

**THE SOUTH CAUCASUS 2018**  
**FACTS, TRENDS, FUTURE SCENARIOS**



Konrad  
Adenauer  
Stiftung



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# FOREWORD

The Konrad Adenauer Foundation has been known for a long time for its programs in international dialogue and cooperation. We value dialogue as an important component of the foundations overall cooperative approach in conducting activities in more than a hundred countries worldwide. On the national and international level, we conduct civic education activities to promote peace, freedom, and justice. Our key concerns include consolidating democracy, enhancing interreligious and intercultural understanding, and promoting peaceful conflict resolution.

In the South Caucasus, the Foundation has been active for almost a decade with the primary goal to support transformation processes for stronger democratic structures and more sustainable economic developments. Equally important is support for regional understanding and rapprochement of the region with European structures. Our commitment to that vision of a more free, prosperous and peaceful development in the South Caucasian Countries shall be a source of inspiration for our activities also in the future.

The publication at hand is part of the Konrad Adenauer Foundations activities undertaken in the region to promote greater understanding between nations, countries, cultures and religions. It contains articles written by senior and junior experts from Armenia, Azerbaijan and Georgia. **Many books and articles** have been produced en masse since the early 1990s, when three countries – Armenia, Azerbaijan and Georgia, regained their independence and the international community discovered the strategic importance of the region at the crossroad between Europe and Asia - ridden by conflicts, protracted transitions, problems of domestic consolidation, and power games of exogenous actors.

The uniqueness of this compilation is that it has been initiated by the authors themselves. The articles follow the same structure that the authors had agreed upon during preparation workshops. This allows the reader to compare developments, trends and scenarios, whether in the political sphere, economic sector or in the perception of security in the three countries. Another unique feature of this volume is that the authors look forward and try to foresee major tendencies the region and their respective countries will face in the years to come. The main concept of the publication is to avoid getting lost in discussions about causes. Instead, authors try to analyze trends and offer scenarios. One would argue that looking forward implies attempting to understand and explain the past as well. Articles in the collection cannot avoid

analyzing legacies of the past, however with the intention to link the dynamic of current developments towards visions, outlooks and perspectives. 2018 is therefore not only a symbolic year referring to the 100th anniversary of the first independence of the South Caucasian countries, but allows with a five year time frame a realistic analysis of future trends. A specific added value of the volume is that it summarizes a set of recommendations in various policy fields for opinion shapers and decision makers of the respective countries.

Publications with the title South Caucasus on their front page always attract critical remarks questioning the very existence of the region as such. Indeed, what unites Armenia, Azerbaijan and Georgia, **except the past? Is there anything** beyond soviet and pre-soviet legacies of inter-ethnic conflicts and conflicting foreign policy orientations that could melt three policies into one region? In other words, does the region have a future? The authors of articles certainly provide some interesting answers. Even though the building blocks of the region South Caucasus are not always positive factors – conflicts, authoritarian backlashes, increasing social disparities, shadows of the past will with high probability still prevail in 2018, there is hope for the joint future of the region.

Models of economic and social developments, scenarios for domestic politics, the role of EU engagement and the possible Europeanization of national policies as well as outlooks for cooperation in the energy sector – articles of the collection cover not all but the most relevant topics in the South Caucasus of today and years to come. "The South Caucasus 2018: Facts, Trends, Future Scenarios" is a valuable source for those who are interested in many aspects of the region and its three countries – Armenia, Azerbaijan and Georgia. At the same time, this publication will be a helpful guide to closely follow developments on the ground. We owe many thanks to all those who have contributed in different ways to this publication. The successful completion of this challenging project however is thanks to the commitment of the distinguished authors who have volunteered to contribute to this volume.

We are confident that this publication with highly valuable analysis and future assessments will contribute to a further debate in and about the region and will be of great interest to the members of the think tank community, regional and foreign researchers dealing and working with the region as well as political decision-makers and the general public.

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# CHAPTER I

POLITICAL TRANSFORMATION:  
SHADOWS OF THE PAST, FACTS  
AND ANTICIPATIONS





# **THE POLITICAL DIMENSION: ARMENIAN PERSPECTIVE**

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## **Introduction**

Throughout much of history, the South Caucasus has served as an arena for the competing interests of much larger regional powers and has been hostage to the broader clash of rival empires. Since the collapse of the Soviet Union, the three small countries in the region, Armenia, Azerbaijan and Georgia, have once again emerged as arenas for competition between more powerful states, as Russia, Turkey and Iran have sought to exert their own influence over the region. Even more significantly, the South Caucasus continues to face a daunting combination of historical legacy and current conflict, posing fundamental threats to the future development of these three infant states.

Against this backdrop of regional insecurity, the three states of the South Caucasus region remain burdened by a difficult course of economic and political reform, systemic transition and nation-building. While the region continues to struggle in overcoming a shared legacy of constraints and challenges stemming from seven decades of Soviet rule, it is not only the external pressure from competing greater powers that has tended to mark this region as an arena for confrontation. The lack of a common shared vision, exacerbated by the conflicts and divisions between the three states, also pose a fundamental challenge to longer term development. Moreover, the deeper regional fragility and vulnerability also stems from profoundly destabilizing unresolved conflicts.

Although the lingering “frozen” conflicts of the South Caucasus have fostered greater international attention and external mediation, the real prerequisites for regional security and stability are rooted more in internal issues. More specifically, for the South Caucasus, the inter-

nal imperatives of legitimacy, leadership and statesmanship are the most essential ingredients for durable security and stability. A second interesting paradox in the region is the fact that, while the strategic perception of the South Caucasus has been largely defined by grand geopolitics, the regional reality is defined more by local politics and economics. From this perspective, it is democratization that must come first, prior to any hopes for an effective or lasting resolution to the “frozen” conflicts in the region. And it is clear that the institutions of democracy matter much more than any individual democrats for real democratization. Consequently, it is the leaders themselves who hold the key to their future. But over the long-term, there is an obvious need for more attention on regional reintegration.

### **Abrupt Independence**

For much of the past two decades, each of the three states of the South Caucasus region, Armenia, Azerbaijan, and Georgia, have been pursuing a difficult course of economic and political reform, systemic transition and state-building, with a widening variance in consistency and commitment. As a region, these countries also continue to struggle to overcome the legacy of constraints and challenges stemming from seven decades of Soviet rule. In terms of the record of reform and state-building in Armenia, the early period of independence was marked by a daunting set of challenges. Even well before independence, Armenia was beset by two seminal events: the eruption of the Nagorno Karabakh conflict and the subsequent outbreak of war with Azerbaijan in February 1988 and a devastating earthquake in December 1989.

Against that backdrop, the sudden and unexpected collapse of the Soviet Union left Armenia largely unprepared for the urgency of independence. The infant state also faced a grave and urgent threat to its survival, as the Karabakh conflict intensified, leading to an expanded war that disrupted trade and transport routes, cut key energy links, and triggered a near blockade of the country by neighboring Azerbaijan and Turkey. To this day, the sudden breakdown of the region’s energy infrastructure and trade and transport links has never

recovered. In fact, as several subsequent regional development projects have demonstrated, including the various energy pipeline and production projects of the 1990s, the disintegration of the region has become the accepted starting point for many governments, both within and beyond the South Caucasus.

### **Conflict Economics**

Throughout the early 1990s, the situation became increasingly grave, exacerbated by constraints of demography and geography, as a small, landlocked country with few natural resources. For Armenia, this early phase of independence was marred by war, blockade and economic collapse, culminating in severe shortages of food, electricity and fuel. These conditions also predetermined the development of the economic system, and seriously distorted reform. The combination of a scarcity of goods, the powerful trade and transport blockade, and the severe disruption of the energy infrastructure all led to the profound closure and isolation of the Armenian economy.

Within this closed economic system and facing little state oversight or regulation, several commodity-based cartels emerged, bolstered by a powerful combination of criminal links and political influence. Their power also stems from opportunities and profit from being able to exploit the conflict economics through the acquisition of monopoly positions controlling scarce commodities, such as gasoline and heating oil, and basic staple goods, ranging from flour to sugar, for some of the more notable examples. These cartels and semi-monopolies quickly eliminated competitors and secured dominant positions over the import and export of key consumer goods, raw materials and foodstuffs.

The emergence of these cartels was initially a consequence of the “conflict economics” of the Karabakh war, and they garnered political influence by generally supporting a feeble and war-weary state. The Armenian government at the time was largely preoccupied with economic measures in other areas, ranging from the successful implementation of sweeping land reform and privatization to the in-

roduction of a stable national currency. The power of these cartels quickly expanded beyond commodities and, as the case of most other post-Soviet states, and acquired inordinate wealth and assets during the privatization process. At the same time, they further consolidated their power by developing new networks of patronage and corruption within the state system of governance itself.

In political terms, the war years of the 1990s also thwarted and deformed early attempts at building democratic institutions and bolstering political reform, and the ongoing state of war only strengthened an already rigid political discourse, as a new vibrant nationalism crowded out more moderate voices within the Armenian political arena. In terms of political developments, the dominant trend in politics that determined the country's political trajectory was the shift in political discourse, moving from moderation to militant nationalism. This was matched by a second trend involving the transformation of the political elite in Armenia, as a new elite from Nagorno Karabakh gained power and consolidating top leadership positions in the country, eventually capturing the Armenian presidency itself. Against this backdrop, the cumulative effect of the past two decades of independence has actually tended to only deepen greater dependence, further marked by more missed opportunities than by demonstrable achievements.

### **The Role of Armenian Political Institutions**

Since a post-election crisis that culminated in a violent confrontation between the Armenian authorities and the opposition on 1 March 2008, Armenia has been plagued by lingering political tension driven by a profound degree of political polarization and exacerbated by widening economic disparities. The authorities have also been hindered by a lack of legitimacy and a "crisis of confidence" that undermined its political mandate and impeded its reform program. For the past several years, the Armenian government remained fairly unpopular and unable to fully overcome these challenges, although neither the authorities nor the opposition was able to resolve the political crisis or to reach any constructive compromise.

At the same time, since the March 2008 crisis, there has been a marked level of fairly intense political activism and civic engagement that first emerged during the initial stage of the post-election crisis. That initial period was marked by a sudden and fairly unexpected “re-awakening” of the population, seemingly no longer content with its previous apathy and disengagement from politics. It was also a time of deadlock, however, as the political crisis stemmed from a polarized stalemate driven by a deadlock between an unpopular government and an opposition movement that seemed devoid of any clear policy alternatives.

On a broader level, Armenia has continued to struggle with a daunting set of challenges, ranging from deficiencies in democratization to significant shortcomings in economic reform. Yet the Sarkisian Administration exhibited a significant new approach toward overcoming the internal political crisis, aimed at addressing discontent among the population and seeking to restore the government’s standing and legitimacy amid a deeper crisis of confidence. Through 2011, this new policy focused on moving to overcome the lingering post-election crisis by releasing a number of detained opposition activists and supporters (commonly seen as “political prisoners”) and seeking to bridge the polarized divide within society by embarking on a constructive dialogue with the opposition Armenian National Congress (ANC) coalition led by former President Levon Ter-Petrosian. Yet the lack of more durable and truly assertive democratic institutions remains a glaring discrepancy in Armenia’s overall reform program. This lack of democratic institutions is also a fundamental obstacle to both ensuring a real separation of power and checks and balances, as well as hindering attempts at reforming the political system.

## **The Political System**

The most serious obstacle facing Armenia’s democratic development today, however, is rooted less in the division between the government and the opposition, but stems more from the structural deficiencies of the Armenian political system. Moreover, the 2008 crisis only re-

vealed the deeper flaws in the political system itself, including the weak state of the rule of law and a serious lack of a separation of powers or systemic “checks and balances,” most notably evident by a compliant judiciary, an ineffective parliament and an overwhelmingly powerful executive branch of government. Similarly, Armenia’s economic transformation has been equally hindered by widening disparities in wealth and equality, driven by an economy that has become distorted by entrenched corruption and the influence of powerfully entrenched commodity-based cartels or semi-monopolies. More crucially, the onset of the recent global financial and economic crisis has only exposed the deeper structural flaws impeding reform in Armenia.

The closed nature of the system is also bolstered by fairly well-developed administrative power, with administrative structures operating on many levels of government and generally seen as competent. Despite some recent reforms in the last four years targeting the civil service, corruption within these structures remain a serious challenge, however, and civil administration remains hindered by a legacy of Soviet-era practices, many of which are now inefficient and burdensome. Additionally, although there is a reasonable administration of justice, adjudication remains contingent on political, personal or financial interference (such as bribery). This is related to a fairly weak rule of law, matched by a flawed system of law enforcement and a sometimes checkered record of justice, primarily in the less developed regions of the countryside, but not excluding incidents in the major cities. Similarly, the lack of an independent judiciary also tends to weaken the efficacy of the state administrative bodies and fosters a general public mistrust in the system.

Therefore, in the face of fundamental flaws in the country’s closed political system and the absence of free and fair elections, the Armenian authorities have normally held virtually unchallenged authority. But since 2010-2011, there has been a marked change, as the tainted presidential election of February 2008 sparked a serious crisis of confidence that has eroded confidence in the government and faces a further challenge in the form of public demands for change. Moreover, insofar as the population has emerged from years of apathy to voice

fresh and strident demands for change, the problem is that within the confines of the closed political system, there is no mechanism for expressing political discontent, a situation that only exacerbates underlying tensions.

### **The Burden of Business and Politics**

Against the backdrop of generally weak state regulatory institutions and a pronounced lack of political will to confront corruption and breakup cartels and semi-monopolies, the now entrenched power and position of the oligarchs now stands as a direct threat to reform and, at least, an indirect threat to the state itself. The oligarchic system has had a devastating impact on Armenia, eroding the power and authority of the state, which can neither tax the oligarchs nor police their business interests. In this context, the state now faces an uphill battle if it is to regain control of the economic system. The emergence of a number of powerful oligarchs in the political arena poses more problems. It is most apparent from the pressure they can bring to bear as parliamentarians, able to influence and impede reforms from the inside. Their direct role within national politics also highlights the risks posed by cozy relationships between business and politics and from the power of the commercial-political elite as an impediment to the development of viable democratic institutions and as a vested interest in blocking or hindering market-based, rule-governed economic reforms.

More specifically, after securing a sizable number of seats in the Armenian parliament election, their political role as deputies demonstrates a convergence of corporate, state, and in some case, even criminal, interests. In addition to influencing the formulation of public policy and garnering substantial leverage over the course of governmental policies, this oligarchic elite has come to embody the difference between the power to rule and the responsibility to govern.

In the case of the other former Soviet economies, this new class of oligarchs has tended to exploit the privatization process to gain economic power first, but has exhibited a subsequent appetite for political power.

It is that political role that inherently threatens the course of democratization and political reform. In Armenia, these oligarchs have been able to extend their informal networks of political power through informal cartels and commodity-based semi-monopolies, and now wield significant economic and political power. The key to defeating the power of the oligarchs is to attack the economic monopolies and cartels that fuel and finance the oligarchic system. Generally, such cartels and monopolies flourish within "closed" economies, averting the transparency and competition that dominate the more open marketplace. But in addition to the need for greater anti-trust legislation and stronger state regulatory bodies empowered to limit or breakup monopolies, it is the rule of law and political will that is needed to overcome this "cronyism." The absence of economic institutions and the resulting weak regulatory framework tended to foster a pattern of flagrant abuse and excess that went relatively unchallenged by the authorities. This lack of an adequate institutionalization of economic regulation and state enforcement provided the foundation for the emergence of this new class of economic elite.

This new elite, or so-called "oligarchs," have acquired economic power at the expense of state authority, depriving the state of both tax revenue and defoliating the country of national assets. In Armenia, as with other former Soviet cases, this new clan-based elite has tended to exploit the privatization process to gain economic power first, but subsequently marked by an appetite for political power that inherently threatens the course of democratization and political reform. Against this backdrop, the real danger for Armenia stems from complacency and for Armenian business, especially given the small size of the national economy, there is a serious need for the state to tackle monopolies and to further open the economy through transparency and competition. Although the emergence of monopolies in the Armenian business sector has not been as profound or as powerful as other of the former Soviet states, they have created two especially serious problems for the overall Armenian economy. First, the rather unique form of Armenia's business monopolies, unlike their counterparts in the case of Russia, for example, are comprised of informal cartels based on a dominant control over the import and export of specific key commodities. Such



a stranglehold has serious economic consequences, as it tends to stifle economic growth by restricting the export-import trade sector. The net result is an overall weakening of economic growth, a barrier to competition and a serious disincentive for foreign investment.

The second economic impact of these commodity-based cartels or monopolies is their role in obstructing the rise and expansion of new firms and businesses. This too harms overall job creation and maintains the closed and limited nature of the national economy. In Armenia's case, this not only reinforces the landlocked and blockaded limits on the Armenian economy, but creates a reinforcing cycle – where the monopolies become “vested interests” in maintaining closed borders in order to reinforce their control over key sectors of the economy. As with lessons from similar cases, the only effective way to tackle this problem has been to introduce “anti-trust” legislation strong enough to counter and contain the monopolies and cartels. But here too, as demonstrated in the experience of other countries, it is the implementation and enforcement of the laws and legislation that matters most. Furthermore, despite the most well designed anti-trust legislation and bodies empowered to limit or breakup monopolies, without the rule of law and political will, very little can be reasonably expected. In larger economies, such “cronyism” has resulted in a high “transaction costs,” whereby corruption becomes so entrenched, even to the point of actually weakening the state by depriving it of much needed tax revenue. It also limits economic growth in the short run, and constrains competition in the long run, which in turn leads to higher prices and slower innovation. Thus, the cumulative effects are devastating on the national economy overall and on society in particular. But as seen in the model of Armenian business in particular, such a failure to tackle the closed, monopolized economy also threatens to only destabilize and further isolate the country.

### **Oligarchs and the Economics of Power**

In most countries economics and politics are far too often intertwined, with a nation's wealthy elite holding too much power and

influence. The dangers from such a close relationship between economic and political power have long been understood, and have even been reflected in the historical maxim that “power corrupts, and absolute power corrupts absolutely.” Recognizing the threat posed by the combination of wealth and political power, democratic reformers have sought to construct “checks and balances” designed to counter such power. And although there were many times when a small wealthy elite was able to acquire and exercise too much power, the institutional system of checks and balances always tended to restore a natural balance over the longer term. But for countries without resilient democratic institutions, like Armenia, there is little recourse, as they lack the capability to check or balance the power of the rich. Moreover, for a small country like Armenia, the disparities of wealth and power become only more apparent, and much harder to correct.

Generally, such cartels and monopolies flourish within “closed” economies, averting the transparency and competition that dominate the more open marketplace. But in addition to the need for greater anti-trust legislation and stronger state regulatory bodies empowered to breakup monopolies, it is the rule of law and political will that is needed to overcome this “cronyism.” Thus, the closed nature of the political system, infected by a clan-based and oligarchic elite, has significantly eroded the state’s most important asset of legitimacy.

## **Armenian Political Parties**

Recent developments in domestic Armenian politics continued to be dominated by conflict and open confrontation among the country’s leading political parties. As evident throughout much of the past few years, the most significant recent political issue centers on a shift in the nature of political competition. More specifically, there has been a notable shift from the traditional conflict between the Armenian government and opposition to a new, much more significant clash within the pro-government coalition itself. This new political confrontation, representing a first-ever conflict within the country’s political elite, is

between the ruling Republican Party, Armenia's largest political party, led by President Serzh Sarkisian, and the Prosperous Armenia party, a junior member of the ruling coalition, led by businessman Gagik Tsarukian, an open supporter of former President Robert Kocharian. The Republican Party seems intent on weakening the Prosperous Armenia party prior to the election, as a strategy to greatly reduce the number of seats held by Prosperous Armenia in the coming parliamentary election. More specifically, this conflict between the Republican and Prosperous Armenia parties has only escalated, marked by an increase in tension within the once united pro-government coalition. However, the Republicans hold the initiative and enjoys the advantage of greater "administrative resources" or the "power of incumbency" as the dominant force within the ruling coalition. Yet, at the same time, the risks for the government stems from its general over-confidence and related tendency to underestimate its opponent, exacerbated by the danger of ignoring popular demands for lasting change and real reform.

But the Armenian government must recognize and meet higher popular expectations for real change, and it must demonstrate a new sense of political will and commitment to reform. More specifically, the Armenian government has moved to resolve the lingering political crisis, sought to ease the polarized deadlock between the authorities and the opposition and exhibited a degree of statesmanship previously lacking in Armenian politics. But public discontent remains, driven by years of widening disparities in wealth and income, a deeper trend of increasing poverty and a pronounced lack of economic opportunity. Despite recent political gains, this economic undercurrent of discontent is only increasing, and although the record of economic reform in recent years has been fairly impressive, it has not been successful enough in addressing the "paradox" of economic growth, whereby several years of double-digit economic growth have resulted in an uneven or partial sharing of wealth and higher living standards among the overall population. And in a broader context, a second serious obstacle in Armenia's democratic development is rooted in the structural deficiencies of the Armenian political system and fundamental flaws in the political system itself, including the weak rule of law, a compliant judiciary and an ineffective parliament.

Most crucially, these structural flaws demonstrate that the current political system is incapable of sustaining itself in the face of mounting pressure and suggests that the only viable avenue toward democratic development in Armenia is through reforming and forcing open the inherently closed nature of the country's political system. Thus, in order to attain lasting gains in the political and economic transformation of Armenia, the current imperative is to focus on overcoming the internal threats to statehood, ranging from the need for leaders who govern and do not simply rule and the imperative to defeat the "cancer of corruption." In this way, legitimacy is the key to stability, while most crucially, institutions matter more than individuals for real democratization.

### **Political Culture in Armenia**

For Armenia, the development of political culture has been driven by a deeper trend of insecurity and militarization, which has resulted in the predominance of primitive politics and an intolerance of compromise. This trend of Armenian insecurity and militarization is rooted in Armenian history, heavily influenced by the tragic narrative of Armenians as eternal victims. It is first driven by the most basic and essential mission of survival. The sole driving force of this mission has been to ensure the physical survival of the Armenian nation and, for much of Armenian history, has emanated not from the imperatives of statehood but from the response of a vibrant nationalism. Most dramatically, it was the history of Ottoman period, with its sporadic threat of pogrom and massacre that culminated in the 1915 Armenian Genocide, which forged this militant nationalism.

This historical influence also incorporated a second element, marked by the brief record of Armenian statehood. With the emergence of the first Republic of Armenia of 1918, the historically defensive concept of a militant nationalism adopted new elements of state security and military strategy. Although the short duration of modern Armenian statehood ended abruptly with its Sovietization, there was a pronounced parallel between the sudden and rather unexpected inde-

pendence of both 1918 and 1991. Such a parallel between 1918 and 1991 was also seen in the perception of the conflict with Azerbaijan over Nagorno-Karabakh as intrinsically linked to the historical threat of Turkey. This perception fostered an emotional and exaggerated identification of Turkey as an eternal enemy, an equation that continues to distort Armenia's concept of military and national security and that also sees little difference between Azerbaijan and Turkey.

## **Conclusion**

In general, domestic Armenian politics has been largely dominated by a jockeying for position and power among the country's leading political parties. At the same time, there has been a significant shift in the nature of political competition, moving from the traditional conflict between the government and opposition to a new, much more significant clash within the ruling pro-government elite, pitting the ruling Republican Party, Armenia's largest political party, led by President Serzh Sarkisian, against the Prosperous Armenia party, a junior member of the ruling coalition, led by businessman Gagik Tsarukian, an open supporter of former President Robert Kocharian. But there is also a more significant opportunity in this period of political change. More specifically, there is a new opening, offering an important opportunity for the Armenian government to overcome the legacy of mistrust and the pronounced lack of legitimacy and providing President Sarkisian an opportunity to emerge from the shadow of his predecessor and offering a fresh start in terms of redefining his own personal image by focusing on statesmanship and legacy.

