azerbaijan. SIPRI Military Expenditure Database 2015. [<https://www.sipri.org/databases/milex>]. Accessed 1 July 2016.

<sup>12</sup> Ibid.

<sup>13</sup> De Waal, Thomas, "Prisoners of the Caucasus: Resolving the Karabakh Security Dilemma." 2016. *Carnegie Europe*. [ <http://carnegieeurope.eu/publications/?fa=63825>]. Accessed 4 July 2016.

<sup>14</sup> Radiosu, Azalidiq, "Report, Azerbaijan Dominates Defense Spending in the South Caucasus", Radio Free Europe/Radio Liberty Azerbaijani Service, 26 June 2013. [<http://www.azadliq.org/a/25254316.html>]. Accessed 8 August 2016.

<sup>15</sup> SOFAZ Annual Report 2015. [[http://www.oilfund.az/uploads/Annual\\_Report\\_2015\\_ENG.pdf](http://www.oilfund.az/uploads/Annual_Report_2015_ENG.pdf)]. Accessed 1 July 2016.

<sup>16</sup> "Azerbaijan Plans More Modest Defense Budget In 2016," Radio Free Europe/Radio Liberty, 2015. Accessed July 2. [<http://www.azatutyun.am/a/27453992.html>]. Accessed 8 August 2016.

<sup>17</sup> SOFAZ Annual Report 2015. [[http://www.oilfund.az/uploads/Annual\\_Report\\_2015\\_ENG.pdf](http://www.oilfund.az/uploads/Annual_Report_2015_ENG.pdf)]. Accessed 1 July 2016.

<sup>18</sup> O'Rourke, Breffni. "Russia, Armenia Sign Extended Defense Pact." Radio Free Europe/Radio Liberty. 20 August 2010. [[http://www.rferl.org/content/Russian\\_President\\_Medvedev\\_To\\_Visit\\_Armenia/2131915.html](http://www.rferl.org/content/Russian_President_Medvedev_To_Visit_Armenia/2131915.html)]. Accessed 8 August 2016.

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<sup>20</sup> "Russia Loans \$200 Million to Modernize Armenian Army," The Moscow Times, 2 July 2015. [<http://www.themoscowtimes.com/business/article/russia-loans-200-million-to-modernize-armenian-army/524930.html>]. Accessed 8 August 2016.

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<sup>25</sup> Babayan, Nelli, "Here's What the Research Reveals about the Violence in Nagorno-Karabakh — and How 'freezing' Conflicts Can Backfire." *The Monkey Cage*, 7 April 2016. [<https://www.washingtonpost.com/news/monkey-cage/wp/2016/04/07/here-what-the-research-reveals-about-the-violence-in-nagorno-karabakh/>]. Accessed 8 August 2016.

<sup>26</sup> Ibid.

<sup>27</sup> Here's How Falling Oil Prices Could Make the World More Peaceful and Cooperative." 2016. Washington Post. Accessed July 3. <https://www.washingtonpost.com/news/monkey-cage/wp/2016/01/28/heres-how-tumbling-oil-prices-could-make-the-world-a-more-peaceful-and-cooperative-place/>.

<sup>28</sup> Markedonov, 2016.