## **Looking to 2018: Surmounting the Parameters of Conflict**

But as the unresolved Nagorno Karabakh conflict has emerged as the central impediment to regional development and cooperation, looking to 2018, there must be a new focus on ways to overcome and surmount the parameters of the conflict. In this way, there are several specific measures to consider. First, considering the lack of significant

progress in the peace process, compounded by ineffective mediation efforts and a fragile military situation, the imperative is to address the underlying lack of trust among the parties to the Nagorno Karabagh conflict. One of the more effective measures may be to seek to create a new environment conducive to fostering a more active, but more limited round of negotiations among all parties to the conflict, including Nagorno Karabagh itself, as a direct party to the conflict. Such a measure would be buttressed by policies to build confidence and trust, on a basis of “bridging divides” and “spanning generational divisions.”

Second, such an initiative would offer a new approach of forging a forward-looking strategic analysis of the Nagorno Karabagh conflict. By offering a long-term analysis focusing on the next five to ten years, this initiative may provide key decision makers and influential elites in each country with a new opportunity for “thinking strategically” about Nagorno Karabagh. What makes this effort especially attractive is that this approach has been largely absent from the debate and dialogue in Armenia, Azerbaijan and Nagorno Karabagh. And from this context, there is a need to look beyond vested interest groups.

This would be one of the most important aspects of engaging the political and economic elites in each country, by looking beyond the current group of officials and leaders and focus on three specific sub-groups. First, it would be useful to engage the emerging political elite, including military and security officers on both sides, many of whom have completed Western training programs. Second, it is necessary to involve commercial and business leaders, especially those engaged and interested in regional or global business opportunities beyond their home base. And the third essential target for creative engagement are student groups, university faculties and societies, and internet-based media sources, also to empower a new generation of Armenians, Azerbaijanis and Georgians. Only then can the people of the region once again recapture the spirit of a region with a shared future.

# **THE INFLUENCE LEVEL OF EXTERNAL FACTORS ON THE POLITICAL TRANSFORMATION IN AZERBAIJAN SINCE INDEPENDENCE**

**Rovshan Ibrahimov**

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## **INTRODUCTION**

Since gaining independence following the collapse of the Soviet Union, Azerbaijan was immediately confronted with the realities of international politics. Since the first days of its independence, the country has encountered numerous problems requiring urgent solutions, such as economic recovery, obtaining political stability, the solution of Nagorno-Karabakh conflict, etc. It should be noted that the post-Cold War international system was shaped according to the Western perception of the world. After the collapse of the Eastern Bloc and the Soviet Union, the West prioritized assistance for the Central and Eastern European states; while the former Soviet states remained part of the Russian sphere of influence. Under these conditions, Azerbaijan tried to attract Western attention by deploying its "oil card" as a means of balancing Russian influence. As a result, the prior policy of West in Azerbaijan was to maintain a stability, which could only be achieved by ensuring order, which could be best provided by a strong central government. While this strategy has contributed to domestic stability in Azerbaijan, it has also hampered the development of democratic institutions and social diversity. This article will assess and explore the external factors that impeded the political transformation in Azerbaijan.

## **The internal situation in Azerbaijan after Independence**

After the restoration of the independence of Azerbaijan on October 18, 1991, the main problem of Azerbaijan's domestic and foreign policy was finding the solution for the Armenian-Azerbaijan Nagorno-

Karabakh conflict. Inherited from the Soviet period, this territorial problem will be crucial in identifying the internal and foreign policy of Azerbaijan during the past 20 years. At that time, administration of the first president of Azerbaijan, Ayaz Mutalibov, tried to find solution to this problem. It is worth noting that Mutalibov was appointed as First Secretary of the Azerbaijan Communist Party on January 24, 1990, immediately after the January events, when Soviet troops stormed Baku and caused the death of more than a hundred people. However, prior to the collapse of the Soviet Union, the Azerbaijan Communist Party became discredited and lost its legitimacy due to its leaders' reluctance to solve the Nagorno-Karabakh problem.<sup>1</sup> Therefore, Mutalibov decided to strengthen his reputation as a reformer and during the last Congress, the resolution on the self-dissolution of the Azerbaijan Communist Party was approved.<sup>2</sup> It is noteworthy that similar processes occurred in other former Soviet republics, but the complete elimination of the parties did not take place. For example, in Central Asia, the Communist parties were only renamed, but their social base remained. This was done on the grounds to maintain social support and retain a power of the state leaders, which all were patrons of republican Communist parties. As time has shown, it was right decision. It is possible to say that the elimination of the Azerbaijani Communist Party was probably the biggest mistake done by Mutalibov, as a result of which he lost support and subsequently the presidency.

At the same time, opposition parties began to be formed in Azerbaijan, which firstly emerged in reaction to Armenia's aggression and the beginning of the Soviet Union dissolution process. As a reaction to these events, on July 16, 1989, the Azerbaijan People's Front (APF) was founded and Abulfaz Elchibey was elected as chairman of this opposition movement. Actually the APF was an organization which was composed of smaller parties, groups and individuals. After

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<sup>1</sup> Ayça Ergun, Post-Soviet Political Transformation in Azerbaijan: Political Elite, Civil Society and the Trials of Democratization, *Uluslararası İlişkiler*, Volume 7, No 26 (Summer 2010), p. 67.

<sup>2</sup> Ayaz Mutalibov, <http://www.engology.com/eng5mutalibov.htm>



independence, the Popular Front became the main opposition force in Azerbaijan which demanded the resignation of the current government and following pro-Western foreign policy course. During the parliamentary elections held in 3 September 1990, the opposition coalition led by the APF gained only about forty of the 350 seats in the Azerbaijani legislative Supreme Soviet and criticized the elections as fraudulent.

Another contender was the chairman of the Nakhichevan Supreme Soviet, Heidar Aliyev, who Mutalibov saw as a threat to his rule. Disagreements between Mutalibov and Aliyev began still in the Soviet period, when the latter fell out of favor with the USSR leader Gorbachev. Mutalibov several times attempted to prevent Aliyev`s return from Moscow to Azerbaijan. Despite all the difficulties, Aliyev returned to Azerbaijan and on September 3, 1991, was elected a deputy of the Nakhichevan Supreme Soviet and then its chairman.<sup>3</sup> Five days later, on 8 September, a general presidential election was held in Azerbaijan, which the population of Nakhichevan, because of the age limit for a presidential candidate, and the opposition boycotted. Despite the fact that Mutalibov won the election with the 98.5 percent of the total vote cast,<sup>4</sup> he was faced with a strong opposition.

Mutalibov believed that strengthening its position, solution of political and economic problem, with which Azerbaijan have faced after regaining of its independence, as well as Nagorno-Karabakh conflict linked to the close relations with Russia. Russia still played an important role in the post-Soviet area. Strong ties inherited from the Soviet past forced Azerbaijan and other former Soviet republics to search for the format for continuing relations. Following the formal dissolution of the Soviet Union on 21 December 1991, Mutalibov`s policy was based on keeping close relations with Russia. Like other former Soviet republics, Mutalibov signed the Almaty Declaration, which pro-

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<sup>3</sup> Николай Александрович Зенькович, Самые Закрытые Люди: Энциклопедия Биографий, Olma Media Group, 2002, p.15.

<sup>4</sup> Azərbaycanı prezident seçkiləri: 1990, 1991, 1992, 1993, 1998, 2003, 16.09.2008, <http://www.mediaforum.az/az/2008/09/16/AZ>

claimed the creation of the Commonwealth of Independent States (CIS). However, this declaration was never ratified by the Azerbaijani parliament, having been strongly resisted by the opposition, represented mainly by the Popular Front of Azerbaijan.<sup>5</sup>

In 1991-1992, during the reign of Ayaz Mutalibov, the Russian priority in relations to Azerbaijan was not yet been clearly defined. For instance, in the Armenian-Azerbaijani Nagorno-Karabakh conflict, Russian mercenaries fought on both sides, Azerbaijani and Armenian. However, this situation began to change after Azerbaijan became actively cooperate with foreign energy companies to begin operation of the offshore Azeri-Chirag-Guneshli. Russia was against the participation of Western companies to develop fields in the Caspian Sea. However, Mutalibov continued negotiations with a number of energy companies that could not affect Russia's position towards Azerbaijan. The situation was aggravated in the autumn of 1991, when President Mutalibov decided to exclude Russia from the contract. This decision became the end for Mutalibov administration and from this period, Russia started to support Armenia in Nagorno-Karabakh conflict.<sup>6</sup> Russia, knowing that the main lever of pressure on this country was the Nagorno-Karabakh conflict, therefore, started to use its support of Armenia in the Nagorno-Karabakh conflict.

Supported by Russia, Armenia, taking advantage of the situation, broadened the military conflict to other Azerbaijani territory outside of Nagorno-Karabakh. Civilians were forced to flee their homes and seek shelter in the eastern part of Azerbaijan. The culmination of the conflict has become a tragedy occurred in the town of Khojaly, populated by Azerbaijanis. On February 26, 1992, armed Armenian military formations with the support of 366<sup>th</sup> Russian regiment, located at the time in Karabakh, committed massacres of civilian populations. According to Azerbaijani sources, 613 civilians were killed at night

<sup>5</sup> Araz Aslanlı, İlham Hesenov, Haydar Aliyev Dönemi Azerbaycan Dış Politikası, Platin, Ankara, 2005, p. 15.

<sup>6</sup> Владислав Шорохов, Энергоресурсы Азербайджана: Политическая Стабильность и Региональные Отношения, <http://poli.vub.ac.be/publi/crs/caucasus/shorokhov.htm>, 25.03.2010.

and 487 people escaped prisoner.<sup>7</sup> Immediately after the tragedy, President Ayaz Mutalibov resigned.

Mutalibov, despite the fact that he relied on relations with Russia, a fatal mistake for him was that he considered to isolate the political and economic relations with Russia from each other and follow two parallel policies. Mutalibov felt because of his miscalculation regarding the external economical relations contradictory with Russian interest. If in the political sphere was carried out pro-Russian policy, in the sphere of economics, Mutalibov preferred to carry out an independent course.

At that time, Russia announced a “near abroad” doctrine which included the geography of the former Soviet Union within the sphere of Russian political and economic influence. The West (the U.S. and its NATO allies and the EU) accepted this perception and agreed to the invisible line of new spheres of influence along the lines of the former Soviet borders.

On June 7, 1992 during the presidential elections, the leader of the Azerbaijan National Front Abulfaz Elchibey was elected as a second president of Azerbaijan. Elchibey received 60 percent of the total votes. In second place at the election marathon was Nizami Suleymanov, the leader of the Democratic Union of the Intelligentsia Party, who received 33.8 percent of votes. It should be noted that, this was the first election in Azerbaijan last seventy years, which was not held under communist control.<sup>8</sup>

on November 1991, the Supreme Soviet voted to establish a fifty-deputy National Council, or Milli Majlis. This council was equally divided between former communists and the opposition, each group represented by 25 delegates. Thus, despite the fact that the Popular

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<sup>7</sup> Emin Arif (Şihaliyev), *Kafkasya Jeopolitiğinde Rusya, İran, Türkiye Rekabetleri ve Ermeni Faktörü*, Ankara, Natürel Yayınları, 2004, p., 56.

<sup>8</sup> Dieter Nohlen, Florian Grotz, Christof Hartmann, *Elections in Asia: A data handbook*, Volume I, 2001, p., 357.

Front criticized the elections to the Supreme Council, the new government did not hold early elections to form a new legislative organ. By this, a new government has resisted fundamental reforms in the structures of power and tried to use the current situation to their advantage.

Five days before the presidential elections on 2 June 1992, a Law on Political Parties was adopted. This law will be formed further political transformation at the early 1990s. Different parties and movements started to be formed at the beginning of the 1990s with different ideological and political background. There were 54 officially registered parties in Azerbaijan. Some important political parties in those period were the National Independence Party (NIP) and the New Azerbaijan Party.<sup>9</sup> The National Independent Party was formed on 17 July 1992 by former APF member Etibar Mammadov, who frequently critiqued Elchibey and even after military failures in March 1993 called for Elchibey's resignation.<sup>10</sup> While the NIP was formed by the former members of APF, the New Azerbaijan Party (NAP) was created by the group on 21 November 1992, which was in opposition to the ruling movement. This group also invited Heydar Aliyev to become the party's chairmen. An appeal signed by 91 Azerbaijani intellectuals, and also known as "appeal of 91 intellectuals" was sent to Nakhichevan. Aliyev accepted this proposal.<sup>11</sup> These two parties became the main oppositional powers during the Elchibey presidency.

In his political view, Elchibey was radically different from Mutalibov. Elchibey followed Western orientation in his foreign policy with the further full integration into the Euro-Atlantic institutions, basing it on the full expansion of relations with Turkey.

Elchibey's pro-Turkish foreign policy course disturbed Russia and Iran. Deterioration in relations with Russia, as well as with Iran,

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<sup>9</sup> Tahira Allahyarova, Farhad Mammadov, *Political Parties in Azerbaijan: from One Election to Another*, SAM, Baku, 2010, pp. 9-11.

<sup>10</sup> Azerbaijan-Government, [http://www.mongabay.com/reference/country\\_studies/azerbaijan/GOVERNMENT.html](http://www.mongabay.com/reference/country_studies/azerbaijan/GOVERNMENT.html)

<sup>11</sup> NAP History, <http://www.yap.org.az/view.php?lang=en&menu=4>

resulted in the fact that Russia continued to pressure Azerbaijan by supporting Armenia in the Nagorno-Karabakh conflict. The same course was to be adhered to with Iran, although the expansion of relations with Armenia in all spheres.

Elchibey had not appreciated the true realities that take place in the international arena and this was his mistake. The role of the European Union and the NATO which influenced democratic processes in the post-Soviet area were minimal. The former Soviet Union republics, including Azerbaijan, were provided with only technical and financial assistance. The existence of the Nagorno-Karabakh conflict also did not allow for the active intervention of the Euro-Atlantic structures in the South Caucasus region. These organizations did not want to be actively involved in a conflict which may collide with the interests of Russia in the region. During this period, their efforts were focused on resolving conflicts in the Balkans that emerged after the breakup of Yugoslavia. The same applies to the United States, which was in no hurry to be active in the South Caucasus region.

As consequence, the Elchibey presidency was short-term and his government quickly lost the credo in the society. The absence of Western interests in the Southern Caucasus region and the private consent to the continuation of Russian influence, undermined attempts to shape the political system in Azerbaijan. In the early 1990s, Azerbaijan was led by a government comprised of populists with little experience. This government faced the most serious political and economic problems and their inability to solve them contributed to mass corruption and intolerance between various political groups.

At the same time, Russia strongly supported Armenia and used a different leverage against the anti-Russian government of the Popular Front.<sup>12</sup> The Elchibey government lasted only one year, and fell by the outbreak of the self-styled Colonel Surat Huseynov uprising in

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<sup>12</sup> De Waal, Thomas. *The Caucasus, An Introduction*, Oxford University Press, 2010, pp., 117-118.

Ganja.<sup>13</sup> On 24-25 May 1993, a few days before the event, the Ganja-based 104th Russian Infantry Regiment left the city six months ahead of schedule, leaving all their weapons in the city.<sup>14</sup> Following the increasingly deteriorating situation, President Elchibey invited Heydar Aliyev from Nakhichevan. Immediately after that, Elchibey fled Baku and settled in the village of Keleki, in Nakhichevan, in the place where he was born.<sup>15</sup> Azerbaijan was left without a president. As a reaction to the Elchibey decision, the parliament decided to conduct a public poll on the matter of expressing confidence in Elchibey. A referendum was held on August 30, 1993 and 92.02 percent voted against confidence in Abulfaz Elchibey. A short time later, Aliyev, agreeing with Huseynov, appointed him prime minister. On October 3, 1993, an extraordinary presidential election was held in Azerbaijan. Heydar Aliyev received 98.8 percent of the vote and became the third president of Azerbaijan.<sup>16</sup>

Despite the fact that only three years passed since Azerbaijan gained its independence, the country witnessed frequent changes of government. The reason for the failure of the first two presidents is incorrectly understood in the international arena.

### **Ensuring stability after 1993: new relations with external actors and balance of policy**

Given the previous experience in the Azerbaijan government, Heydar Aliyev knew that he needed to improve relations with neighbors and if possible, to restore relations with Russia. Azerbaijan joined the Commonwealth of Independent States (CIS), which was established directly with the assistance of Russia, a reason why Elchibey at the

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<sup>13</sup> Thomas De Waal, *ibid*, p., 121.

<sup>14</sup> Kornell, Svante, *Azerbaijan Since Independence*, M.E. Sharpe, New York, 2011, p., 76-77.

<sup>15</sup> Kamer, Kasim, "Armenia's Foreign Policy: Basic Parameters of the Ter-Petrosian and Kocharian Era", *Review of Armenian Studies*, Ankara, ASAM, Volume 1, No 1, 2002, p., 97.

<sup>16</sup> Central Election Commission of Azerbaijan Republic, <http://www.cec.gov.az/en/common/election-referendum/1993.htm>

time refused to join the organization. In this way, Aliyev tried to fix relations with Russia and, if possible, expand their reach.<sup>17</sup>

Incidentally, the initial non-participation of Azerbaijan in the CIS allowed Armenia to use the situation to their own advantage in the war around Karabakh. One of the main priorities of Baku was an attempt to find authorization for the Karabakh problem, including within the Commonwealth.<sup>18</sup>

Aliyev was not limited to the restoration of political relations with this country, given the errors that Mutalibov made and the situation in Nagorno-Karabakh, despite the fact that the relations between the two countries continued to be strained. The attempts of Azerbaijan to restore relations with this country have failed. Azerbaijan has not been an indicator in relations with this country and Russia's policy towards Azerbaijan had been already been formed and the changes demanded a new approach and time. As a result, Russia has continued a pro-Armenian policy in the South Caucasus region.

Russia continued to put pressure on Azerbaijan. For example, it was believed that Russia supported the failed coups in Azerbaijan, on the eve of the signing a "deal of the century" with the Western energy companies. Despite the many difficulties, on September 20, 1994, Azerbaijan managed to sign the contract of the century to develop the offshore Azeri, Chirag and Guneshli oil fields.<sup>19</sup>

In addition, since the beginning of the Chechen war, Russia, citing the reason that Azerbaijan provided Chechnya with weapons transfers and hired soldiers, closed its border with that state. Thus, an informal economic blockade against Azerbaijan started. However, despite open pressure of Russia on Azerbaijan, this country has not been

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<sup>17</sup> Ađacan, Kamil, "Deđişim Zamanı: Rusya Federasyonu'nun Güney Kafkasya Politikası", *Stratejik Analiz*, Istanbul, Volume 6, No 61, ASAM, (May, 2005), p 52.

<sup>18</sup> Ровшан Ибрагимов, Неформальный Саммит СНГ: Взгляд из Баку, <http://www.eurasianhome.org/xml/t/expert.xml?lang=ru&nic=expert&pid=743>, (28.07.1975)

<sup>19</sup> "ExxonMobile in Azerbaijan", *Caspian Energy*, Baku, No 3, (July-August, 2002), p., 22.

able to achieve significant success in achieving own interests in Azerbaijan. As a result, relations between the two countries were greatly exacerbated. Aliyev demanded that Russia end the supply of arms to Armenia and withdraw Russian bases from the Southern Caucasus. At the same time, Aliyev did not conceal their interest in closer cooperation with NATO, especially with the United States and Turkey.<sup>20</sup>

Given this situation, Aliyev sought ways to reduce pressure on Azerbaijan and Russia involving Western interests in the country. After signing the "contract of the century," the U.S. attitude towards Azerbaijan began to change. Economic interests of the U.S. and its allies emerged in the region. The consortium, created to develop Azerbaijani offshore Azeri-Chirag-Guneshli oil fields, included a number of Western companies.<sup>21</sup> Attracting foreign companies allowed Azerbaijan to balance the influence of the Armenian Diaspora, and to begin the process of pursuing the national interests of the United States in Azerbaijan.

Still, immediately after signing of the contract, the situation was far from the stable. Surat Huseynov, who became Prime-Minister, turned against President Aliyev. Aliyev appealed on national television to the people in order to prevent another coup in which he blamed Russia. For a short time, thousands of people gathered around the presidential palace, forming a human shield. Thus, a coup was averted.<sup>22</sup>

The construction of a strong stable state was a priority for the new management; society strengthening was left for the second plan. In the short-term, the problems connected with the maintenance of political stability, the termination of military operations and a suspension of economic recession had been solved. On 12 November, 1995, a general election to the Milli Majlis was conducted. The election procedure was held on a mixed system: 100 deputies were elected as single-member mandates and 25 through the proportional ballot

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<sup>20</sup> Гейдар Алиев, <http://www.lenta.ru/lib/14163305/full.htm>, (10.01.2012).

<sup>21</sup> State Oil Company of Azerbaijan Republic, Projects, <http://www.socar.az/projects-en.html>, (05.04.2011).

<sup>22</sup> Svante E. Kornell, *ibid*, pp.,85-86.



system. Ballot papers for the election from the proportional system included 8 parties. Some parties proposed only 5 to 12 candidates lists.<sup>23</sup> This fact points to the weakness of political parties and their unwillingness to submit candidates for all seats in the proportional list. Only 30 percent of all candidates represented political parties and 124 deputies were elected. The New Azerbaijan party received 53 seats in parliaments, the National Independent and Popular Front Parties each 4, and all other parties received totally 8 mandates. Independents received other 55 mandates for places in Milli Majlis.<sup>24</sup> Thus, Heydar Aliyev's party won the elections and took almost half the seats in parliament. This strengthened the position of the new administration and allowed them to adopt a more assertive domestic and foreign policy.

Aliyev understood that the internal stability of the country depended on the correct perception of the international system and the appropriate application of the state foreign policy. This governmental purpose was successfully realized. After the beginning of the exploitation of oil, a new period of political and economic development began in Azerbaijan. Skillfully using the oil trump card, President Aliyev was able to achieve the desired results. The participation of Western companies in the contract of the century allowed, over the medium-term, the country to achieve stability, as well as to conduct a balanced foreign policy.

Relations with Russia also started to develop. After Putin became the Russian president, relations between the countries became normal. Putin made an official visit to Azerbaijan, after which the two states normalized economic relations, and began increasing trade turnover.<sup>25</sup> Around the same time, the legal format of relations between Azerbaijan and the European Union, NATO and the Union States, started to

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<sup>23</sup> Tahira Allahyarova, Farhad Mammadov, *ibid*, pp., 39-40.

<sup>24</sup> Tahira Allahyarova, Farhad Mammadov, *ibid*, p.,a 41.

<sup>25</sup> Zengin, Eyüp, Rövşen İbrahimov, Putin'in Azərbaycan Ziyareti ve Azərbaycan Rusya İlişkileri, Bağımsızlıkların 10. Yılında Türk Cumhuriyetleri, Haarlem, Hollanda Gürsoy-Naskali Emine ve Şahin Erdal (edu), Türkistan ve Azərbaycan Araştırma Merkezi Yayını, 2003, pp., 202-204.

develop. A new program called "Partnership for Peace" was announced at the NATO Summit in Brussels,<sup>26</sup> and on May 4, 1994 Azerbaijan became a member of this program. With regard to the EU a new legal instrument, the Partnership and Cooperation Agreement, for the development of relations with the countries of the former Soviet Union, was developed.<sup>27</sup> These tools offered by both NATO and the EU were not crucial for the development of relations, but rather played the role of a transitional mechanism. After completing the largest round of enlargement in 2007, the EU decided to develop its relations with neighbours on a new structural level under the framework of the New Neighbourhood Policy.<sup>28</sup> The European Commission also proposed the Eastern Partnership towards the former Soviet Union states, which is located in Europe, but not included them in the full integration process.<sup>29</sup> Simultaneously, despite a widely accepted statement that oil income has a negative effect on democracy development; in the case with Azerbaijan it could have positive consequences.

The orientation of Azerbaijan to Europe and oil and gas exports to the West creates communication between this country and the Euro-Atlantic zone that as a result could lead to full integration of Azerbaijan into the structures.<sup>30</sup> However, considering a policy of the EU in the region, it is possible to draw a conclusion that this structure is not ready to encourage reforms in Azerbaijan in the given context. In January 1997, the U.S. declared the strategic importance of the South Caucasus region. By this, the U.S. intended to achieve stability and develop democracy and a market economy in the region. In the context of strengthening the stability in the state and formation of the interna-

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<sup>26</sup> NATO Handbook, Brussels, NATO Office of Information and Press, 1110, 2001, p.,67.

<sup>27</sup> TACIS Annual Report 1998, Brussels, European Commission, 23.07.1999, p.,6.

<sup>28</sup> Ferrero-Waldner, Benita, "The European Neighbourhood Policy: The EU's Newest Foreign Policy Instrument", *European Foreign Affairs Review*, Volume 11, No 2, Holland, Kluwer Law International, (Summer, 2006), pp., 139-140.

<sup>29</sup> Aliboni, Robert, "The Geopolitical Implications of the European Neighbourhood Policy", *European Foreign Affairs Review*, Volume 10, No 1, Holland, Kluwer Law International, (Summer, 2006), p, 3.

<sup>30</sup> Svante E. Kornell, p.196.

tional actors interests towards Azerbaijan, on November 11, 1998, the next presidential election was held. For the first time since independence, one of the state leaders has managed to hold on to power whole period in a 5 years, as determined by the constitution. Presidential elections were also a symbolic confirmation that in Azerbaijan, leadership was capable of creating stability in the country and participating in regional projects. In the 1998 presidential elections, six candidates were registered by the Central Electoral Commission. Some major parties, such as the Popular Front, Musavat and Liberal parties, boycotted the elections, despite the fact that president Heydar Aliyev appealed to them not to do that. As a result of the election, Heydar Aliyev was elected a second time as the Azerbaijani president and received 76.11 percent of the votes. The second place second place went to Etibar Mammadov, who received 11.6 percent of total votes.<sup>31</sup>

### **Continuation of balancing policy and expectation for more concrete steps by West**

Heydar Aliyev's election to a second term was welcomed in the international arena. The Western states, which have already formed their interests in Azerbaijan, accepted the election results as a pledge of billions of dollars investments and as a guarantee for the continued implementation other projects in the country. Aliyev's election made it possible to start a number of regional transport projects. Their implementation required the political will and support by the West and it was obtained. Cooperation between the West and Azerbaijan was not only limited to the economic filed. Azerbaijan's geopolitical positions also played a crucial role for the development of political cooperation. During the 1999 OSCE Summit in Istanbul, the U.S., along with Azerbaijan, Georgia, Turkey and Kazakhstan, signed a memorandum of support for the construction of the Baku-Tbilisi-Ceyhan (BTC) pipeline. Support from the U.S. was crucial because Russia was opposing the project. After the September 11, 2001 terrorist attacks, the U.S. started a full-scale war against international terrorism and began cooperation with a number of states. Azerbaijan was one such state.

<sup>31</sup> Tahira Allahyarova, Farhad Mammadov, *ibid*, pp., 44-45.

The U.S. pledged to suspend the 907 amendments to the Freedom Support Act. Thanks to this regulation, Azerbaijan had the opportunity to receive state aid from the United States. In 2002, Azerbaijan opened its airspace and airports to the U.S. Air Force.<sup>32</sup>

By early 2000, Azerbaijan turned to the U.S. as a strategic partner. In addition to the economic interests associated with the development of energy projects, the U.S. had political interests in Azerbaijan. Azerbaijan's strategic geopolitical position was necessary for the U.S. and its NATO allies in order to provide logistical support to the troops in Afghanistan.

This development in cooperation in different fields played an important role in strengthening stability and economic welfare in Azerbaijan. Realities of the geographical location of Azerbaijan are that without strengthening these relationships, it could not get rid of the political and economic dependence on Russia. In this case, Azerbaijan would be unable to perform successfully in the international arena as an independent actor, which meant actively participating in ensuring European energy security.. In addition, there is a constant threat of Islamic radicalism on the part of Iran, which is a threat to the secular regime in Azerbaijan. Incidentally, the same threat is coming from Russia, or rather, from the North Caucasus republics, where extremism has already become a headache for Moscow. However, despite the increased interest of the West towards Azerbaijan, this kind of relationship is not enough to strengthen further reforms in Azerbaijan, and in the region as a whole.

The main problem continues to persist for Azerbaijan is the Nagorno-Karabakh conflict and the occupied territories. Lack of existing mechanisms for the resolution of this conflict leads to the fact that both Azerbaijan and Armenia are not able to pursue a more assertive policy in their desire to integrate into Euro-Atlantic institutions. This would enable the countries in the region to successfully implement multi-vectoral reforms without looking at the geopolitical realities.

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<sup>32</sup> Quliyev, Samir, Bağımsızlıktan Sonra Azerbaycan-ABD İlişkileri, Ankara, 2005, p., 179.

But there is a very successful example of the transition of Eastern and Central European countries, which successfully passed political and economic transitional reformation with the assistance which they gained from NATO and the EC.

On the other hand, these regional organizations do not express a desire to help in facilitating these processes. Despite the fact that the EU proposed a new approach in its relations with its neighbours, they can be characterized as a reflection of uncertainty as the EU approached the former Soviet Union republics. The EU does not want to offer a higher status for relationships, which means full integration, and try to find a middle ground in the relationships with these states. This organisation does not want to continue the enlargement process at least in the medium-term.<sup>33</sup> However, such limited initiatives are not perceived as satisfactory and sufficient by the South Caucasus states. Azerbaijan considers the given initiative within the limits of a balanced foreign policy. A more active pro-Western policy does not allow the lack of desire in the West, to ensure the possibility of full integration into Euro-Atlantic structures.

At the same time, the U.S. interest in the region is only limited by the formation of a secure region through the development of the market economy and democracy without designing definite tools. As a result, it is possible to see some differences in implementation of this policy. The U.S. actively supports the "democratization process" in Georgia, while towards Azerbaijan, this attitude is quite different. One of the reasons for this is that 60 percent of the population in Azerbaijan supports the solution of the Nagorno-Karabakh conflict through military means, and in this way, the opposition may use this expectation of public opinion for its own motto with the purpose to come to power.<sup>34</sup> In this case, if full-scale war between Azerbaijan and Armenia will be started in the region, the implementation of the transport and energy projects and investment can be faced with problems.

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<sup>33</sup> Dankreuther, Roland, "Developing the Alternative to Enlargement: The European Neighbourhood Policy", *European Foreign Affairs Review*, Volume 11, No 2, Holland, Kluwer Law International, (Summer, 2006), pp., 186-187.

<sup>34</sup> Markedonov, Sergey, Де-факто Отступление, 20.06.07, <http://www.prognosis.ru/news/region/2007/6/20/coldwar.html>, (08.07.11)..

The West thought that stable Azerbaijan is much more “commercially” attractive. There is an unwritten arrangement at which for the purpose of the safety of the observance of contracts and to guarantee profitability of the investments a strong and stable government is necessary. In that case, the Western companies indirectly promote the centralization of force and an exception of potential oppositional groups. The Western companies are guarantors of the status quo in Azerbaijan and for protecting a stable state.

In 2003, because of Heydar Aliyev’s serious illness,<sup>35</sup> his son Ilham Aliyev was selected as a candidate from the New Azerbaijan party during the presidential elections of Azerbaijan. The changing of the leader was a sight of hope for the representatives of opposition parties who saw this event as a possibility for coming to power. The given statement of the opposition became also stronger because of “velvet revolutions” that occurred in a number of the states of the former Soviet Union, such as Georgia and Ukraine, where groups assumed as democratic came to power. It was known that new forces in these countries had strong Western support, thereby, having had an opportunity to accelerate the change of the ruling elite. Therefore, the opposition in Azerbaijan also began to search for support from the West, considering that conditions for their arrival to power in the country had come.

However, the opposition’s expectations were not realized. Having have 77 percent of the total vote cast, Ilham Aliyev won the election and became the fourth president of Azerbaijan. Musavat leader Isa Gambar received 13.96 percent of the total vote cast.<sup>36</sup> Despite the presidential electoral defeat, the opposition hoped to do better in the parliamentary election on November 6, 2005. However, this time the leading New Azerbaijan party received 61 of the total 125 seats in parliament. Mostly pro-governmental independent deputies received another 46 seats. The major opposition party Musavat received only 5 seats in the

<sup>35</sup> Torbakov, Igor, Azerbaijan President Heydar Aliyev’s Illness Underscores Leadership Conundrum in Azerbaijan, 30.04.2003, <http://www.eurasianet.org/departments/insight/articles/eav050103.shtml>, (15.12.2012).

<sup>36</sup> Allahyarova, Tahira and Fərhad Məmmədov, *Azərbaycanda siyasi partiyalar: seçkidən seçkiyə*, Bakı, 2010, p. 65.

new parliament.<sup>37</sup> This disparity of the Azadlıq Bloc representing Azerbaijan opposition forces which hoped to have the U.S. support, inspired from the Ukraine's "Orange Revolution" and chose orange color for pre-election propaganda. But the elections in which Azadlıq Bloc took only 6 seats even though was criticized by many foreign observers and were accepted that declared political bankruptcy of opposition.<sup>38</sup>

As consequence, despite the hopes of opposition parties in support of West, on a wave of "velvet revolutions" as it has occurred in Georgia and in Ukraine, in 2003, the presidential election was won by İlham Aliyev, and after two years, on November 6, 2005, the ruling New Azerbaijan party won the parliamentary elections. As seen, velvet revolution initiatives of the opposition were not supported by the West. The availability of a strong stable state was a priority for the Western states in Azerbaijan; society strengthening was left to the second plan. Almost the same situation emerged after the parliamentary election on November 7, 2010. The New Azerbaijan party received 72 seats in the new parliament, while independents received 48 mandates. This parliamentary election was the worst for the main opposition parties in Azerbaijan. Ten parties represented by 13 deputies. So, the second biggest party in parliament, the Civil Solidarity party, was represented by only 3 deputies. None of the 40 candidates from the Popular Front Party and Musavat won enough votes to enter parliament.<sup>39</sup>

## **CONCLUSION**

The year 2013 is a year of the next presidential elections. Current President İlham Aliyev is the main candidate for the next 5 years. It became possible after the constitutional amendments after the referendum held on 18 March, 2009, when the provision about the limita-

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<sup>37</sup> Tahirə Allahyarova and Fərhad Məmmədov, *ibid*, p. 69.

<sup>38</sup> Azer, Oktay, Окта́й Аса́дов - Новый Спикер Парламента?, *Zerkalo, Vaku*, 02.12.2005.

<sup>39</sup> Azerbaijan: Parliamentary Elections Yield a Lone Opposition Voice, 08.11.2010, <http://www.eurasianet.org/node/62335>

tion of the presidential term was abolished.<sup>40</sup> As it was in the previous election, serious rivals to President Aliyev are not foreseen. Firstly because, the current Azerbaijan president traditionally has a high popularity rating in society. Moreover, the popularity of President Aliyev is evaluated and observed not only in compliance with the internal estimates. In the ranking of the most successful heads of the states, compiled by the World Economic Journal, Aliyev took 15th place.<sup>41</sup>

Besides that, there is no serious opponent for President Aliyev in the political scene of Azerbaijan. Over the last twenty years, none of the significant oppositional party leaders has actually changed. The present leaders of the parties are simply outdated and do not meet the requirements of contemporary political struggle. They are partially or completely discredited themselves and have no support in society. The unwillingness of the old leaders to leave the political scene prevents the possible process of new politicians appearing as possible alternatives. The impact of the new political entities, among which the right-centric "Real" movement can be distinguished, but are also not sufficient. These movements and groups have not yet formed their social base in the Azerbaijan society and there is a strong shortage of qualified staff. In general, these groups make extensive use of virtual possibilities of social networks, for the popularisation of their ideas.

To the point, social networks have become a springboard of political struggle not only for such a groups but also for individuals, young activists which try to express own ideas and position. Precisely through social networking sites a series of meetings with the social demands, but clearly political assurances in the centre of Baku have been organized. Despite the fact that social demands contained slogans have more impact in society than calls of the opposition parties leaders, such kind of protesting movements have no nominated leaders and formed political agenda. In perspective, it is hardly expected that

<sup>40</sup> Voters support all amendments to Azerbaijani Constitution: CEC initial results, 20.03.2009, <http://en.trend.az/news/politics/1443734.html>

<sup>41</sup> Анна Егорова, Составлен рейтинг самых удачливых президентов 2012 года, 01.03.2013, <http://www.km.ru/economics/2013/03/01/vladimir-putin/705157-sostavlen-reiting-samykh-udachlivykh-prezidentov-2012-god>



such movements can be converted into a serious political structure, which will be able to demonstrate a serious alternative to the current administration. The absence of serious internal and external changes brings the situation on the political scene in Azerbaijan which will not be changed until 2018. Since the processes are not sufficient for further reforms and political transformation in the country, the most important influencing factor is external. Factors affecting the stagnation of political processes in Azerbaijan and accelerate reforms can be listed based on the following:

- Continuing with the Armenia Nagorno-Karabakh conflict;
- Russia's desire to retain influence over the region of the South Caucasus and the use of factors of deterrence, which could destabilize the situation in the countries of the region. Such factors of influence can be marked as conflicts in this region and the use of the ethnic card, especially in the north of Azerbaijan;
- Influence of Iran, and the possible spread of religious radicalism and extremism;
- The lack of a clear program of the Euro-Atlantic structures in the future prospects of the development of relations between them and Azerbaijan.

As a result, currently, Azerbaijan is not able to change the situation on external factors, but successfully balances between the challenges to national security. However, such a situation does not allow for wider political reform, there is some stagnation, which may be changed in case of only a fundamental change in the international area, namely the guarantee for Azerbaijan's full integration with Euro-Atlantic structures. Only under these conditions can further political transformation occur in Azerbaijan, which would not threaten the stability and security of the country.



# GEORGIAN POLITICS IN TRANSITION: TRENDS AND OBSTACLES FOR POTENTIAL TRANSFORMATION

**Kornely Kakachia**

## **Introduction**

In the aftermath of the communist system's collapse, the post-Soviet states inherited a political culture that lacks democratic traditions, elements of civil society, mutual trust and a culture of dialogue. The majority of them, Georgia including, also innated national minorities, secessionist treats, the need to consolidate democracy and the basis for national integration and establish a constitutional framework within a short period of time. The transition period was also the scene of antagonistic debate about how to define values contributing to the societal culture of the newly emerging political community.

It is well-known argument, that creating a democratic system of government is fundamentally different and more difficult than maintaining an established democracy. The recent record of the Post-revolutionary Georgia has shown that: " "color revolutions" and other breakthroughs-even if they may express genuine popular longings for freedom and bring important progress in some areas-are not enough to bring about democracies."<sup>1</sup> Since 2004, Georgia has made substantial progress in clamping down on corruption and consolidating good governance. It has modernized the country's business environment, cut the number and rates of taxes, improved tax and fiscal administration, streamlined licensing requirements and simplified customs and border formalities. Surveys show that the demand for bribes declined when companies interacted with licensing, registry

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<sup>1</sup> Ghia Nodia, *Freedom and State*, Journal of Democracy, Volume 21, Number 1, January 2010. p.141

and tax authorities.<sup>2</sup> In addition, "Georgia is one of the best-performing partners of the Eastern Partnership in adopting reforms, although problems still persist as regards their implementation."<sup>3</sup>

This progress is recognized and acknowledged by Georgian society as well as by the international community. At the same time, serious shortcomings and drawbacks have accompanied the process of political reform. These successes were not accompanied by the same positive dynamics in the process of building democratic institutions in the country as strengthening of democratic institutions was viewed as the next stage in the country's development.

### **Role of Institutions in Political System**

As politics works through institutions, good and democratic political institutions are indispensable to a sustainable democracy. Organized governance is largely about how institutions operate in giving expressions to specific constellations of power, interests, and organizations, both formally and informally. Georgia, more than any other country in the post-Soviet space, has publicly committed itself to establishing the rule of law and building democratic institutions. Similarly, establishing a sustainable, law-based system of governance become central to Georgia's aspirations of becoming a fully-fledged member of the democratic family of nations, and this goal is repeatedly held up by politicians of all stripes as essential to the country's development.<sup>4</sup>

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<sup>2</sup> According to the Global Corruption Barometer 2010, Survey by Transparency International: In the past twelve months, only 3 % of Georgians surveyed had to pay a bribe, one of the lowest numbers amongst all countries studied. Georgia has the highest rate, with 78 % of respondents, stating that corruption has "decreased a lot" or "decreased" in the past three years; only 9 % said corruption had increased in the past three years, the lowest for all countries surveyed. 77 % of respondents state that the Georgian Government has been "effective" or "extremely effective" in fighting corruption - the highest rate of all countries in the survey.

<sup>3</sup> European Parliament resolution of 17.11. 2011, recommendations to the Council, the Commission and the EEAS on the negotiations of the EU-Georgia Association Agreement (2011/2133(INI)) <http://www.europarl.europa.eu/sides/getDoc.do?type=REPORT&reference=A7-2011-0374&language=EN>.

<sup>4</sup> Salome Tsereteli-Stephens. Caucasus Barometer: Rule of Law in Georgia - Opinion and Attitudes of the Population. June 27, 2011. Available at: <http://crrcenters.org/activities/reports/>

Georgian political elites understand that this path implies the consolidation of its democratic institutions, the irreproachable state of fundamental rights, and maintaining the successes obtained in the fight against corruption and in the quality of public service, which have been recognized and praised by the international community.<sup>5</sup>

Overall, the Georgian political system remains in the process of transition, with frequent adjustments to the balance of power between the President and Parliament, and proposals ranging from transforming the country into a parliamentary republic to re-establishing the monarchy. Until recently, the executive branch of authority structure prevailed in the political system and was characterized by an unbalanced system of governance where the executive dominates over other state bodies.<sup>6</sup> The government is highly centralized, both vertically and horizontally. The President and a relatively small group of insiders are responsible for critical decision making and the running of the state.<sup>7</sup> The Georgian constitution was amended in 2010, and one of the things it did was reduce the president's authority, while simultaneously increasing the powers of the prime minister.

Although the legislative framework has changed significantly during the last years in Georgia, application of democratic electoral process remains a serious problem. The weak delegation of authority,<sup>8</sup> poor communication with the general public, incomplete execution of functions, weak horizontal links between the political institutions, still remains problematic. As a result, weak democratic institutions in the almost two decades of independence have contributed to much political instability. In a political system where the executive dominates

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<sup>5</sup> Thornike Gordadze. Quatre ans après la guerre russo-géorgienne. *Liberation*. 15 août 2012. Available at: [http://www.liberation.fr/monde/2012/08/15/quatre-ans-apres-la-guerre-russo-georgienne\\_839915](http://www.liberation.fr/monde/2012/08/15/quatre-ans-apres-la-guerre-russo-georgienne_839915)

<sup>6</sup> Charles Fairbanks, H., Jr. Revolution reconsidered. *Journal of Democracy*, 18(1), (2007). 42-57.

<sup>7</sup> International Crisis Group Europe Policy Briefing N°58, *Georgia: Securing a Stable Future*. Tbilisi/Brussels, 13 December 2010 <http://www.crisisgroup.org/~/media/Files/europe/B58%20Georgia%20--%20Securing%20a%20Stable%20Future.ashx>

<sup>8</sup> One key argument put forward by the government is that of the need of a strong central-level government against the background of the ongoing threat to the territorial integrity of the country

the legislative and the judiciary, and significant checks and balances are not in evidence, democratic political culture is embryonic to say the least.

Georgia also suffers from an underdeveloped culture of political competition and a lack of transparency in governmental business. After the Rose Revolution the political arena remained uncontested, with no viable opposition to Saakashvili, which allowed for his semi-authoritarian behavior.<sup>9</sup> United National Movement (UNM) still dominates Georgian politics and media. UNM offices are central to local politics, often doubling as the seat of the local government. Most of the opposition is divided, under-funded, and in some cases presumed to be backed by either Moscow or the government. The emergence of a one-party system with strong ties between the ruling party and the state, a less-free media climate, the government's willingness to manipulate the election law, demonstrated that the consolidation of democratic institutions and a competitive political space in Georgia is still needed.

As Georgia's government struggles to consolidate the democratic gains of the Rose Revolution, It has become obvious that at present Georgian society lacks both a strong political will and experience in democratic governance. Even though Georgia is listed among countries that have had improvements, in Freedom House's report Nations in Transit 2012,<sup>10</sup> Georgia remains in the category called "transitional government or hybrid regime," together with Ukraine, Bosnia Herzegovina, Albania and Moldova. Until recently, the deepest problem for Georgia's unconsolidated democracy was that there were no societal forces or political institution powerful enough to effectively balance the government. The formal framework of the multi-party politics contradicts a profound personalization of party politics in which notions of stable political constituencies are largely irrelevant. Opposition political parties were not able to offer any challenging political agendas and seemed incapable of uniting behind a

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<sup>9</sup> Katya Kalandadze, Mitchell A. Orenstein. Electoral Protests and Democratization Beyond the Color Revolutions. Comparative Political Studies Volume 42 Number 11 November 2009 1403-1425 © 2009 Sage Publications

<sup>10</sup> <http://www.freedomhouse.org/report/nations-transit/2012/georgia>

clear programme for democratic change. There is lack of experience how to organize effective party structures, how to formulate appropriate electoral platforms, and build consensus, which is an essential ingredient of democratic systems.

### **Georgian Party Politics: Source of Instability?**

In theory, political parties are one of the central institutions of modern representative democracies and are the major actors in the system that connects the citizenry and governmental process.<sup>11</sup> Parties turn the demands into political issues, they recruit candidates for public office, formulate programs for governmental action, compete for votes, and if lucky, exercise executive power until ejected from office. In general, a well-functioning political party system is evidently an important condition for a well-functioning representative democracy.

It has often been said that in Georgia and largely in South Caucasus political parties are in a state of decline. Actually, this has been a long-standing opinion in certain circles, arising largely out of a latent hostility to parties, which are viewed as a divisive force among citizens, a threat to national unity, and an enticement to corruption and demagoguery. In fact, Georgia has weak and volatile party system with highly fragmented and personality-driven opposition parties. As most Post -communist countries of Eastern Europe Georgian party politics characterized by low popularity of parties, relatively low turnout, small party membership, weak partisan identities, weak grounding of parties in civil society. Its financial dependence on state and low level of organizational loyalty among politicians are the most obvious signs of weak institutionalization.

Georgian political parties are often characterized by top-down hierarchical structures in which the chairperson is the single most important figure. As a result, Georgian political parties are being built around the persons leading them and not around the political platform. In fact, politics is so personalized that legitimate divergence in political

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<sup>11</sup> Hans Dieter Klingemann Richard I. Hofferrbert, Ian Budge. *Parties, Policies, and democracy*. Westvewpress. 1994 p.5

opinion often go unnoticed.<sup>12</sup> This generates a focus on personalized debates, not on topics. Since all parties are founded on a personality, it could probably explain why there are more than 100 registered political organizations. This often leaves the Georgian population inclined to either vote for candidates on the basis of personality and charisma, rather than real political issues, or simply against the current government to show dissatisfaction, rather than for an actual candidate.<sup>13</sup>

The lack of members and loyal supporters makes it difficult for parties to articulate and aggregate preferences. Many commentators of Georgian politics complain that political parties have not grown out of social cleavages, do not represent large segments of society (though they may articulate their sentiments) and are difficult to identify on the left-right spectrum of classical political ideologies. Moreover, Georgia's political parties have persistently failed to satisfactorily perform functions that are associated with political parties in established democracies, such as representing groups in society, aggregating interests, or mobilizing voters.<sup>14</sup> Subsequently, parties were rather weak in performing the functions of integration, mobilization and mediation.

Most observers of Georgian politics suspect that behind the generally low level of popularity of party politics stand weak linkages between parties and social groups. For instance unlike in western European democracies Unions appear to lack widespread public trust in Georgia. According to regular surveys conducted by the International Republican Institute (IRI), levels of confidence in trade unions are consistently low, although there is a slight positive trend over time.<sup>15</sup>

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<sup>12</sup> Iliia Roubanis, Georgia's pluralistic feudalism: a frontline report. 3 July 2009. <http://www.opendemocracy.net/article/georgia-pluralistic-feudalism>

<sup>13</sup> Konstantine Kandelaki, "Local Government in Georgia: Developing New Rules in the Old Environment," LGI Report (Open Society Institute), 275, Available at: <http://www.eurasianet.org/resource/georgia/links/government.shtml>

<sup>14</sup> Max Bader. Fluid Party Politics and The Challenge for Democracy for Democracy Assistance in Georgia. *Caucasian Review of International Affairs* Vol. 2 (2) – Spring 2008. P.84

<sup>15</sup> Transparency international, Georgia report. *The Georgian Trade Union Movement*. February 2010



In the most recent survey, trade unions (with just 21 percent approval) are the second least trusted institution of the 16 included in the survey, beating only the mafia.<sup>16</sup>

### **Infant Political Culture**

Contemporary political experiences in the European neighbourhood confirms that democratisation is a process deeply bound up with the foundations of political culture and societal identity, and that the challenges to democratic reform are formidable where these foundations of democracy are weak, or only newly born, or even virtually non-existent.<sup>17</sup> Political culture is also often seen as the foundation of all political activity, or at least as a factor determining the nature, characteristics and level of political activity. Quite consistent with Almond and Verba's original argument<sup>18</sup> that both the inauguration and stability of democracy is promoted by certain traits of political culture among the citizenry.

For nearly two decades, Georgia has been struggling to develop its democratic political culture. Although significant progress have been made in democracy and the election process, multi-party systems, and rule of law the country still characterized by a democratic deficit, a weak civil society, and an infant parliamentary culture. Georgian political culture is dominated by the notion of enmity, where citizens are becoming increasingly suspicious and critical of the political elites and of leaders who pretend to be working for more democracy, even though this may not be the case. According to Enyedi<sup>19</sup> in such circumstances

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<sup>16</sup> The church, by contrast, enjoys 91% trust and parliament 41%. The 2009 figures are a relative improvement. According to the June 2005 survey, Georgians were more likely to consult their local Al Capones for help than their trade union and came bottom of the survey.

<sup>17</sup> Democracy's Plight in The European Neighborhood. *Struggling Transitions and Proliferation of Dynasties*. Michael Emerson and Richards Youngs (editors). Centre for European Policy Studies. Brussels. 2009. P.7

<sup>18</sup> For detailed account see: Almond, Gabriel A., Verba, Sidney, *The Civic Culture*. Boston, MA: Little, Brown and Company, 1965

<sup>19</sup> Zsolt Enyedi. *Party Politics in Post-Communist Transition*. In *Handbook of party politics*, edited by R. S. Katz, 228-238. London: Sage, 2006.

as a result struggle for power between elite factions unfolds on nonelectoral fields, while elections only register the victory retrospectively.

Another problem influencing the development of local political culture is the nonappearance of a stable, responsible political elite anchored to a democratic and operational governmental system. Subsequently, emerging political class has problem of formulating political strategies, explicit and clear concept of democratic development. There is also some discrepancy between what was pronounced and what was in fact exercised, low accountability of authorities to their words continue to dominate political reality. Moreover, as ruling political elites never get tired to stress their devotion to Western, democratic values and goals, practices might differ greatly from stated values. At times it seems that "Georgian political class have no confidence in masses, trying to avoid where possible democratic structures and procedures of decision making under the pretext of democratic immaturity of population and its lack of political knowledge and skills."<sup>20</sup> One of the reasons of such behavior as Georgian analyst Alexander Rondeli put it is that "at a deeper level, the political culture of Georgian society itself - an unstable fusion of Marxist and democratic visions and clichés concerning the state and its role, and socio-economic development - remains an issue."<sup>21</sup> Accordingly, the task of building a modern state and effective, impartial, transparent governing institutions is far from solved.

One more powerful obstacle to designing Georgia's future is immaturity of political parties. Lack of an issue-based party system is one of the indicators of the "immaturity" of democratic political society. Most experts (Nodia) blamed the political parties, including the ruling party that see revolution as the primary means of winning power. The core of this problem is this very confrontational political culture which was developed after the independence in parallel with Civil war and mili-

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<sup>20</sup> Nana Sumbadze & George Tarkhan-Mouravi. *Democratic Value Orientations & Political Culture in Georgia*. Institute for Policy Studies. 2003 Available at: <http://pdc.ceu.hu/archive/00002562/>

<sup>21</sup> Alexander Rondeli. *Georgia: politics after revolution*. Open Democracy. 14 November 2007. Available at: [http://www.opendemocracy.net/article/conflicts/caucasus/georgia\\_after\\_revolution](http://www.opendemocracy.net/article/conflicts/caucasus/georgia_after_revolution)

tary coup d'état. In addition to that, there is little appreciation of the rules of procedure or "spirit: of the constitution, necessary prerequisites for a functioning parliamentary democracy. Reckless obstruction by Georgian political parties holds back progress in many fields including economy. It should also be noted that not a single president has completed a full term since the country declared independence after the fall of the Soviet Union which is the clear illustration of fragility of Georgian political system.

### **Role of Media and Troubled Media Environment**

The impact of independent media is inseparable from the larger issue of political pluralism. In some sense, the mass media is a crucial part of respective political culture contributing substantially to shape the rest of it. The media plays a crucial role in a Georgian society, as on one hand it informs people's attitudes and opinions about different political leaders and on the other hand it gives politicians an opportunity to assess the public mood, which makes it possible for all to participate in free political debates. In the European Union's Neighborhood Policy action plan, Georgia has committed to ensuring and improving freedom of the media, one of the fundamental institutions necessary to develop and consolidate a democratic political system.<sup>22</sup>

However, as many analysts argued after the Rose Revolution, "relations between the Georgian government and local media have increasingly caused concern, because the government has attempted to tame the press by administrative measures under the plausible excuse of establishing the rule of law."<sup>23</sup> Although, Georgia has mostly progressive and liberal laws governing the establishment and operation of media entities; as observers claim in practice the media remains less

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<sup>22</sup> The Georgian government also committed to "encourage proper implementation of the Law of Georgia on Broadcasting and the Law of Georgia on Freedom of Speech and Expression", European Neighborhood Policy action Plan EU-Georgia, [http://ec.europa.eu/world/enp/pdf/action\\_plans/georgia\\_enp\\_ap\\_final\\_en.pdf](http://ec.europa.eu/world/enp/pdf/action_plans/georgia_enp_ap_final_en.pdf). (accessed on April 1, 2010)

<sup>23</sup> Zaal Anjaparidze Georgian media shackled after rose revolution. The Eurasia Daily Monitor, 1(62). (2004, July 29). Retrieved January 23, 2009, from [http://www.jamestown.org/single/?no\\_cache=1&tx\\_ttnews%5Btt\\_news%5D=26679](http://www.jamestown.org/single/?no_cache=1&tx_ttnews%5Btt_news%5D=26679)

transparent, accountable and independent.<sup>24</sup> Partisanship pervades the news industry, media elite, especially mainstream television, are busy toeing the government line, while their smaller, opposition-minded cousins relish in highlighting the government's bad practices.<sup>25</sup>

Consequentially, some Georgian television stations and newspapers, which had gained a following with their relatively freewheeling reports, have significantly toned down their criticism of the government. Today, any media outlet that refuses to kowtow to the government faces increasing problems. Although press freedom in Georgia is considered better than in much of the former Soviet Union,<sup>26</sup> conditions under Saakashvili have varied over time, which made EU to stress that "freedom of expression and freedom of the media are essential elements in the bilateral dialogue with Georgia."<sup>27</sup>

An evaluation made by local and international organizations emphasizes that media freedom remains a significant challenge despite the fact that Georgian legislation defends freedom of speech and expression (the Law of Georgia on Broadcasting, the Law of Georgia on the Freedom of Speech and Expression, Constitution of Georgia). While the country enjoys a pluralistic, albeit small print media, Georgia lacks a truly pluralistic television sector. Despite the fact that there are two local TV stations in Tbilisi now run by the opposition and newspapers are generally critical of government, some critic claim the country's media is now less free than it was before the Rose Revolution in 2003.<sup>28</sup> While

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<sup>24</sup> See: Freedom House. Freedom of the Press report, Georgia 2011 <http://www.freedomhouse.org/template.cfm?page=251&year=2011&country=8042>

<sup>25</sup> IREX – Media Sustainability Index. <http://www.irex.org/resource/georgia-media-sustainability-index-msi>

<sup>26</sup> Freedom of the Press 2012. Table of global press freedom rankings. Available at: <http://www.freedomhouse.org/sites/default/files/Global%20and%20Regional%20Press%20Freedom%20Rankings.pdf>

<sup>27</sup> Council of the EU: *EU-Georgia Cooperation Council, 10th meeting*, press release, October 26, 2009, Available at: [http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/er/110768.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/er/110768.pdf).

<sup>28</sup> Georgia's ranking in an annual survey of global press freedom released by Freedom House in 2012 remained "partly free. 1 of the 12 former non-Baltic former Soviet states – Georgia, Moldova and Ukraine - are ranked as "Partly Free", others have been assigned to "Not Free" category."

opposition politicians are given air time to voice their opinions, including the national public broadcasting channel, their views are generally neutralised by editorial programming that is blatantly biased.

According to Transparency International reports, Georgians receive 96 percent of their political information from television news and television remains the dominant source of information.<sup>29</sup> Two private channels, Rustavi-2 and Imedi, together account for nearly two-thirds of viewers. However, people and events that do not get on the central television channels remain less known to the overwhelming majority of the population. Being aware of potential biased reporting on television stations, many news consumers feel they can make up for that by watching a variety of stations, however, outside the capital it is much more difficult to access channels with editorial policies significantly different from those of national media outlets. The CRRC survey also indicates that viewers in Georgia show a clear appetite for investigative reporting with 75 percent of respondents saying they would like to see investigative reports on healthcare, the courts, elections, the protection of freedom of speech and 64 percent saying they would also like to see relations between politicians and the Georgian Orthodox Church investigated.<sup>30</sup>

As to freedom of Internet-based media outlets, opinion is largely free and criticism of the government is made openly which makes the Internet and blogging, at least in this regard, relatively irrelevant. Though the internet is not subject to government regulation, few newspapers have regularly updated websites, and many journalists lack knowledge about internet technology and web tools. Despite this, blogs and social networking sites such as Facebook and Twitter are playing a growing role in spreading news and information. Social media could potentially become a tool to undermine the news cartel of national TV channels and

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<sup>29</sup> Transparency International Georgia. Television in Georgia – Ownership, Control and Regulation. Report, November 20, 2009 Available at: <http://transparency.ge/sites/default/files/Media%20Ownership%20November%202009%20Eng.pdf>

<sup>30</sup> Caucasus Research Resource Centers. (2009) "Caucasus Barometer". [dataset] Retrieved from <http://www.crrccenters.org/caucasusbarometer/> on November 15,2010.

contribute to a more pluralistic media landscape. However, only 27 percent of Georgians accessed the internet in 2010. In general the media environment in Georgia defies a single, sweeping verdict.

### **Weak Outreach and Structural Defects of Civil Society**

The critical hub of political democracy is constituted of the demand for political participation and the involvement of the people in the choice of their leaders and decision-making. Unlike most of the Post-soviet states, in Georgia you could see key elements of civil society, pluralistic media, free business, active citizenry and vibrant religious community.<sup>31</sup> Civil society mostly associated with non-governmental sector and emerged as in the context of state lacking democratic institutions.<sup>32</sup> It faces many similar features regardless of the transition stage the country finds itself in. These features of the environment civil society is operating in typically include: reduced or only formal recognition of their role internally (by governments, the business community and the general public), limited capacity, over-reliance on international support and resources, which in turn leads to further estrangement from the local base and an environment (political, economic, legal) which is not generally conducive to civil society development.

After the Rose Revolution,<sup>33</sup> while Western support for post-revolutionary Georgian government resulted in a sharp increase in foreign aid to the government, civil society suffered as funding for the advocacy groups that had been at the heart of the Rose Revolution dried up, forcing organizations to shut down programs that could monitor and challenge decisions. In addition, many civil society leaders and media representatives took up posts in government, parliament and the administration of the president thus leaving the public sec-

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<sup>31</sup> Irakli Areshidze. *Democracy and Autocracy in Eurasia. Georgia in Transition*. Michigan State University Press. 2007. p.97

<sup>32</sup> Alexander Rondeli., *Georgia: Foreign Policy and National Security Priorities*, discussion paper Series 3, Tbilisi, 1999.

<sup>33</sup> For a detailed insight see, Cory Welt, *Georgia's Rose Revolution from Regime Weakness to Regime Collapse*. In *Democracy and Authoritarianism in the Post Communist World*, (Ed) by Valerie Bunce, Michael McFaul, Kathryn Stoner-Weiss, Cambridge University Press, 2010, p.155-188.

tor “disintegrated and hollow”.<sup>34</sup> Although there was no decrease in the number of organizations since 2004, the influence of civil society in policy formulation is rather low. Though thousands of NGOs are formally registered officially, only 20 to 30 are visible and politically active.<sup>35</sup> As a result of a weak role of the civil society sector, the supremacy of party politics becomes ever more obvious. This is partially due to “a reluctance of public institutions to engage in systematic public policy debates with civil society actors.”<sup>36</sup> According to many experts public officials often fail to see the benefit of involving a wide range of stakeholders in the policy formulation process.

The Georgian public sector still lacks intermediary forms of civil activism such as strong trade unions, interest-aggregation groups and broad social movements. As result of , a “social vacuum” exists where no organized civil society can challenge the dominance of political parties. In addition to that situation gets even more difficult as some of the well-established Georgian NGOs either too close to government or siding opposition, which makes bipartisan analysis of current situation mission impossible. They have generally been reluctant to criticize the government or opposition. Due to different reasons (self-censorship, lack of capacity, etc), most of them do not produce much of analytical products and mainly involved in training activities, which lowers research and analytical parts of their work.

The comprehensive civic engagement survey<sup>37</sup> organized by the CRRC in 2011 posed questions about the Georgian population’s current levels of civic engagement, attitudes toward and perceptions of NGOs and think tanks, willingness to participate in NGO campaigns, current membership in organizations and political values. Following from this, the survey data

<sup>34</sup> *Civil Society and Rose Revolution in Georgia*, ed. George Khutsishvili. Publication of the International Centre on Conflict and Management, Tbilisi, 2008, p. 13

<sup>35</sup> Christopher H. Stefes, *Understanding Post-Soviet Transitions. Corruption, Collision and Clientelism*. Palgrave MacMillan, 2006. p.57

<sup>36</sup> David Aprasidze. *Nations in Transit 2012-Georgia*. Available at: <http://www.freedomhouse.org/report/nations-transit/2012/georgia>

<sup>37</sup> Caucasus Research Resource Centers, *Social Capital Report Literature Review, Final Report and Briefing Paper*, Tbilisi November-December 2010. Briefing Paper accessible at: <http://www.crrc.ge/research/projects/?id=2>

indicate that the five major obstacles to civic engagement in Georgia are: 1) the public's fundamental lack of understanding and knowledge of what an NGO is and does, 2) a mismatch between the issues that deeply concern citizens and the issues that NGOs most often address, 3) dependence on family and friends as a form of informal insurance that substitutes for engagement with NGOs, 4) the currently challenging economic environment that creates a lack of resources for participation, and 5) a lack of institutionalization of informal engagement so that pro-social behaviors are often one-off rather than regular events.

The civic engagement survey also found that current levels of public engagement with NGOs, political activism and membership in organizations are very low among the Georgian population.<sup>38</sup> The data show that only 4.5 percent of the Georgian population have attended a meeting organized by an NGO, 3.5 percent have participated in a training sponsored by an NGO, 2.2 percent have called or visited the office of an NGO and 5.9 percent have had someone from an NGO come to their door over the last two years. In such an environment, despite millions of dollars in aid from international donors, citizen engagement with the civil society sector in Georgia remains extremely low. According to some reports,<sup>39</sup> Georgian civil society has degraded to the position it occupied 10 to 12 years ago, which must force this sector to think of new developmental possibilities. Civil society actors need to rethink and recreate their role within society at large as they no longer play a leading role as government watchdogs and critics.

## **Conclusion**

For all its shortcomings and frustrations, Georgia is an important experiment in democracy in a vital but troubled part of the world as it provides a good opportunity to study the process of democratic

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<sup>38</sup> see Leslie Hough. Scholar Research Brief: *Civic Engagement in Georgia: The Challenge of Formalizing the Informal*. September 2011. Available at: [http://www.irex.org/sites/default/files/IREX%20Final%20Report\\_Hough\\_Georgia\\_FINAL.pdf](http://www.irex.org/sites/default/files/IREX%20Final%20Report_Hough_Georgia_FINAL.pdf)

<sup>39</sup> *An Assessment of Georgian Civil Society*. Report of the CIVICUS Civil Society Index. Caucasus Institute for Peace, Democracy and Development (CIPDD) Tbilisi, September 2010. Available at: [http://www.civicus.org/images/stories/csi/csi\\_phase2/georgia%20final%20acr.pdf](http://www.civicus.org/images/stories/csi/csi_phase2/georgia%20final%20acr.pdf)



transformation. In the political field, most uncertainties are linked to future election performance. In the coming years, Georgia will enter another election cycle, with parliamentary elections in October 2012, followed by presidential elections in 2013 and local elections in 2014. As these elections seen within and outside Georgia as another democratic litmus test from which conclusions would be drawn, the key challenge for Georgia's democratic governance will be ensuring that these elections are fair and transparent. As results of the elections could shape Georgia's future trajectory for years ahead, what matters is whether Georgia's unconsolidated democracy survives its most competitive electoral competition as upcoming elections are expected to produce the first peaceful transfer of power since its independence.

As the new more parliamentary system of governance strengthens Georgia's democratic credentials and intend to bring balance to the government dominated by Saakashvili, he together with Georgian voters might be in position to decide how to shape a post-election. Despite the fact that, Saakashvili cannot himself run as president and will be leaving the presidential office in 2013, thanks to controversial new constitutional changes, he is likely to retain significant power in Georgian politics for next five years. Some analysts and opposition figures argue he will seek another high-level position after he completes his maximum two terms as president in 2013. So far there are signs that he is acutely aware that a move to any high post would damage the government's democratic image internationally, especially as it seeks to contrast itself with the Russia president Vladimir Putin. However, a major role for Saakashvili remains – handing over authority through elections would be the greatest testament to his democratic credentials.

A closer look to Georgian political party system gives rise to questions. This is a country where politics is about leadership and not representation and it most likely it could be the trend for next five years. Although the ruling party maintains a powerful social network through which it can mobilizes supporters, (especially during elections), in the absence of Saakashvili's leadership it must be seen what could be the

future of UNM. Taking into consideration that Georgian political parties are largely built around personalities rather than constituencies it could be serious factor for UNM as it's may be lacking a substantial platform without charismatic leader.

The key trends and political priorities for the near future could be challenged or reshaped by the many risks and uncertainties which could alter the agenda of Georgian politics. During next five years to boost its successful transformation Georgia needs to bring the state closer to a balanced political system with more power residing with the parliament and more vibrant functional system of checks and balances. The media and business environment needs to be improved, as does the judiciary, so as to alleviate the symptoms of super-executivism. Moreover, structural advances are needed in the realm of local government to ensure political freedom and active participation for the Georgian population.

The Georgian political elites need to overcome the zero-sum approach to politics and learn to govern through coalition. If the opposition has no chance of winning the elections and the government has no chance of losing them, both parties will grow weaker. Whatever will be result of the elections all parties should respect and accept the election results. As the success of these elections depends on a responsible opposition, which has the legal right to promote its goals while respecting the rules of the campaign incumbent government needs to engage in a good-faith dialogue with multiple political forces, civil society representatives and business leaders while designing and implementing key reforms. It also needs to take up recommendations from international and local organizations on the electoral issues and eliminate partisan abuse of public resources during elections, investigate previous election violations and intimidation cases.

To sum up, Georgia is, once again, facing a period of uncertainty. It is up to the Georgian political spectrum as a whole to show everyone that by behaving like responsible actors, they could lead the country towards stable transformation model and truly support the strengthening of democratic institutions.

Nations in Transit Ratings and Averaged Scores										
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Electoral Process	5.25	5.25	4.75	4.75	4.50	4.75	5.25	5.25	5.00	5.00
Civil Society	4.00	3.50	3.50	3.50	3.50	3.50	3.75	3.75	3.75	3.75
Independent Media Governance*	4.00	4.00	4.25	4.25	4.00	4.25	4.25	4.25	4.25	4.25
	5.50	5.75	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
National Democratic Governance	n/a	n/a	5.50	5.50	5.50	5.75	6.00	6.00	5.75	5.75
Local Democratic Governance	n/a	n/a	6.00	5.75	5.50	5.50	5.50	5.50	5.50	5.50
Judicial Framework and Independence	4.50	4.50	5.00	4.75	4.75	4.75	4.75	4.75	5.00	5.00
Corruption	5.75	6.00	5.75	5.50	5.00	5.00	5.00	5.00	4.75	4.50
Democracy Score	4.83	4.83	4.96	4.86	4.68	4.79	4.93	4.93	4.86	4.82

Annex. Freedom House Nations in transit 2012-Georgia



# CHAPTER II

SOCIO-ECONOMIC DYNAMICS:  
COMMON CHALLENGES,  
DIFFERENT SOLUTIONS?



# ECONOMIC DEVELOPMENT CHALLENGES OF ARMENIA

**Levon Barkhudaryan**

## **1. Recent economic trends. The impact of the global financial crisis.**

High economic growth rates in 2002-2007 (average annual GDP growth was 13 percent) were superseded in Armenia by drastic decline in 2008-2010 primarily preconditioned by the global financial and economic crisis. In 2008, the GDP growth reduced to 6.9 percent versus 13.7 percent of 2007, while the decline of -14.1 percent in 2009 was among the highest not only among the CIS countries but in the entire world.

The wave of global financial crisis started in 2008 did not have an instant negative impact on the economy of Armenia because of the low incorporation of the financial and banking systems in the international financial markets. Somewhat later, i.e. in the end 2008 and throughout 2009 the impact of the crisis has been visible primarily through reduction of private transfers and remittances (equivalent to at least \$300 million) and reduced potential for sales of goods and services. As a consequence, declining consumption naturally gave rise to under-collection of indirect taxes<sup>1</sup>.

The GDP growth rate and its sector structure over the recent years are set out in the Table<sup>1</sup>.

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<sup>1</sup> See L. Barkhudaryan, K. Danielyan, D. Galoyan, G. Hayrapetyan. Armenia – EU economic relations. The impact of the Deep and Comprehensive Free Trade Agreement on the bilateral trade relations. Center for European Studies. YSU, Yerevan. 2012

**Table 1: GDP growth rate by sectors in 2007-2011**

	2006	2007	2008	2009	2010	2011
<b>GDP growth rate (%), including</b>		13,7	6,9	-14,2	2,1	4,7
Industry		3,1	2,4	-7,6	9,5	14,1
Agriculture and forestry		10,2	1,3	-0,1	-13,4	14,1
Construction		18,6	7,2	-42,3	3,7	-11,5
Services		13,4	9,0	-1,1	4,6	4,3
Net taxes		31,1	16,8	-20,5	9,4	2,8
<b>GDP sector structure (%)</b>	100	100	100	100	100	100
Industry	17,2	15,6	14,9	16,1	17,2	
Agriculture and forestry	8,7	18,1	17,2	20,0	17,0	
Construction	3,7	24,7	24,7	16,6	16,9	
Services	1,9	31,8	32,5	37,4	38,3	
Net taxes	8,5	9,8	10,7	9,9	10,6	

Source: NSS and Sustainable Development Programme Progress Report, 2011

According to the table, the share of construction over the recent years reduced and, at the same time, that of services increased. The agricultural structure holds high sensitivity to natural and climatic changes, and this is one of the particular reasons of a 13.4 percent decrease of its share in 2010 GDP.

In implementing anti-crisis activities, the government attracted and mediated involvement of borrowings from foreign states and international organisations and channelled them primarily to provide financial support to small and medium enterprises (SMEs) and banks. Withdrawal from sources of financing particularly downgraded the construction sector. Instead, the share of services in GDP relatively increased.

Financial and economic crisis and decline of gross demand have had their impact also on the indicators of the export and import of goods and services (See: Table 2).

**Table 2. Export and import indicators, 2006-2011 (% of GDP)**

	2006	2007	2008	2009	2010	2011
Export of goods and services	23,7	19,3	15,1	15,5	19,9	23,7
Import of goods and services	-39,7	-39,0	-40,7	-42,6	-45,3	-47,3
Balance of goods and services	-16,1	-19,7	-25,6	-27,2	-25,4	-23,6
Current account	-1,8	-6,4	-11,8	-15,8	-13,9	-10,9

Source: NSS, Ministry of Finance of Armenia



Thus, in the circumstances of the growth of the share of exports of goods and services, in GDP, however, decline of exports in absolute terms was recorded taking into consideration the overall 14.1 percent decline of GDP. The same trend has been recorded in imports whereby despite the two percentage point increase of imports of goods and services in GDP in 2009 (relative to 2008), they curtailed about 23 percent in absolute terms.

Overall, in 2006-2010, and especially in pre-crisis period decline in exports of goods and services was observed accompanied with increase in their imports which caused significant deficit of both trade and current account balances. In macroeconomic terms this kind of developments bear major risks since such deficit is funded from foreign sources, in particular from private remittances, which may not be considered a sustainable or permanent source in the long-term perspective. The major reason for the above deficits is the deteriorated volume of exports, which was brought about primarily by artificial appreciation of Dram/USD exchange rate in 2003-2008, which, on top of all, boosted high rates of imports. A situation emerged when private remittances, that expanded gross demand, were used to finance increasing expanding share of GDP (as high as 20 percent), as well as the increasing volume of imports. Import of goods and services became more beneficial as opposed to exports because the monopoly holding businessmen never reduced the prices for imported commodities (which naturally take place in any environment of appreciating national currency) and generated excess profits. It was the turn of the Central Bank in these circumstances to fail to sustain the stability of national currency because relevant actions would require incremental inflationary risks, while stability of prices for consumer goods would actually contribute to containing the rate of Dram appreciation.

Data associated with consumer price indices and exchange rates are set out in Table 3.

**Table 3. Consumer price indices and exchange rates, 2007-2011**

	2007	2008	2009	2010	2011
Consumer price index	104.0	109.0	103.4	108.2	107.7
Exchange rate (dram/USD, end of year)	304.2	306.7	377.9	363.4	385.7

Severe decline of dram exchange rate in 2009 is linked with implementation of floating exchange rate policy introduced since early March of the same year. Generally taken, growth of consumer price indices in the circumstances of over-appreciated Dram should have been lower (especially in 2007-2008). This state-of-affairs reflects unsatisfactory competitive environment in general, and existence of monopolies in particular. The rapid increase of prices for imported goods in those years is also partially attributed to this factor.

The government's fiscal policies in 2009-2011 aimed at alleviating and partially neutralising genitive effects of the global financial and economic crisis on the Armenian economy, as well as securing social protection of population. Expansionary fiscal policies aiming at promotion of gross demand were helpful to pivotal enterprises and mortgage markets, and to implement large-scale programmes of improving infrastructures et cetera. In the circumstances of deteriorating revenues, this has come to increase budget expenditures, which resulted in growth of state budget deficit and, as a result, public debt.

Aggregate indicators of consolidated budget are set out in the Table 4 below.

**Table 4: Actual revenues, expenditures and deficit of the consolidated budget of Armenia, 2008-2011 (% of GDP)**

	2008	2009	2010	2011
Revenues	22.6	23.19	23.47	23.3
Tax and social contributions	20.7	20.46	20.51	
Tax	17.8	17.19	17.51	17.3
Expenditures	23.4	34.84	28.98	26.1
Social		14.34	12.66	
Economic		8.16	3.69	
Deficit	-0.7	-11.65	-5.51	-2.8

According to the data in Table 4, revenues of consolidated expenditures relative to GDP increased in both 2009 and 2010-2011, which

happened, however, in the circumstances of decreasing tax revenues relative to their level of 2008. At the same time, the increase in expenditures/GDP in 2009-2010 was significantly higher especially in 2009, which noticeably inflated budget deficit. Moreover, relative increase of expenditures in 2009 is mainly due to increased spending in social and economic sectors, which reflect approximately 74 percent of the increase in expenditures/GDP ratio.

The above facts reveal that tax revenues in Armenia are particularly sensitive to volumes of imports. Drastic decline of gross demand in 2009, mainly preconditioned by reduction of private remittances caused by global financial and economic crisis, has become the primary reason for drop in tax revenues. This means that there is a need to design tax policies that would encourage diversification and international cooperation, help boost domestic production and design of export-oriented economic systems.

In the pre-crisis period continuous reduction of poverty level and economic growth were recorded in Armenia, but crisis dictated economic decline and increased poverty level afterwards. Thus, in terms of the 2004-2008 share of population below general poverty level was reduced by 11.1 percentage points reaching 23.5% in 2008 (versus 34.6% in 2004)<sup>2</sup>. The share of poor population has increased first time since 1999 and reached 28.7%. Similar trends are recorded among extremely poor population.

In the pre-crisis period economic growth targeted also reduction of income inequalities. Thus, in 2004-2008, incomes of the 20 percent poorest population generated on employment and sales of agricultural produce grew faster than their overall monetary incomes, which is attributed to economic growth. At the same time, monetary incomes of poor population grew faster in comparison with those of the non-poor. Thus, in 2004-2008 monthly average per capita monetary incomes in the poorest deciles increased 2.3 times, while the com-

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<sup>2</sup> See: Sustainable Development Programme Implementation, Progress Report 2011

parable indicator for the most secure deciles was 1.7 times<sup>3</sup>; in other words, income inequality or the income gap between the non-poor and poor has reduced. Indeed, monetary incomes of the 20 percent best-off population in 2004 were 10.6 times of the incomes of the poorest decile, and in 2008 this indicator was 7.8. Jinni coefficient has also reduced in 2004-2008 (See: Table 5). In 2009, increase in poverty rate was accompanied with increase of all indicators of inequality.

**Table 5. Income distribution inequality indicators, 2004-2009**

	2004	2005	2006	2007	2008	2009
Ratio of monetary incomes of the 20% most well-off and 20% poorest population (times)	10.6	9.5	7.6	8.0	7.8	8.0
Ratio of monetary incomes of the 10% most well-off and 10% poorest population (times)	20.8	17.9	13.9	15.6	14.1	14.5
Jinni coefficient of income concentration	0.395	0.359	0.369	0.371	0.339	0.355

*Source: Armenia Social snapshot and poverty, NSS Armenia, 2007, 2008 and 2010*

Global financial and economic crisis therefore has had negative impact also upon poverty and inequality realities in the country.

An essential precondition of poverty reduction among the population is the economic growth. Consequently, securing high rates of economic growth is one of the priorities highest on reform agenda. One of the most important factors of economic growth is the development of business and investment environment. Being a land-locked country and implementing economic activities in the realities of transport blockade, Armenia has scarce natural resources and its comparative advantage in relation to its regional neighbours include quality and cheap labour force and higher availability of foreign markets and investments associated with the Diaspora, Armenian capital increasing in other countries and business links. To this end, swift

<sup>3</sup> See: Sustainable Development Programme Implementation, Progress Report 2011

development of business environment in relation to our neighbours will enable more efficient realisation of competitive advantages of Armenia. This is associated competitive environment and development of business infrastructures in the first instance. Consequently, active anti-monopoly policies, improvement of governance systems, and combat against corruption are currently the highest priorities of the Armenian authorities. Enhancing efficiency of public governance, embedding principles of democratic governance not only entail establishment of civil society and best possible realisation of human rights in various spheres of civil life but also lay fertile bases for business activity, sustainable and stable economic growth.

The highest priorities on the public governance reform agenda include structural and functional reforms, enhancing efficiency of public and civil service, improvement of judicial systems and public finance.

The success of policies and programmes along these lines is of crucial importance in the context of European integration.

## **2. Challenges, bottlenecks and problems**

The major problems and bottlenecks for economic development in Armenia is the low efficiency of the anticorruption policy and not sufficient speed and success in implementation of the public sector administration reforms or governance reforms in general.

Overall, efficiency and quality of public governance systems are characterised through a number of indicators which are extensively applied in international practices, in particular, in making comparisons of governance systems of various countries (see Table 6).

These indicators have been designed by the World Bank and they come to assess economic, political and institutional aspects of governance, they are equipped with scoring whereby the higher the score (or percentage estimate) the higher is the overall assessment of governance in a given sector.

**Table 6. Public governance indicators, Armenia, 2007-2010**

<b>Governance indicators</b>	<b>Year</b>	<b>Percentage estimate (0-100)</b>	<b>Planned indicator of governance system, SDP, 2010 (percentage estimate, 0-100)</b>	<b>Governance scoring (-2.5 to +2.5)</b>
Voice and accountability	2011	27.7		-0.75
	2010	26.1	50.0	-0.85
	2009	23.2		-0.89
	2008	25.0		-0.86
	2007	26.9		-0.76
Political stability (and absence of violence)	2011	43.4		-0.10
	2010	47.2	51.2	+0.03
	2009	52.1		+0.21
	2008	43.8		-0.03
	2007	47.1		+0.11
Government effectiveness	2011	52.1		-0.09
	2010	49.8	58.1	-0.15
	2009	55.5		0.00
	2008	50.0		-0.16
	2007	44.7		-0.36
Regulatory quality	2011	58.3		+0.26
	2010	58.4	67.8	+0.28
	2009	60.3		+0.29
	2008	60.2		+0.30
	2007	60.2		+0.27
Rule of law	2011	43.4		-0.40
	2010	39.8	45.1	-0.47
	2009	40.3		-0.46
	2008	45.7		-0.30
	2007	42.1		-0.45
Control of corruption	2011	33.6		-0.58
	2010	30.6	47.1	-0.67
	2009	32.1		-0.57
	2008	32.5		-0.61
	2007	24.8		-0.73

The table above shows each of the six indicators describing public governance has declined relative to at least one of the preceding

years. Moreover, none of the values of the above indicators defined in the government long-term strategic programme as benchmarks for 2010, i.e. sustainable development programme (SDP), has been reached within the respective period. It should also be noted that achieving the programme values of these indicators did not require significant financial resources hence may not bear negative impacts of global financial and economic crisis. The challenge has been within the capability of the government to demonstrate political will in achieving the programme objectives.

It should also be noted that quite some work has been implemented in combat against corruption over the recent years; in particular, the number of corruption criminal cases investigated by all types of law-enforcement agencies, and a task-force, sub-groups and plans of actions have been established and designed in accordance with the Programme of Activities annexed to the 2009-2012 Anti-Corruption Strategy of Armenia.

In the context of these measures special investigation service has been created to handle exclusively the cases associated with high-rank officials of legislative, executive and judicial authorities and officers implementing special state service, either implying the involvement or direct infringements by the above. In addition, engagement of civil society in combat against corruption has been enhanced, et cetera. Despite these and many other measures, the indicators describing corruption keep deteriorating. This is also witnessed by the dynamics integrated corruption perceptions index maintained and conducted by renowned Transparency International organisation. More specifically, the value of this index in 2011 was 2.6, which placed Armenia on the 129th in the international classification of all countries. For comparison purposes it should be noted that Georgia holds 64th line in the same classification.

In general, comparison of corruption and other governance indicators for Armenia and other CIS countries shows that Armenia is fairly advanced but, as the same time, lags behind in comparison with relevant indicators of the Eastern European Countries and Baltic states.

**Table 7. Public governance indicators: Armenia, former USSR, Eastern European countries and Baltic states, 2010 (scored)**

Indicators	Armenia	Former USSR republics	Eastern Europe and Baltic states, average	Europe and Central Asia (2011)
Voice and accountability	-0.85	-1.04	+0.52	-0.75
Political stability and absence of violence	+0.03	-0.37	+0.23	-0.1
Government effectiveness	-0.15	-0.65	+0.33	-0.09
Regulatory quality	+0.28	-0.59	+0.61	+0.26
Rule of law	-0.47	-0.88	+0.27	-0.40
Control of corruption	-0.67	-0.97	+0.08	-0.58

Source: <http://info.worldbank.org/governance/wgi/index.asp>

One of the major objectives of government over the upcoming years is to improve indicators of government effectiveness and quality with a view to approximate them to at least the average indicators of 2011 in the Eastern European and Baltic states. This, in turn, will significantly contribute to the process of European integration of Armenia.

One of the pivotal indicators of public governance, and public finance management in particular, is the taxes-GDP ratio. The lower this indicator is, or in other words the rate of tax collection, the higher is the degree of shadowiness of the economy. Over the recent years this indicator hardly changed, and it even displayed low increasing rates in the pre-crisis period, which entailed underperformance of planned budget revenue benchmark indicators. In addition, not only the percentage value of the taxes/GDP indicator is important in this case, but even more important is the difference between its programme and actual values. The larger this difference is the higher is the degree of shadowiness of the economy in a given country. To this end, the data in table 8 are fairly representative, as they reflect tax rates of countries lower than those in Armenia but the rate of tax collection is incomparably higher than in Armenia.



**Table 8. Tax revenues and rates, 2011**

	<b>Tax revenues (% of GDP)</b>	<b>Corporate profit tax (%)</b>	<b>Value added tax (%)</b>
Armenia	16.3	20	20
Chile	18.1	20	19
Cyprus	25.9	10	15
Georgia	24.9	15	18
Ireland	44.3	12	21
Latvia	27.7	15	22
Moldova	31.4	15	20
Romania	28.2	16	24
Serbia	33.7	10	18

*Source: Armenia, prevent economic disaster, Policy Forum Armenia, 2012*

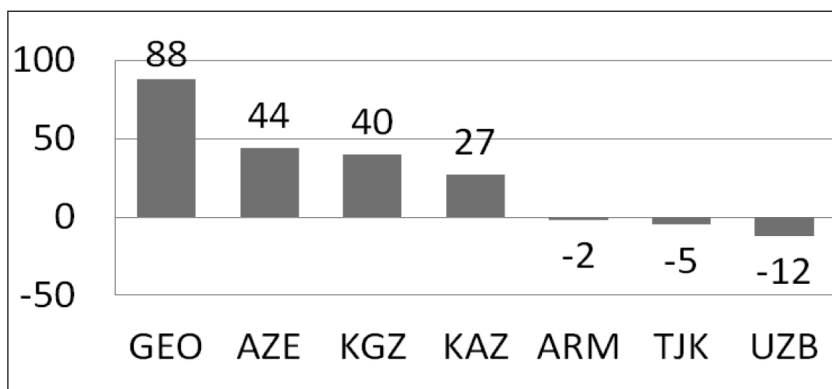
The table shows that in a number of countries, such as Serbia, Georgia and Cyprus, the rates of the two types of taxes are lower than in Armenia, but the collection rate is 1.5-2 times higher than in Armenia.

This reality reveals a negative phenomenon of sponsorship in respect of certain companies in the economic environment, which seriously undermines competitive environment in the country.

In 2010-2011 the government undertook certain measures aiming at improvement of business environment in the country. Electronic company registration systems and one-stop shop approach to company registration were introduced in 2010, which reduced business registration timing and associated costs. The quantity of areas within mandatory licensing was significantly reduced, and the period for issuing construction permission was reduced from 137 days to 27. In 2011 a council of small and medium enterprise support was established, which will provide swifter reaction to challenges and problems in the SME sector. The EU provides support to the government in implementing reforms in customs administration towards enhancing efficiency, in particular with a view to accelerate customs clearance procedures. In addition, in 2011 important amendments and changes were introduced in the legislation on economic competition, according to which fines and penalties applicable to monopolies were increased and the roles and powers of the economic competition commission were enhanced.

Despite these positive developments and changes, indicators describing business environment and economic competition in the Armenian economy over the recent years have not recorded any significant progress. Thus, in parallel with certain progress in the context of Doing Business indicator of the World Bank (Armenia has progressed from line 61 to 55 in 2011 in the rating table), overall change for the recent five years period is yet negative (See: diagram 1).

**Diagram 1. Doing Business indicator, changes in ratings in 2006-2011**



According to the diagram above, the biggest progress in terms of the indicator in question has been registered in Georgia.

### 3. Priority reform areas

Improvements of business and investment climate over a certain period will necessarily entail rise in economic activity, of which the most important outcome in case of Armenia is the value added associated with exports of goods and services. One of the most important factors of export promotion is the increase in competitiveness. Taking into consideration the imperatives of enhancing competitiveness of the country, securing sustainable economic growth and export promotion, the government has adopted a concept paper on export-oriented industrial policies aiming at enlargement of export-oriented sector through identification of export potential and efficient realisation.<sup>4</sup>

<sup>4</sup> Strategy: Export oriented industrial policies of the Republic of Armenia, 2011

The substantial improvement of business and investment climate, further democratisation of the governance are key priority areas of economic and institutional reforms. Therefore, we think that the government of Armenia in its development programs should highlight the following areas of policy measures:

- Development of the competition atmosphere, diminishing the role of monopolies in the market;
- Diversification of the economy, based on the expansion of the export oriented sectors of the economy;
- Removal of the bureaucratic obstacles to do the business;
- Successful implementation of the public sector administration reforms by increasing, first of all the transparency and accountability of public governance both at the central and local levels;
- Enhance the participatory processes in the public governance;
- Efficient implementation of the government’s anticorruption program.

#### 4. Economic development trends in 2013-2018

The economic developments for Armenia in 2013-2018 are envisaged by two main scenarios: (1) baseline scenario with the current trends of economic developments, and (2) optimistic scenario with the higher rates of economic growth based on the efficient implementation of the above mentioned reforms (see table 9).

**Table 9. GDP growth projections for 2013-2017 (%)**

	2011	2012	2013	2014	2015	2016	2017	2018
World	3.9	3.5	4.1	4.4	4.5	4.6	4.7	
Advanced economies	1.6	1.4	2.0	2.4	2.6	2.7	2.7	
Emerging and developing economies	6.2	5.7	6.0	6.2	6.3	6.3	6.3	
Armenia(baseline scenario)	4.4	3.8	4.0	4.0	4.0	4.0	4.0	
Armenia (optimistic scenario)	4.4	7.0	6.4	6.5	6.5	6.5	6.6	6.7
Azerbaijan	0.09	3.1	1.9	2.8	2.9	2.98	3.0	3.1
Georgia	6.25	6.95	6.0	5.5	5.5	5.5	5.5	5.7

Source: IMF projections as of June 2012.

As seen from the table, taking into consideration the economic potential of Armenia, the rates of growth of Armenian economy could be higher than in the neighboring countries or in the emerging and developing economies provided that there will be sufficient political will and commitment in the government to fight against corruption and to improve substantially business and competition atmosphere.

# **ECONOMIC AND SOCIAL DEVELOPMENT PERSPECTIVES OF NON-OIL SECTOR OF ECONOMY IN AZERBAIJAN WITH A VIEW TO 2018**

**Vugar Bayramov**

**August 2012**

## **Recent Economic Trends**

For the past 20 years of independence, the Republic of Azerbaijan has been through periods of crisis, stability, and rapid development. All these steps taken toward development have been remembered ever since for both their uniqueness as well as their conformity to economic realities: firstly, the recession (1992-1995) recovery (1996-1997), boom (1998-2008) and final slump (starting 2009).<sup>1</sup> Thus, when evaluating the past 20 years of the economy of the Republic of Azerbaijan, it is of great importance to pay close attention to its growth and prosperity and draw conclusions about the developmental process. However, the overall picture is that it is hydrocarbon resources and its gradually increasing income that play a profound role in helping Azerbaijan achieve economic stability.

In fact, these resources are not infinite, and annual decrease of revenues from these resources puts the future of Azerbaijan's economy at risk. And this one-sided development of the country's economy relates to dependence on the oil industry<sup>2</sup>. Development is good, but its sustainability and stability is important, too. From this point of view, except for the first years of independence, the Azerbaijani economy has shown positive trends from 1996 until the present. Economic growth rates have increased, the level of unemployment and inflation have decreased, and large amounts of foreign investments have flowed into the country, which have all contributed to the development of the economy. In recent years, however, one-sided development of the economy has begun to show its negative symptoms. As a result, the

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<sup>1</sup> "Azerbaijan's economy since independence", Vugar Bayramov, 2012

<sup>2</sup> IMF, World Economic Outlook, 2009

country's economic growth rate in 2011, for the first time, decreased to its lowest level since 1996. The main cause of this was the decrease in the oil sector by 9.3 percent. In this respect, even the 9.4 percent growth in the non-oil sector could not counteract this negative impact on economic growth, which has had a negative impact on the industry and a 5 percent decrease has already been noticed in this field.

According to State Statistics Committee<sup>3</sup> in 2011, 77.9 percent of industry was realized in mining, 17.0 percent - in processing, 4.5 percent - in production, distribution and supply of electricity, gas and steam, 0.6 percent - in water supply, treatment and processing of waste. As seen from the figures mining constitutes main part the whole industry and at the same time more than 50 percent of processing industry consists of oil processing.

All this proves once again that oil is still the dominant factor in the economy of Azerbaijan and that in spite of the continuing efforts of the government, dependence on oil hasn't been reduced in the last few years. However, it should be noted that the government is aware of the negative consequences of over-dependence on the oil sector, and thus, the development of non-oil sector has recently become one of the highest priorities. It is being discussed in almost every government meeting. From that point of view, Azerbaijan's economy since independence, its overall success, and difficulties faced along the way have been of great interest. . This article is devoted to analysis of the economic development of the Republic of Azerbaijan for the last 20 years, including the main macroeconomic indicators and the leading role of the oil sector.

### **Challenges, Bottlenecks & Problems**

After announcing its independence, Azerbaijan's economy has faced a number of challenges. The most influential factors hampering economic growth were the loss of the previous economic relations with other former Soviet Union countries, structural problems with the Azerbaijani economy, and lack of financial resources. In addition, the Nagorno-

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<sup>3</sup> State Statistics Committee, Press release, [http://www.azstat.org/press\\_reliz.php?id=1153](http://www.azstat.org/press_reliz.php?id=1153)

Karabakh war with Armenia and subsequent occupation in the initial years of independence shattered Azerbaijan's economy. The loss of 20 percent of Azerbaijan's territory and 1 million citizens becoming refugees severely affected a number of economic sectors, including the agricultural, lighting and power, and food industries. Moreover, the then-existing political crisis worsened the situation. Back then, attracting foreign investors and moving toward a new economic system were almost impossible. Foreign investors were even hesitant to invest in the oil industry. On the other hand, the state didn't have enough resources to invest either. At that time, overcoming the regress of the economy seemed to be an impossible task. During this period, production rates had seriously declined and, at the same time, inflation and unemployment levels were high. As a result of all of these negative factors, Azerbaijan was to remain in the crisis until 1995.

However, in 1994, development of Azerbaijan's sector of the Caspian Sea began when Azeri, Chirag and deep-water Gunashli (ACG)-International Contract No. 1-was signed by Azerbaijan and the participating international companies on September 20, 1994. Because of its potential reserves estimated at 6 billion barrels (950,000,000 m<sup>3</sup>) of oil, this project is often referred to as the "Contract of the Century". The projected investment for this project is \$13 billion. A few months later in 1995, a consortium known as the Azerbaijan International Operating Company (AIOC) was organized. Originally, AIOC was composed of eleven major international companies: BP (UK), Amoco (U.S.), LUKoil (Russia), Pennzoil, (now Devon of U.S.), UNOCAL (U.S.), Statoil (Norway), McDermott (U.S.), Ramco (Scotland), TPAO (Turkey), Delta Nimir (now Amerada Hess of U.S.), and SOCAR (Azerbaijan). Azerbaijan's share of the oil produced is 80 percent; the remaining 20 percent is shared among the other investors<sup>4</sup>. Right after the "Contract of the Century" and AIOC was established, it started to work on the approved program along with SOCAR. The result of this cooperation was successful and paved the way for about 30 agreements with 41 oil companies from 19 countries around the world<sup>5</sup>. The "Contract of the Century"

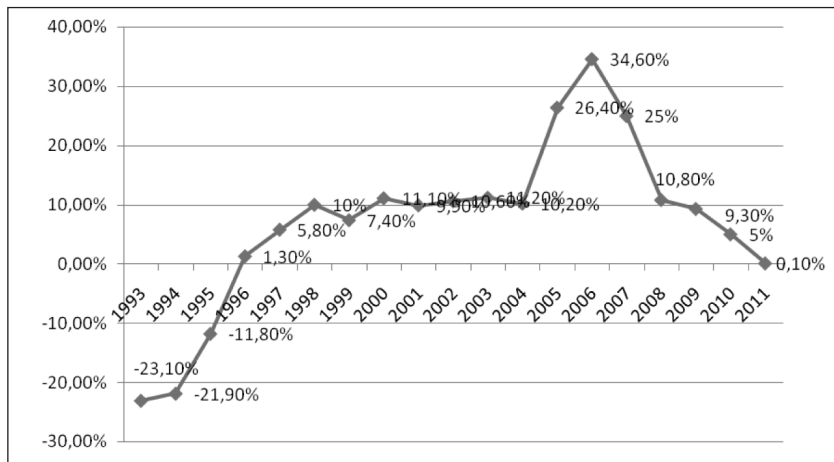
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<sup>4</sup> Ministry of Economic Development

<sup>5</sup> The State Oil Company of Azerbaijan Republic

was important both for the volume of hydrocarbon resources and for the volume of investments from all around the world making it one of the largest contracts in the history of mankind. According to the signed agreements, investment totaled \$64 billion, of which \$57.6 billion was spent on exploration and development of offshore deposits. After the signing of the “Contract of the Century,” which was the birth of a new era in Azerbaijan’s oil industry, a dynamic pace of prosperity began for the whole economy in general. According to the contract, \$100 million and \$600 were invested in the Azerbaijani economy in 1995 and 1996, respectively. By successfully executing “The Contract of the Century,” Azerbaijan managed to involve a number of EU countries and the US. Even with the Baku-Supsa and Baku-Novorossiysk pipelines, Azerbaijan was not able to meet growing demand for the export of its oil, so the Baku-Tbilisi-Ceyhan oil pipeline was built. Billions of dollars from foreign investors were invested in Azerbaijan to realize the project. Substantial investments by foreign oil companies in the oil sector revived the economy in a short time. As a result, since 1996, Azerbaijan’s economy has shown high growth rates until recent years. The highest growth rate recorded was in 2006, when real GDP growth was 34.5 percent<sup>6</sup>.

**Figure 1 1993-2011 growth rates in the economy of Azerbaijan**



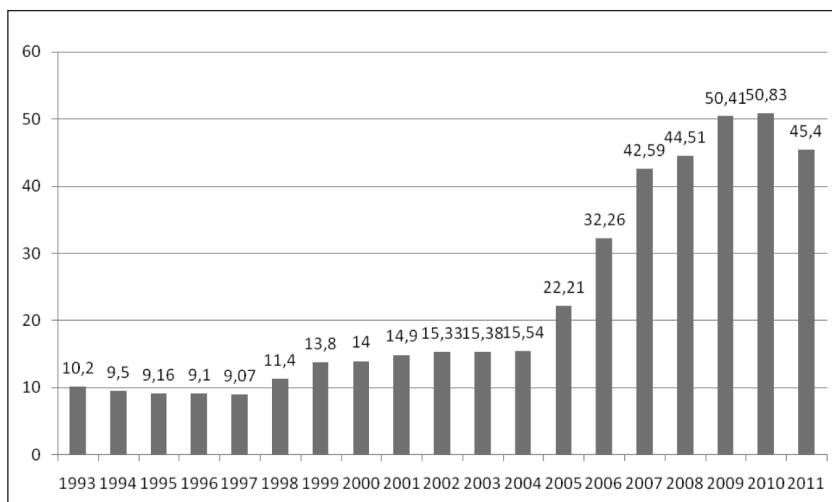
Source: **State Statistics Committee, 2011** [http://www.azstat.org/statinfo/system\\_nat\\_accounts/en/index.shtml](http://www.azstat.org/statinfo/system_nat_accounts/en/index.shtml)

<sup>6</sup> State Statistics Committee, 2011 [http://www.azstat.org/statinfo/system\\_nat\\_accounts/en/index.shtml](http://www.azstat.org/statinfo/system_nat_accounts/en/index.shtml)



As shown in Figure 1, the highest growth rate of the economy of Azerbaijan was in 2006, which is attributed to the increase in oil exploration and production. 45 percent of the increase was due to oil production totaling 32.2million tons, which was 10 million tons more than that of the previous year<sup>7</sup>.

**Figure 2 1993-2011-in oil production (million tons)**



Source: **State Statistics Committee, 2011** [http://www.azstat.org/statinfo/balance\\_fuel/en/index.shtml](http://www.azstat.org/statinfo/balance_fuel/en/index.shtml)

As Figure 2 shows, in 2006, the sudden increase of 10 million tons of oil production contributed to the 34.5 percent growth in GDP. However, in spite of the growing level of oil production in the following years, the GDP growth rate kept decreasing. The main reason for this decrease was the “low base effect” concept, in which every next year GDP increased by a larger base and thus was disproportionally reflected in real GDP growth. In other words, GDP has been growing on a higher base each year. As a result, in spite of the highest growth of oil production recorded in 2010, GDP real growth was merely 5 percent<sup>8</sup>. Thus, in 2011, the decrease of 5 million tons in oil extraction

<sup>7</sup> State Statistics Committee, 2011 [http://www.azstat.org/statinfo/balance\\_fuel/en/index.shtml](http://www.azstat.org/statinfo/balance_fuel/en/index.shtml)

<sup>8</sup> Ministry of Economic Development, [www.economy.gov.az](http://www.economy.gov.az)

had a substantial negative impact on the GDP growth rate. For the first time since 1996, the real growth rate declined to 0.1 percent<sup>9</sup>. At the moment, the government, non-governmental organizations, as well as the general opinion of independent experts is that certain measures should be taken in order to reduce dependence on the oil industry as an economic driver and to improve diversification of the economy of Azerbaijan. If we take a close look at the official data of the State Statistics Committee, it is clear that oil sector constitutes up to 94 percent of total exports, more than 60 percent of the local industry, and 60 percent of the state budget revenues<sup>10</sup>. It should also be noted that 60 percent of the funds transferred directly to the state budget are received by the State Oil Fund<sup>11</sup>. Moreover, if we include the amount of funds received through SOCAR and other oil-based sources, then we can deduce that the oil sector actually constitutes 70 percent of budget revenues.

There is no alternative that can replace the oil sector. Indeed, leading industries in the non-oil sector are actually indirectly funded by the oil sector, including construction, tourism, and finance. . Most of the aforementioned fields are not able to contribute revenue to the state and some even incur losses. According to the International Monetary Fund's report on Azerbaijan<sup>12</sup> issued in January 2012, one of the main concerns is the dominant role of public expenditure on non-oil growth. In order to achieve sustainable economic development, the existence of a diversified private sector is important. It is also noted that monopoly, administrative barriers, and excessive bureaucracy are the main factors that impede the development of the non-oil sector. As a result, foreign trade - especially the share of the non oil sector - declines. Thus, the future development of the economy of Azerbaijan, given weakening growth in the oil sector, will depend on the speed of the reforms. These reforms include WTO membership, the

<sup>9</sup> International Monetary Fund, World Economic Outlook, [www.imf.org](http://www.imf.org)

<sup>10</sup> State Statistics Committee, [www.statistics.az](http://www.statistics.az)

<sup>11</sup> State Oil Fund of Azerbaijan, [www.oilfund.az](http://www.oilfund.az)

<sup>12</sup> Republic of Azerbaijan: Selected Issues, January 2012, IMF country report No.12/6 <http://www.imf.org/external/pubs/ft/scr/2012/cr1206.pdf>

fight against monopoly and corruption, faster diversification of the economy, the development of small and medium enterprises, and the elimination of existing barriers to foreign trade. Although there is the State Anti-Monopoly Policy and Consumer Rights Protection Service under the Ministry of Economic Development, their operational capacity is poor<sup>13</sup>. The Service is mainly engaged in fighting against minor violations of law. Within the framework of the fight against corruption, certain laws, including procurement laws, have been adopted; however, serious improvements in this direction have not been observed<sup>14</sup>. Most procurements are still based on direct orders without tenders. Although the Government declared war on corruption in the beginning of 2011, this fight weakened subsequently. Except for minor bribe cases, the fight against corruption is not serious. The fight against corruption should not only be carried out by administrative means but also as part of a broader strategy. It should include measures from the determination (selection) of bids for infrastructure projects through tender offers [to the implementation of educational procedures. However, the number of organized tenders is decreasing. Moreover, the tenders lack transparency and are subject to doubt. Also, costs of large-scale projects carried out at the expense of the state budget, and especially by the State Oil fund, (for example, the Oguz-Gabala-Baku water pipeline, the Baku-Tbilisi-Kars railway project, etc.) are periodically being changed<sup>15</sup>. And this is the main factor which allows corruption to occur. Lack of control over the spending by the government, lack of transparency in the implementation of projects, and problems relating to state procurement create a significant risk that state funds will be the subject of corruption.

Unfortunately, corruption places severe constraints on a country's capacity to undertake economic reforms. This is because reforms require greater transparency, accountability, free and fair competition, deregulation, and reliance on market forces and private initiative,

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<sup>13</sup> Center for Economic and Social Development, [www.cesd.az](http://www.cesd.az)

<sup>14</sup> Center for Economic and Social Development, [www.cesd.az](http://www.cesd.az)

<sup>15</sup> State Oil Fund of Azerbaijan, [www.oilfund.az](http://www.oilfund.az)

as well as limiting discretionary powers, special privileges, and price distortions – all of which will reduce opportunities for economic rent on which corruption thrives. The rich and the powerful, the main beneficiaries of a corrupt system, will therefore oppose reforms.

At the same time, e-government, which is a key tool for fighting corruption in terms of minimizing opportunities for civil-officials to engage in corruption, is still missing. The biggest success in the direction of e-government that Azerbaijan has achieved so far, as stated in the World Bank report, is the reduction of the duration of the business registration process<sup>16</sup>.

Mainly due to aforementioned, in 2012, Azerbaijan was ranked 66th among 183 countries on World Bank's Doing Business annual report.<sup>17</sup> According to the same report, the most important problems in business that still exist relate to the functional side of business. (registration is simple and fast, but enterprises face huge challenges and delays<sup>18</sup>).

Azerbaijan was ranked 170th for transboundary trade, and 172nd for building permit acquisition. All of these negative factors are indicators of sizable problems that impede the development of small and mid-sized entrepreneurs<sup>19</sup>.

For example, entrepreneurs' access to additional financial resources is weak. They don't have access to alternative financial resources other than high-interest bank credit. This has a number of reasons. First, entrepreneurial activity is weak and most entities don't apply international accounting standards, corporate governance standards,

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<sup>16</sup> World Bank, Doing Business Report, <http://www.doingbusiness.org/data/exploreconomies/azerbaijan/>

<sup>17</sup> Ease of Doing Business in Azerbaijan, <http://www.doingbusiness.org/data/exploreconomies/azerbaijan/>

<sup>18</sup> Ease of Doing Business in Azerbaijan, <http://www.doingbusiness.org/data/exploreconomies/azerbaijan/>

<sup>19</sup> Ease of Doing Business in Azerbaijan, <http://www.doingbusiness.org/data/exploreconomies/azerbaijan/>

and other standards. Thus, they are not able to attract additional financing by issuing bonds, shares, or other securities<sup>20</sup>.

Poor development of the securities market of the country can be added to its list of problems. Types of financial intermediation such as venture funds, hedge funds, and mutual funds are still not available. Despite the adoption of a law on investment funds in 1999, there is still not a single fund operating in Azerbaijan. The second reason is that the shareholders are not paid dividends. This, in turn, reduces the interest of potential investors.

Another problem is related to the high value of manat. In February 7, 2005, a decree "On changing (denominating) nominal face value of money units and scale of the prices" was signed by the President of Azerbaijan Republic<sup>21</sup>.

According to the provisions of this legislative decree, on January 1, 2006 due to transition to the new Manat 1 new Manat equaled to 5000 Manats. As a result of denomination Manat's exchange rate increases and this negatively affects export of Azerbaijan. Currently Azeri Manat is the most expensive currency in the region. According to the Central Bank's official exchange rate reports 1 Russian Ruble is equivalent to 0.0268 Manat, 1 Turkish Lira 0.4437 Manat, 1 Ukrainian Grivna to 0.0978 Manat, 1 Georgian Lari 0.473<sup>22</sup>.

1 US dollar is equivalent to 0.7861 Manat. As you can see from the aforementioned information Manat's high value impedes export and weakens Azerbaijan's position in foreign trade.

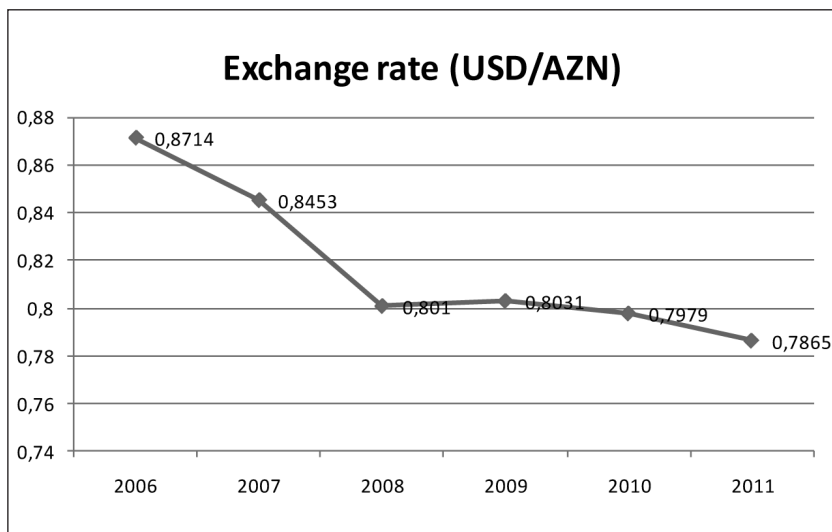
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<sup>20</sup> Ease of Doing Business in Azerbaijan, <http://www.doingbusiness.org/data/exploreconomies/azerbaijan/>

<sup>21</sup> Central Bank of Azerbaijan, Then the National bank of Azerbaijan, [www.cbar.az](http://www.cbar.az)

<sup>22</sup> Central Bank of Azerbaijan, [www.cbar.az](http://www.cbar.az)

**Figure 3. 2006-2011 exchange rate (USD/AZN)**



*Source: Central Bank's official exchange rate*

As seen from the graph Manat's exchange rate rose in 2006 compared to that of USD by 10 per cent and in the end of February 2012, 1 dollar has been equivalent to 0.7861 manat. From this it can be concluded that, the value of manat continues to grow and this negatively affects export potential of the country.

### **Priority Reform Areas**

General priority reform area in Azerbaijan is non-oil sector. In order to determine, however, priorit reform areas comparative advantage rates for each sphere in non-oil sector shall be finded out. According to the CESD researches, light industry, food-producing industry, agriculture, chemical industry, electric energy industry have comparative advantages.

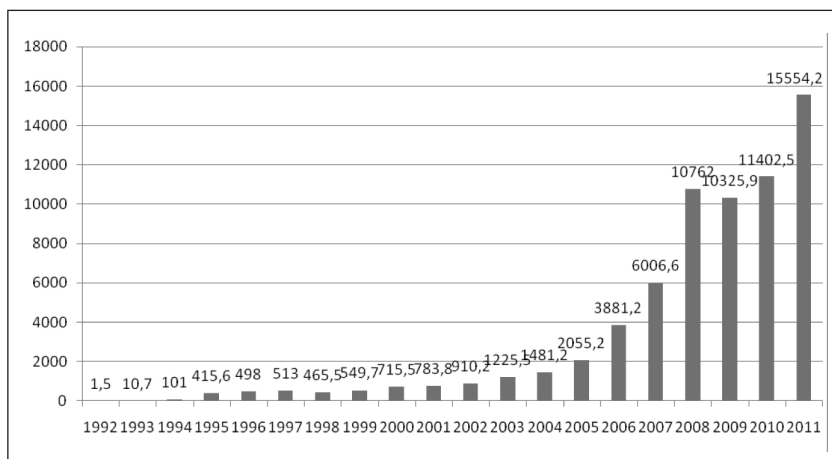
For the first time since its independence, Azerbaijan achived macro-economic stability and economic growth from 1996 to 2011. During this period the average economic growth rate was 11.8 percent<sup>23</sup>.

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<sup>23</sup> CESD calculations, based on figures from State Statistics Committee

Compared to 1992, the state budget revenues of Azerbaijan have increased more than 10 times. In this same period, the ratio of budget revenues to GDP increased from 30 percent to 38 percent.

**Figure 4. State budget revenues of Azerbaijan in 1992 – 2011 years ( in million manats).**



Source: **National Budget Group, 2011** [www.budget.az](http://www.budget.az)

As seen from the chart, except for the decrease in the budget revenues in 2009, which is considered a post-crisis period, Azerbaijan has been able to keep a steady growth rate of budget revenues in the remaining years.

These enabled Azerbaijan to implement large-scale projects such as Baku-Tbilisi-Kars railway project, the Oguz-Gabala-Baku water pipeline and other infrastructure projects. However, this rapid annual growth in budget revenues was the result of money transfers from SOFAZ. Accordingly, it is not possible to assess distinctly the growth of budget revenues.

**Table 1 . SOFAZ's transfers to the state budget**

Year	Transfers from SOFAZ to the state budget (million AZN)	Growth rate	Share in budget	Share of transfers in SOFAZ's expenditure
2003	100	--	8.2 percent	41 percent
2004	130	30.0 percent	8.6 percent	77 percent
2005	150	15.4 percent	7.2 percent	70 percent
2006	585	290.0 percent	15.6 percent	59.6 percent
2007	585	0.0 percent	9.7 percent	55.1 percent
2008	1100	88.0 percent	35.3 percent	88.5 percent
2009	4915	346.8 percent	40.4 percent	92.8 percent
2010	5915	20.3 percent	51.4 percent	90.5 percent
2011	6480	9.6 percent	53.7 percent	94.9 percent

Source: State Oil Fund of Azerbaijan, <http://www.oilfund.az>

As can be seen from the table, the State Oil Fund's budget share in 2011 increased by 64,8 times in comparison with 2003, which contradicts the principle of conserving oil money for future generations.

On the other hand, dependence on oil revenues may create risks for the future sustainability of the state budget. According to independent experts' calculations, the share of non-oil revenues in the budget totals \$5.7 billion, which constitutes 51 percent of current budget spending of \$11 billion<sup>24</sup>.

Considering that current expenses are important in terms of the state's economic functioning, barriers to this function as well as fiscal risks and social dissatisfaction may occur in the future. However, in terms of the global economic crisis, the current state of Azerbaijan's economy can be considered positive. According to official data, the growth of Azerbaijan's economy in 2011 was a result of growth in non-oil sectors<sup>25</sup>.

<sup>24</sup> National Budget Group, 2011, [www.budget.az](http://www.budget.az)

<sup>25</sup> State Statistics committee, [www.azstat.org](http://www.azstat.org)



The State Statistics Committee claims that the non-oil sector increased by 9.4 percent in 2011. Last year, the nominal volume of GDP was AZN 50.1 billion or approximately \$63 billion and this constituted 47 percent of total GDP. Although non-oil GDP has not exceeded oil GDP, for the first time since the independence of Azerbaijan, equilibrium was reached between them.

Azerbaijan managed to preserve macroeconomic stability during the crisis. In such conditions, steady enhancement of the Manat's exchange rate relative to other currencies, preservation of the inflation rate up to an optimum level by the Central Bank during high volatility in the world market, and stabilization of the financial sector have been achieved<sup>26</sup>.

Except for some unstable banks, growth in the banking system has been observed. The total capital of banks in the 10th month of 2011 has increased compared to the first month of 2011. The number of new branches and divisions of banks has dramatically increased<sup>27</sup>. Moreover, the volume of credit investments by banks in the first nine months of 2011 increased by 5.1 percent. Besides, growth in foreign trade turnover and strategic currency reserves and other related factors lead us to conclude that the world's economic crisis had little or no effect on Azerbaijan's economy<sup>28</sup>.

Despite the crisis period, Azerbaijan's strategic currency reserves increased, too. According to official data, on November 1, 2011, strategic currency reserves reached \$41.5 billion, of which approximately \$7 billion, or 17 percent, is the Central Bank's foreign currency reserves. Compared to 2010, the Central Bank's currency reserves have increased by 10 percent<sup>29</sup>. It should also be noted that the growth of strategic currency reserves is very important in terms of

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<sup>26</sup> Central Bank of Azerbaijan, [www.cbar.az](http://www.cbar.az)

<sup>27</sup> Central Bank of Azerbaijan, [www.cbar.az](http://www.cbar.az)

<sup>28</sup> Central Bank of Azerbaijan, <http://cbar.az/lpages/statistics/indicators-of-credit-institutions/>

<sup>29</sup> Central Bank of Azerbaijan, <http://cbar.az/lpages/statistics/key-monetary-indicators/>

Azerbaijan's economic reputation. It is also beneficial in terms of the flow of investments into the country because investors are always inclined to invest in countries with stable economies. The increase of Azerbaijan's currency reserves of signals to investors that it has an ability to pay and is capable of fulfilling its financial obligations in a timely manner.

However, Azerbaijan lacks active policies in its management of strategic reserves. In other words, these funds played a positive role in terms of the international image of the country's economy but didn't make a serious impact on the country's economy. At least some part of these funds could be directed to the country's economy. As a result, weakened economic growth due to increase in the oil sector can achieve favorable conditions to develop certain areas of the economy.

The volume of investments in Azerbaijan's economy continues to grow as well . According to official data, since 1994 the volume of investments in the country's economy exceeded \$100 billion<sup>30</sup>.

A growth trend was observed until 2009. However,for the first time, the volume of investment has decreased by AZN 3 billion, or \$3.8 billion in 2009<sup>31</sup>. This was attributable to the end of numerous investment projects by foreign oil companies.

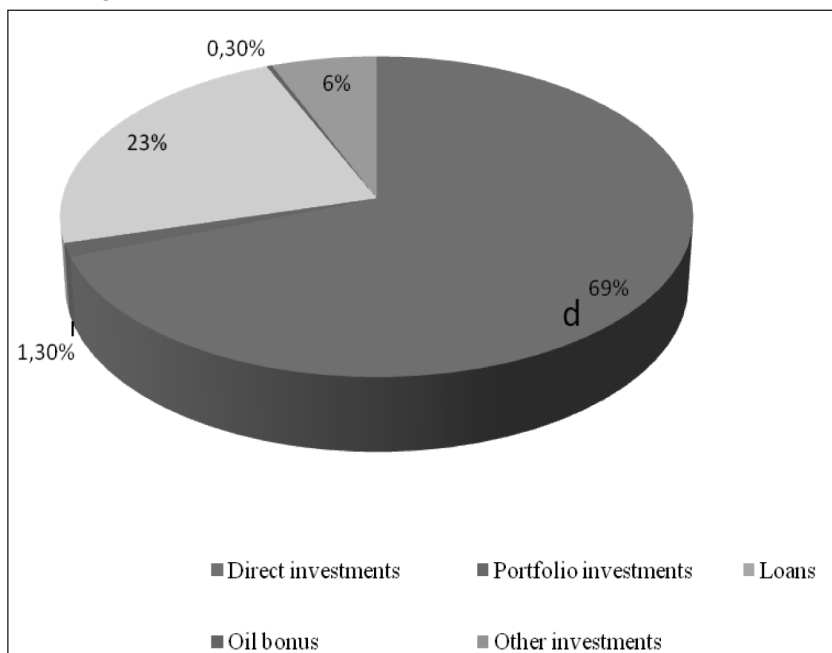
According to the Ministry of Economic Development, from 1995 to 2010, foreign investment in the country's economy totaled \$54.2 billion, which consisted of 23 percent in loans, 69 percent in direct foreign investment, 0.3 percent in the oil bonus, 1.3 percent in portfolio investments, and 6 percent in other investments.

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<sup>30</sup> State Statistics Committee, [www.azstat.org](http://www.azstat.org)

<sup>31</sup> State Statistics Committee, [www.azstat.org](http://www.azstat.org)

**Figure 5. Structure of the foreign investments into the Azerbaijani economy in 1995-2010.**



Source: Ministry of Economic Development, 2011

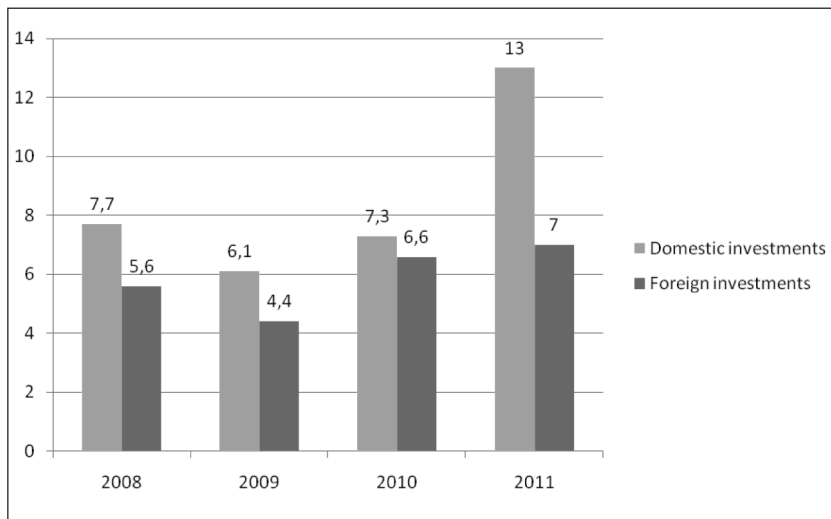
The major reason for the small volume of portfolio investments is the poor development of the securities market.

According to the results of 2011, the volume of transactions in the Securities Market totaled AZN 6 billion 717 million or 13.4 percent of GDP. If we consider that it is 4.4 times more than that of 2010<sup>32</sup>, then we can see how small the volume of securities market was in previous years. At the same time, loans are one of the fastest growing types of foreign investment. These investments mainly include loans from international financial institutions at a low interest rate with the state's guarantee. 61 percent of total foreign direct investment or 33.1 billion U.S. dollars were invested in the oil sector throughout 1995-2010. Since 2008, the volume of domestic investment exceeded that of foreign investment<sup>33</sup>.

<sup>32</sup> CESD calculations and figures of State Securities Commission, [www.scs.gov.az](http://www.scs.gov.az);

<sup>33</sup> State Statistics Committee, [www.azstat.org](http://www.azstat.org);

**Figure 6 2008-2011-directed investments in the structure of the economy of Azerbaijan (in billions of manats)**

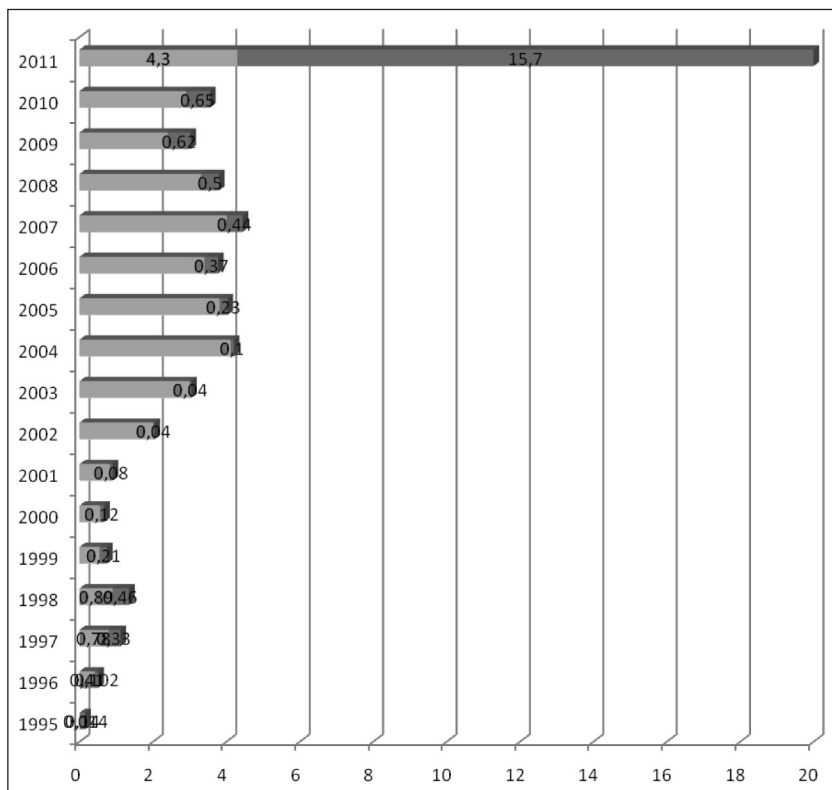


Source: Ministry of Economic Development, 2011 [http://economy.gov.az/index.php?option=com\\_content&view=article&id=1710&Itemid=155](http://economy.gov.az/index.php?option=com_content&view=article&id=1710&Itemid=155)

As seen from the diagram, the volume of domestic investments in the country's economy in 2008 was 37 percent more than the volume of foreign investments. In 2011, domestic investments exceeded foreign investments by approximately 85 percent<sup>34</sup>. It should be noted that domestic investments mainly consist of investments that are funded by the state budget. The proportion of domestic investments in the composition of total investments in the Azerbaijani economy has been increasing in recent years. The reduction of foreign investment, in particular the reduction in the volume of investments directed to the oil sector, is a result of the global economic crisis. Domestic investment growth is itself a positive factor, however, in our case these investments mainly consist of funds from oil revenues that are directed through the state budget. This dependence on oil revenues may create a risk of in-sustainability.

<sup>34</sup> Ministry of Economic Development, 2011 [http://economy.gov.az/index.php?option=com\\_content&view=article&id=1710&Itemid=155](http://economy.gov.az/index.php?option=com_content&view=article&id=1710&Itemid=155)

**Figure 7. The structure of investments to oil and non-oil sectors of Azerbaijan in 2008-2011 (In billions of U.S.dollars)**



Source: Ministry of Economic Development, 2011

As seen from the chart, although the investments in the oil sector dominated the economy in the previous years, it is a positive sign that in 2011, the volume of non-oil investments exceeded the volume of oil investments by a factor of more than 3.6. This year, for the first time, more funds were invested in non-oil sectors. However, it bears reiterating that these investments mainly came from the state budget fund.

**Socio-economic developments 2013 - 2018**

Socio-economic developments 2013-2028 will be directly depended on what extent the government of Azerbaijan will be successful on developing non-oil sector. There are some optimist tends related to

non-oil development since non-oil GDP increased up to 9.4 percent in 2011. Share of oil sector, however, still is dominant in state budget revenues which shows high oil dependency in public income. In fact, the Azerbaijani economy is dominated by natural resource-based revenues which have risen in spectacular ways in the past few years. Petroleum production provides 85 percent of Azerbaijan's state budget revenues, accounts for 67 percent of the country's GDP and 93 percent of Azerbaijan's export. Oil and oil products constituted 92 percent of Azerbaijan's export by results of January-September<sup>35</sup>.

In fact, the volume of the Azerbaijani economy in 2011, in comparison with 1991, when it earned its independence, has increased 18.5 times. If nominal GDP in 1991 was AZN 2.7 billion, or approximately \$3.4 billion with the current exchange rate, in 2011 this figure was AZN 50.1 billion or approximately \$63.4 billion. During this period, the volume of nominal GDP per capita increased 39 times and reached \$7 billion<sup>36</sup>

According to SOCAR, Azerbaijan will produce 44 million tons of oil in 2012 and CESD researches show that oil boom in Azerbaijan is doomed to end in a few years. Azerbaijan's high dependence on oil exports poses a potential threat to the economy given the potential volatility in the international oil market. Oil reserves, however, started decreasing in 2011 and last year was a peak in oil production. In long term, decreasing of oil output will cause tax revenues decline and budget deficits increase, driving up interest rates<sup>37</sup>. CESD assessment model also include tendency of decreasing of oil production in Azerbaijan.

State Oil Company of Azerbaijan (SOCAR) produced 50 million ton oil in 2010. SOCAR targets 46 million ton for 2011 which 2 million ton less than last year's output. Meanwhile, the latest predictions confirm that oil production will be decreased to about 33 million ton in 2015

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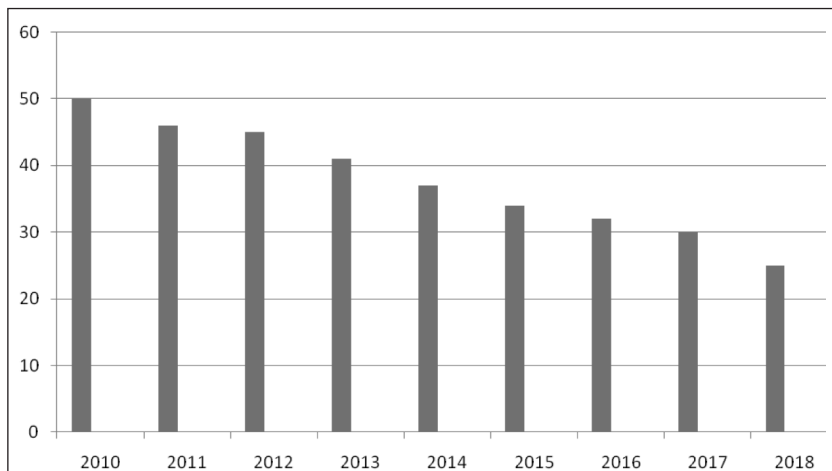
<sup>35</sup> CESD calculations

<sup>36</sup> State Statistics Committee

<sup>37</sup> State Oil Company of Azerbaijan, [www.socar.az](http://www.socar.az)

(see figure 08). Even with current prices of crude oil in the world market, SOFAZ’s assets will be totally spent within the budget lines if current unbelievable transfers’ level kept. Keeping such fantastic transfers can result in negative consequences because of theatrical cutting of budget expenditure lines due to potential lack of financial resources.

**Figure 08. Oil Production in Azerbaijan (2010-2018, million tons)**



Source; IMF, SOCAR, International Energy Academy calculations, 2011

Meanwhile, consolidated budget draft of Azerbaijan is made with the forecast of SOFAZ’s revenues at AZN 10.697 billion (\$ 13,54 billion) and expenditures at AZN 10.482 billion (\$ 13,27 billion). The Ministry reports that the Draft Law says that the oil sector will provide at least AZN 12 billion (\$ 15, 28 billion) or 73.2 percent of revenues and the non-oil sector AZN 4.4 billion (\$ 5, 56 billion) or 26.8 percent next year. Transfer to the State Budget from the State Oil Fund of Azerbaijan (SOFAZ) will reach AZN 9.905 billion (\$12.538 billion) or 60.3 percent of all budget revenues. The transfers from SOFAZ to the State Budget have shot up from \$ 686 million in 2007 to \$11.64 billion in 2011 and a decision has been taken to further raise the transfer to \$12.538 billion in 2012. It means that amount of transfers from the fund to the state budget is 18 times higher than in 2011 compare with 2007<sup>38</sup>.

<sup>38</sup> Ministry of Finance, <http://www.maliyye.gov.az/>

Figures show that positive tendency is related to non-oil GDP growth, but the government has to the best to decrease oil dependence in public revenues. Therefore, 2013-2018 trends will be mainly ordered by government reform initiatives.

### **Recommendations for economic policies**

As a result of research the main problem of the Azerbaijan economy is a high degree of dependence on the oil industry. Thus, the economic growth rate predominantly depends on oil as well. If we take into account that oil production will decrease in the coming years, the Azerbaijani economy may face macroeconomic and fiscal risks.

It is true that in recent years the government has initiated efforts to develop the non-oil sectors of the economy. In this regard, some measurable results have already been achieved: the share of non-oil sector in GDP reached 47 percent in 2011. This was the first time that the volume of investment in non-oil sectors was 3.6 times more than that of investments in the oil sector.

In spite of the foregoing, Azerbaijan has been prodigal with its funds. In other words the necessities and priorities of public investments are not seriously analyzed and properly selected.

This, in turn, reduces the effectiveness of investments. In fact, it is not the amount of money spent, but the result that is important. In some cases, investments are directed to the implementation of the same projects several times. As a result, the share of investments in the budget continues to grow instead of lessening each year. It also shows that, there is lack of strong entrepreneurship in Azerbaijan. Thus, the burden on the state increases instead of decreasing each year. Moreover, a great amount of oil money in the state budget does not have a positive impact on the economy because the budget funds are either not executed properly or are not executed at all.

The oil industry's influence on the economy of the country is so prominent that a lot of effort and power is required to reduce overdepen-



dence on it. However, if the government had taken certain steps, it would have been able to free the economy gradually from substantial dependence on oil.

The country's economic growth rate had begun to decrease since 2007, and in this regard, we have already lost more than four years. During those years, an alternative sector could have been developed. In this regard, more free economic zone experience of other oil rich countries could be used.

**For the development of non-oil sectors in the coming years the government must continue reforms in the following areas:**

- In order to attract an increasing volume of investments in non-oil sectors, the results and efficiency of the investments should be monitored closely, bureaucratic barriers should be removed, and independence of the courts should be increased.
- GDP growth rates' dependence on oil production and oil prices should be reduced. Small and medium-sized enterprises should be developed, and the economy should be diversified.
- An alternative industry or service area with the capacity of producing a product or service that can compete in foreign markets and bring export revenue into the country must be identified and developed. These areas should be given state support in at least the first year of their operation.
- The fight against monopoly and unfair competition should be strengthened and prioritized by adopting the competition code and increasing the authority of the anti-corruption department.
- Access to additional funds for small and medium-sized enterprises should be increased
- Activities of venture companies and investment funds should be supported, and banks should be motivated to offer different services in addition to the traditional ones such as credit and deposit services) by providing tax benefits.

- In the country, especially in the regions, business incubators, centers providing free legal and economic advice to entrepreneurs to improve business management skills, should be created and involve foreign experts who can participate in each center's trainings and seminars
- The number of illegal inspections by the tax authorities of business owners' operations must be reduced. A center monitoring these inspections should be created, and the number and quality of electronic services provided by the Ministry of Taxes should be increased
- The volume of funds transferred from the Oil Fund to the state budget should be reduced to an optimal level, and certain limits should be applied to the level of those transfers.
- The share of tax revenues in the budget should be increased
- Artificial barriers to foreign trade must be eliminated, and the transparency of customs must be improved, for example by, by broadening the use of electronic services in this system. The process of accession to the WTO should be accelerated.
- Control over the spending of budget funds should be strengthened by increasing civil society's involvement and the Chamber of Accounts' authority in this process.
- The fight against corruption and bribery should be accelerated and carried out systematically with special attention to the formation of anti-corruption institutions.
- The process of establishing electronic government and abolishing or combining inefficient government agencies should be accelerated. Furthermore, increased wages and social protection for employees in state bodies should be guaranteed
- State monopolization of some large agencies should be privatized to achieve more effective management and to reduce the burden on the state budget
- In order to increase the share of the agricultural sector in the economy, decrease the costs of production, and increase mar-

ket competitiveness, modern technology and practices should be introduced.

- Socio-economic development of the regions must be accelerated by improving the existing state program in this field.
- Insurance markets and insurance companies should be developed. In particular, medical insurance and high-quality medical care should be developed to reduce the burden on the state budget.
- -The quality of education and healthcare systems must be increased by providing teachers and medical staff with training at foreign universities. Subsequently, the capacity of the secondary schools and universities should be strengthened, including expanded use of the internet and integrated teaching methodology.



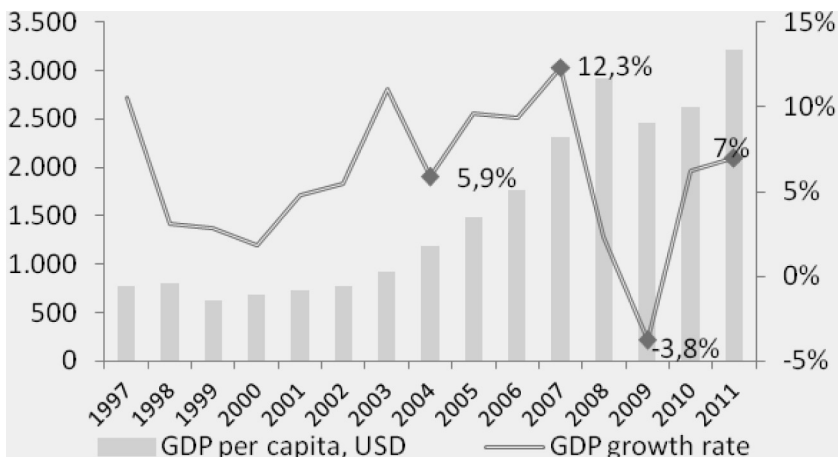
# CHALLENGES AND ECONOMIC POLICY DIRECTIONS OF GEORGIA

Alex Aleksishvili

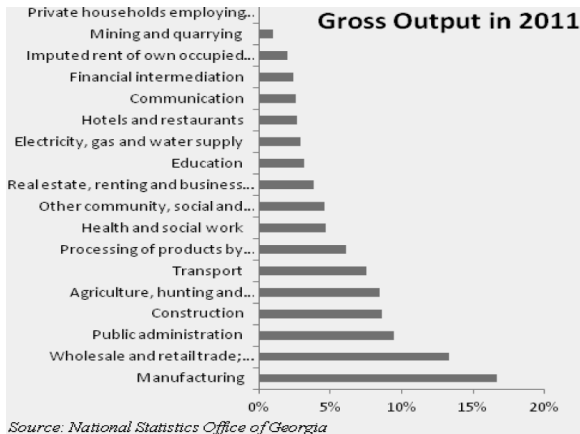
Recent political developments in Georgia may significantly change the economic policy decisions which cannot be fully reflected in this article as the policy decisions are not yet disclosed. However, part of the disclosed policy changes is already reflected in this article.

## 1. Recent Economic Trends

- Territory - 69,700 km<sup>2</sup>
- Population: 4.4 million (2003 Census)
- GDP: \$14.366 billion (2011, current prices)
- GDP per capita: \$3,237 (2011)
- Literacy rate – 100 percent (2009)
- Life expectancy at birth: 73 (2010)
- Poverty headcount ratio at national poverty line: 24.7 percent (2009)
- Current Account Balance: - \$1.682 billion, -11.7 percent of GDP (2011)
- Unemployment rate: 15.1 percent (2011)



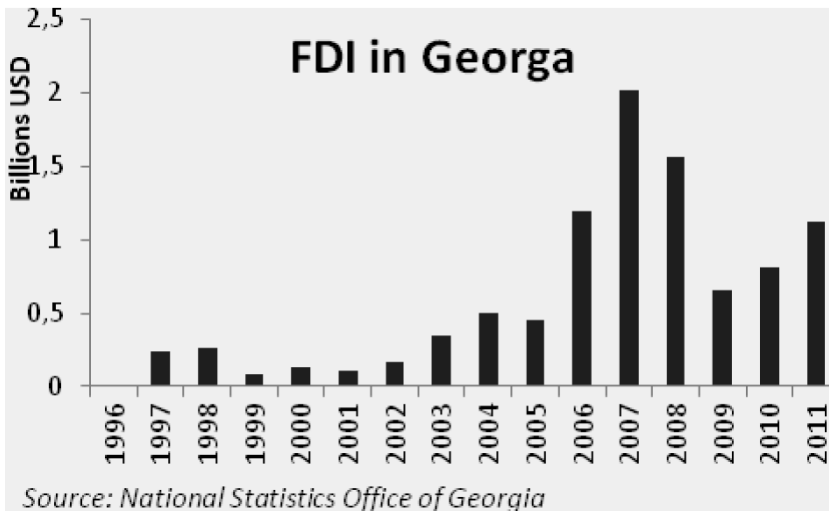
- 9<sup>th</sup> in the ranking of World Bank's Doing Business Survey, 2013
- 77<sup>th</sup> in the Global Competitiveness Index by the World Economic Forum 2012-2013 (rank out of 144)
- Labor Freedom Index 2012 - 92.1



Achieving macroeconomic stability and maintaining consistently high growth have been the top priorities for the government of Georgia for the past several years. Since 2004, Georgia has successfully implemented significant economic, institutional, structural and policy reforms, contributing to the growth of the economy. Together with improving the public institutions and increasing their capacity, the government was working hard to improve the business environment in the country, including fiscal and administrative reforms. Consistent and prudent policy implemented by the government has brought significantly positive results, demonstrated by the level of high growth of the economy, and by achieving an average growth rate of 10.4 percent for 2005-2007 and 12.3 percent in 2007. Despite the global economic crises and the war with Russia in 2008, the country was highly resilient to political and external economic shocks. Last year, the Georgian economy remained robust and grew by 7.0 percent in real terms, while high economic growth was achieved in the second half of the year, amounting to 7.5 percent and 8.8 percent in the third and fourth quarters.<sup>1</sup>

<sup>1</sup> National Statistics Office of Georgia; [www.geostat.ge](http://www.geostat.ge)

According to last year's GDP sector analysis, the manufacturing and trade sectors were the largest contributors to overall economic growth (see chart below).



Foreign direct investment (FDI) was one of the main contributors to this growth, which was characterized by high growth rates from 2004 to 2007. FDI sharply increased from 2004 and reached over \$2 billion in 2007. It is also important to note that all large projects related to the Baku-Tbilisi-Ceyhan (BTC) and Baku-Tbilisi-Erzurum (BTE) oil and gas pipeline projects were completed in 2005, that there were no comparable large projects since then. This fact shows the diversification of the sectors in the Georgian economy that attracted investment. After the war with Russia in 2008 and the global financial crises in 2008-2009, the level of FDI shrank significantly, however, but is now recovering year by year. To review the composition of FDI, the areas of transport and communications, manufacturing, real estate and energy sectors were most attractive for high investments over the last five years.<sup>2</sup>

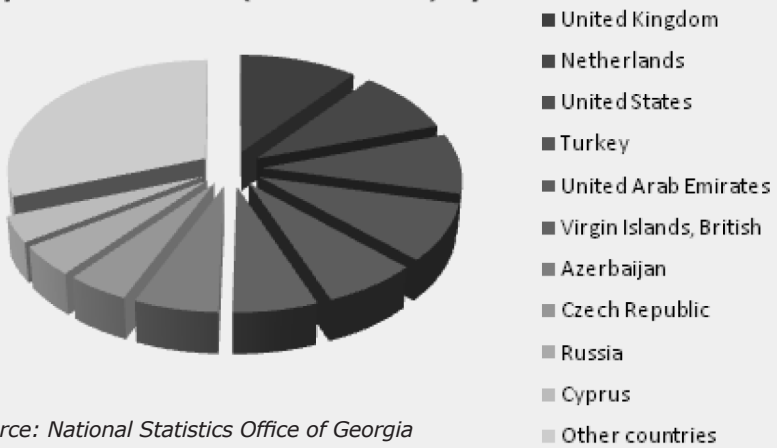
FDI also had a significant influence on Georgia's export base before the crisis of 2008, when the level of FDI inflows were observed in the export industries, e.g. metal and mining. Hence, the decreasing value of investments had a negative impact on the export market as well.

<sup>2</sup> National Statistics Office of Georgia; [www.geostat.ge](http://www.geostat.ge)

High dependency on FDI makes it an utmost priority for the economy, as without it, the country should look for alternative ways of promoting economic development, which is hard to be achieved as the country does not have a favorable capacity to rely on domestic investments.

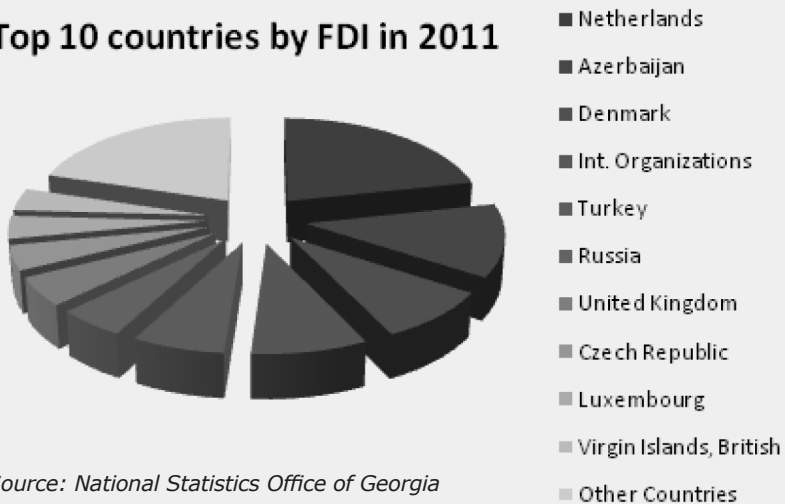
The largest three foreign investors during the year 2011 in Georgia were the Netherlands, Azerbaijan and Denmark, and during 2003-2011, the United Kingdom, the Netherlands and the United States.<sup>3</sup>

### Top 10 countries (2003-2011) by FDI



Source: National Statistics Office of Georgia

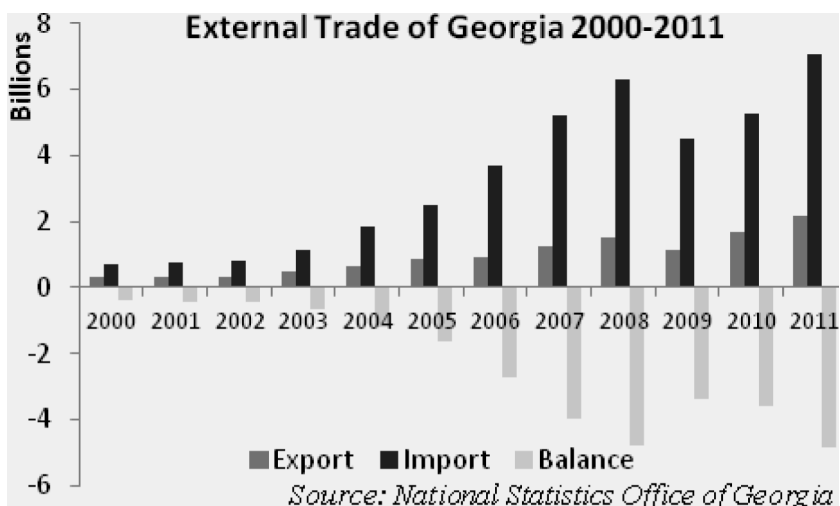
### Top 10 countries by FDI in 2011



Source: National Statistics Office of Georgia

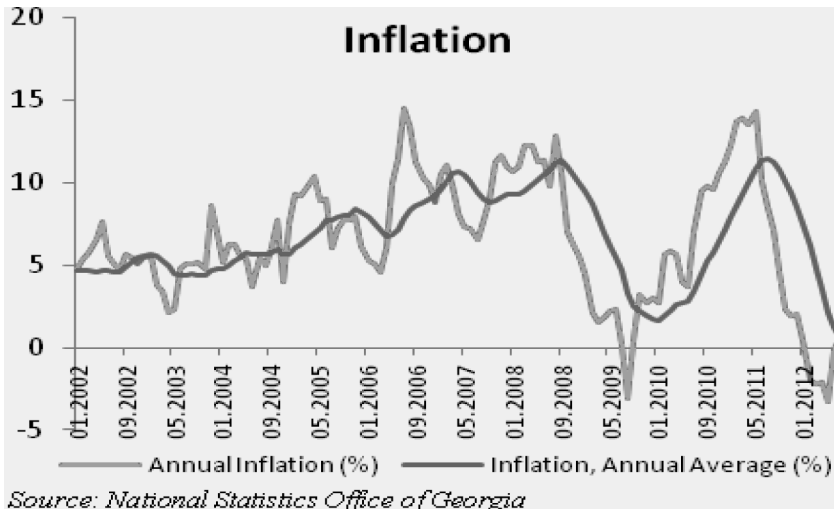
<sup>3</sup> National Statistics Office of Georgia; [www.geostat.ge](http://www.geostat.ge)





According to official statistics (Geostat), the level of external trade is increasing over the last decade, and was also interrupted by the crisis of 2008. In absolute terms, the period is characterized by an increasing trade deficit. In 2007 and 2008, the level of imports was over four times larger than that for exports, but in 2011, the share decreased to 3.2 times. A high trade deficit has accounted for a significant share in the country's current account deficit and is largely determined by it. Despite the fact that the export growth rate was slightly higher than that for imports, the trade deficit has increased in absolute terms as the amount of imports were higher.

The economic liberalization reforms implemented during these periods has been reflected in the overall picture of the trade across the border. Also, it is worth to mention that the trade statistics have dramatically improved during the early years of the reforms, 2004-2007, in part due to the successful tax and customs administrative reforms.



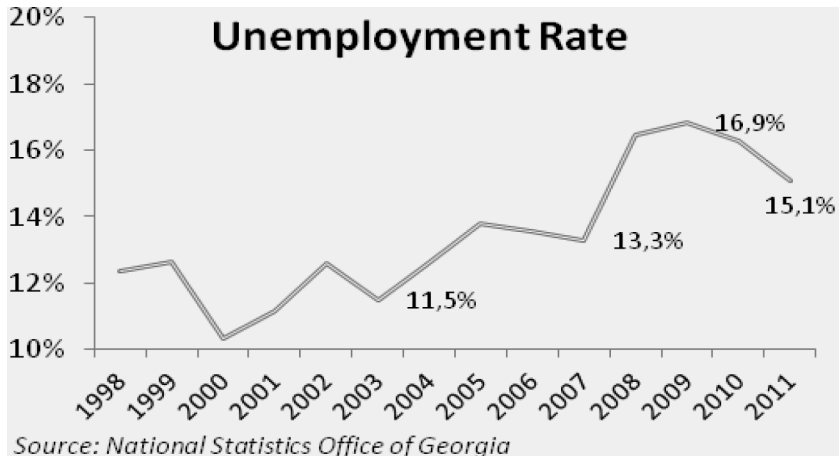
The average period inflation rate in 2011 was at 8.5 percent, while the end of period inflation rate did not exceed 2.0 percent. Currently, under the existing inflation targeting regime according to the resolution of the parliament of Georgia,<sup>4</sup> the inflation target for the years 2011-2013 is set at a level of 6 percent growth of the consumer prices in the medium term period. Accordingly, in the case of the inflation rate exceeding the targeted level, then relevant measures will follow, including a tightening or loosening of monetary policy.

In terms of an analysis of inflation, it is also worth to mention that the price dynamics of tradable and non-tradable goods, which had different tendencies during the last years. Compared to tradable goods, for example, the prices for non-tradable were increasing more rapidly before 2008. According to the NBG analysis<sup>5</sup> after the crisis in 2008, *“these tendencies faded, as the overall macroeconomic environment precluded drastic increases in aggregate demand leading to a slowdown in prices for non-tradable. In contrast, high volatility in the international markets immediately affected prices for tradable goods. In parallel to global commodity price gains, there was a rapid acceleration in domestic*

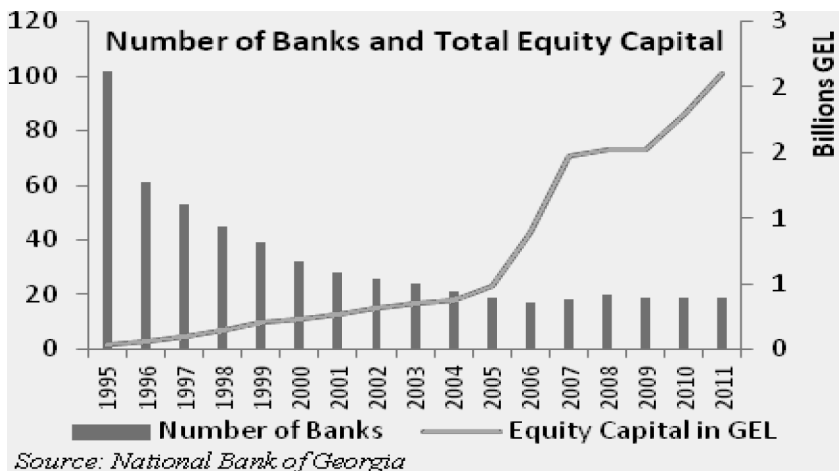
<sup>4</sup> Resolution of the Parliament of Georgia “On Main Directions of Monetary and Exchange Rate Policies in 2011-2013

<sup>5</sup> Annual Report 2011, National Bank of Georgia

prices for tradable.” Imported goods hold a significant share of the consumer basket in Georgia and accordingly, the price dynamics in trading partner countries have a strong influence on domestic inflation, which was quite clearly demonstrated over the last decade.



Unemployment is one of the biggest challenges facing the government of Georgia, which has been gradually increasing over the last decade. Compared to 2010, the unemployment rate has dropped in 2011, and reached 15.1 percent. The structure of employment was also reshaped, and the share of hired employees (vs. self-employed) has increased from 32 percent to 38 percent.



The financial sector in Georgia was mainly dominated by commercial banks during the last decade, which was one of the most dynamic sectors of the economy. As of 2011, according to the official statistics published by the National Bank of Georgia there are 19 commercial banks operating in Georgia, which own more than 95 percent of the total assets of the financial sector, or 52.3 percent of GDP. In terms of foreign capital participation and ownership, there were 15 Georgian banks and two branches of foreign banks. The share of non-residents in the banks' paid-in capital equaled 84.4 percent. These banks also control 93 percent of total banking assets and 98.4 percent of non-banking deposits.



The banking sector is the most developed among other financial institutions in Georgia, leaving behind the non-bank depository institutions, microfinance organizations, exchange bureaus, stock exchange, insurance companies and pension funds. There were 105 commercial banks registered in Georgia in 1995 and since then, the number has been decreasing over time and the total equity capital of banks was significantly increasing. The inflow of foreign capital in this sector has had a substantial impact on the industry, which is also shown on the graph for the years 2005-2006 (see above).

The securities market in Georgia is at a very early stage of development. The Georgian Stock Exchange represents the securities market and has been operating since 1999, and based on 2011 data, its assets represent some 0.01 percent of total assets of the financial sector.

The insurance market is also at a low level of development in Georgia, which as of 2011, according to the annual report of the national bank of Georgia,<sup>6</sup> was represented by 16 insurance companies with total assets of GEL 504.1 million, including one branch of a foreign insurance company, and three of them owned by non-residents.

Georgia currently has a floating exchange rate regime which was applied during the last decade by using various levels of interventions and regulations that resulted in different levels of flexibility over the period. During this period, the exchange rate was not characterized as having rapid changes if not considering the one in November 2008, when GEL/USD depreciated by 16 percent, mainly as a consequence of war and the global financial crisis. Looking at 2002-2012, the Lari to USD monthly exchange rate was between 2.23 and 1.4, which since 2002, entered into the stage of appreciation and currently stands at around 1.65.

The overall priority of the exchange rate policy of the National Bank of Georgia (NBG) for the past several years was to promote market principles in exchange rate formation, develop a foreign currency market and maintain the level of international reserves at an adequate level. For the last 2-3 years, the goal was to gradually achieve a free floating exchange rate via reducing the foreign exchange intervention and allowing more short-term volatility to reduce speculative pressure, contributing to overall macroeconomic stability. In 2009, the Tbilisi Interbank Foreign Exchange mechanism was changed to the Bloomberg trading system and NBG interventions switched to volume-based auctions, and since then, NBG intervention has been reduced significantly. According to the NBG annual report for 2010-2011, the volume of NBG purchases/sales of foreign currency was approximately four times less than in 2008, and resulted in a smaller share in the interbank FX market turnover, thereby promoting market principles. Regarding international reserves adequacy, according to the traditional reserve adequacy indicators it appears to be adequate. The foreign currency reserve in absolute terms on average was

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<sup>6</sup> Annual Report 2011, National Bank of Georgia – [www.nbg.gov.ge](http://www.nbg.gov.ge)

increasing over the last decade, increasing from \$199 million at the end of 2005 to \$2.59 billion by the end of 2011, which has significantly improved the traditional indicators, with gross international reserves in proportion of months of imports increasing from 2.8 percent in 2007 to 4.3 percent in 2011.

The public finance indicators of Georgia have significantly improved for recent years. This was due to the fact that in 2004, the Georgian government started to implement economic reforms and managed to successfully accomplish a number of very important reforms in the tax, customs, and budget spheres in a relatively short period of time. The Tax and Customs Codes of Georgia has been unified and changed to be simple and easy. The number of tax categories has decreased from 21 to 6 and at the same time, tax rates were significantly lowered, setting one of the lowest tax rates in the region (e.g. VAT 18 percent, Income Tax 20 percent, and Profit Tax 15 percent).

The main source of consolidated budget revenue over the last decade was from taxes that were 80.8 percent of the total revenue in 2002 and increased to 89.3 percent in 2011. With regards to the taxes, the income from the value added tax was the biggest contributor, followed by the income tax and profit tax.

## Dynamics of the Consolidated Budget Revenue

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011*
Revenue (millions of Gel)	1143,7	1345,0	2266,9	2828,9	3850,2	4972,7	5854,2	5264,5	5865,8	6873,7
Percentage of Revenue:										
Taxes	80,8%	74,8%	67,5%	70,1%	68,7%	73,8%	81,2%	83,4%	83,0%	89,3%
Income Tax	15,5%	15,2%	17,6%	14,7%	14,6%	14,4%	27,3%	25,5%	24,7%	25,3%
Profit Tax	8,9%	10,1%	10,6%	10,6%	12,9%	15,1%	12,5%	11,8%	11,8%	13,6%
Value Added Tax	43,8%	40,5%	43,2%	49,8%	50,4%	53,8%	43,5%	46,7%	45,3%	45,4%
Excise	18,7%	19,3%	13,9%	15,5%	13,8%	11,7%	10,9%	10,1%	11,5%	10,0%
Custom Tax	6,4%	8,0%	9,4%	6,3%	5,0%	1,4%	1,1%	0,8%	1,4%	1,5%
Property Tax	3,3%	7,0%	4,1%	3,0%	3,2%	2,9%	2,8%	3,7%	3,9%	3,6%
Other non- classified Taxes	3,4%	0,0%	1,3%	0,2%	0,2%	0,7%	2,0%	1,4%	1,3%	0,6%
Social Contributions	11,8%	16,6%	17,7%	15,2%	13,1%	14,5%				
Grants	2,0%	3,6%	5,5%	3,7%	5,1%	2,1%	10,5%	7,4%	8,0%	3,3%
Other revenue	5,5%	5,1%	9,3%	11,1%	13,1%	9,6%	8,3%	9,3%	9,0%	7,5%
Source: The National Statistics Office of Georgia										

The Georgian government has made significant efforts to achieve easy filing (e-filing) and easy procedures, improved tax and customs control and administration. In spite of easing the tax burden, the ratio of tax revenues to GDP increased from 12 percent in 2003 to 25 percent in 2008 and being kept stable. In 2011, tax revenue to GDP ratio reached 25.3 percent and total revenue to GDP to 28.4 percent, and the Georgian government now plans to further improve the tax filling and payment procedures for taxpayers and also to bring down some tax rates that will further facilitate investment climate improvement and in turn to robust economic growth.

To further facilitate the economic liberalization process, the government has enacted a new law, the Economic Liberty Act, according to which, beginning in 2013, the budget deficit shall not exceed 3 percent of GDP, and budget expenditures at 30 percent of GDP, while the public debt is set to a 60 percent of GDP limit. In addition, under the same law, the government will not be able to increase national taxes without conducting a national referendum.

Another vital achievement of the Georgian administrative, structural and policy reforms was a significant reduction in the informal economy, which has been reduced from around 65 percent to 15 percent of GDP. Eventually, Georgia achieved mass-corruption free environment that was widely acknowledged by the international community, including, Transparency International, among others.<sup>7</sup>

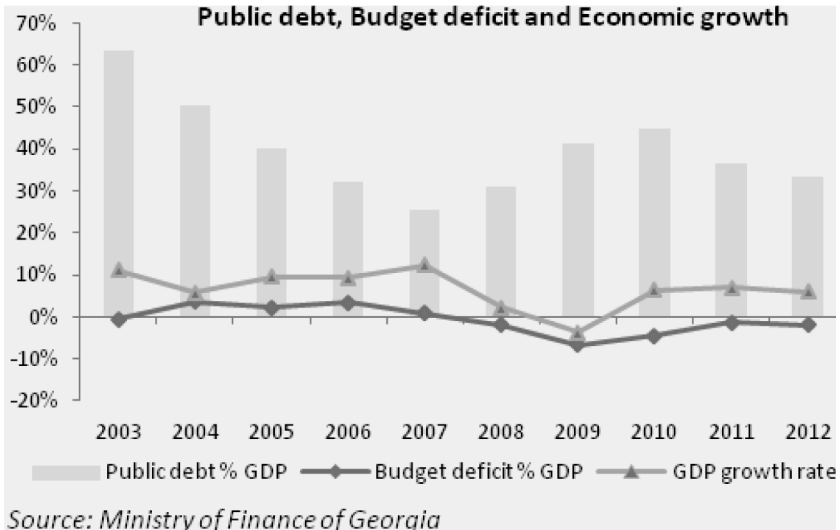
The introduction of the Medium Term Expenditure Framework (MTEF) and a program-based budgeting approach, better macroeconomic analysis and the allocation of resources according to the priorities was another contributor to this success. The government introduced a Basic Data and Directions (BDD) document that defines the balance between current and capital expenditures in the medium term in order to ensure sustainable growth. Other important changes have been implemented in the treasury and accounting and reporting

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<sup>7</sup> Corruption Perceptions Index 2011, Transparency International; <http://cpi.transparency.org/cpi2011/press/>



systems and on top of that the e-Treasury and International Public Sector Accounting Standards will be introduced for public sector in the coming years to further improve accounting and reporting of government finances.



The public debt and budget deficits in Georgia were kept at sustainable levels during the last decade and there were no significant threats in these regards, which are vital indicators in assessing the fiscal sustainability of the economy. Public debt was on a decreasing path during the years 2003-2007, decreasing from 63.2 percent to 25.5 percent, which was caused by accelerated payback to several debtors (including, Turkmenistan, Austria, etc. ), high GDP growth rate and to some extent, exchange rate appreciation, as 85 percent of public debt was external debt, nominated in US dollars. Also, according to the GFS 2001 classification of the International Monetary Fund (IMF), the budget deficit was negative in these periods.

In 2008-2010, public debt was increasing, caused by a significant increase in the budget deficit, and then decreased in 2011, reaching 36.7 percent of GDP. Based on current data, the marginal indicators of public debt do not approach the marginal levels of traditional debt burden parameters and the budgetary system is fiscally sustainable. However, the country’s total external debt should also be mentioned,

which currently exceeds \$11 billion. On the one hand, total external debt has a significant impact on the country's credit ratings, which in turn, determines the interest rate of the country's future liabilities, including the accessibility and interest rates of the sources of financing the state budget deficit and on the other hand, if the private sector is not able to service external liabilities, it will become the government's challenge.

The state budget expenses were increasing in parallel to the increase in budget revenues. Increasing public debt was pushing up the debt service costs, rising from 1.7 percent in 2008 to 4 percent in 2011. Social expenditures were also increasing in nominal and relative terms. In the past few years, almost a quarter of the total budget amount was spent on these items.

The fiscal policy of Georgia was significantly affected by the Russia-Georgia war of 2008 and the global financial crisis in 2008. As a result of the decrease in GDO, budget revenues were decreased, but the government could not manage to decrease the budget expenses, indeed to overcome the economic crises, the government chose to adopt a fiscal stimulus and used a \$2 billion package for it. As a result, budget deficit increased by up to 6.7 percent, making Georgia highly dependent on debt and donor assistance.

As of 2011, spending on social benefits was around 29 percent of the consolidated budget expenses and the dynamics of the consolidated budget spending follows:

#### Dynamics of the Consolidated Budget Expenses

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011*
Expense (millions of Gel)	1114,1	1261,4	1835,8	2425,9	2978,7	4379,0	5410,9	5397,1	5480,3	5786,6
Percentage of Revenue:										

Compensation of employees	19,9%	22,9%	25,8%	22,7%	18,9%	15,9%	18,6%	19,4%	20,4%	19,6%
Use of goods and services	29,2%	25,4%	23,4%	23,6%	26,4%	36,3%	29,7%	20,5%	20,8%	20,9%
Interest	13,2%	13,4%	8,3%	5,0%	3,5%	2,3%	2,2%	3,2%	3,8%	5,0%
Subsidies	9,4%	8,3%	11,8%	18,0%	14,1%	6,1%	6,7%	11,4%	6,9%	7,4%
Grants	0,0%	0,0%	0,0%	0,2%	0,2%	0,4%	0,2%	0,2%	0,2%	0,2%
Social benefits	28,3%	30,0%	29,8%	23,0%	22,2%	21,3%	24,9%	27,9%	29,6%	28,6%
Other expense	0,0%	0,0%	0,9%	7,6%	14,7%	17,7%	17,6%	17,5%	18,3%	18,3%
<i>Source: National Statistics Office of Georgia</i>										

In parallel with lowering the tax burden and liberalizing the economy, the government has changed its approach to social security to improve the effectiveness of the system, which in case of social assistance was targeted assistance for those individuals whose economic conditions were below the established threshold. The new system allowed the government to give more attention to the part of the population that needed the assistance the most. The pensions have also increased and the government's goal is to further increase and to improve the social safety net for retired citizens. As of 2011, some 509,324 helpless families were registered in the unified database and 26 percent were receiving subsistence allowance and the total number of pensioner amounted 826,750, including old age pensioners, disability pensioners, survivor's pensioners, victims of political repressions and seniority pensioners. The state pension system in Georgia is organized as a universal pay-as-you-go where allocations model are made from the state budget. The current voluntary private pension schemes are at the very low level of development with a quite insignificant value of total assets.

The health sector in Georgia has also influenced major reforms over the past decade, resulting in a high share of the private sector participation in the field. The government has introduced a subsidized medical insurance mechanism available for the elderly population, children (under age 5) and individuals whose income are below the poverty line. The overall goal of the government was to increase the health condition of the population and increase the accessibility to the health services, but a significant improvements are still needed in this area as big part of the population is without an insurance policy and government funding is not sufficient to cover health service costs, leading to limited access to the health services, which remains as one of the biggest challenges for the government.

The education sector's restructuring and financing in Georgia was gradually developing over the last decade when some major changes and improvements were implemented, and resulted in increasing the fairness, objectivity and credibility of the system. However, the overall quality of general education still at less than favorable levels in Georgia and the government has invested in efforts to address this issue, which is also to emphasize in the current government strategy for the development of education through 2015. According to World Bank data, net student enrollment, gross primary and secondary enrolment rates and school completion rates have all improved in the past several years when public spending on the education is lower compared to the region, varying between 2.1-3.2 percent of GDP during the years 2000-2009. In 2009, the expenditure per student for primary, secondary and tertiary education was 14.8, 15.5 and 11.4 percent of GDP per capita respectively, and the adult literacy rate was 99.8 percent.

Among some of the most significant achievements in this field, reforms in higher education admission exams drastically changed the system and sharply decreased corruption, and resulted in a more fair and objective admission system in universities. Also, in recent years, the focus was given to improvements in ICT literacy (e.g. providing net-books to first graders), English language proficiency, teacher qualifications and other measures, etc.

According to official statistics, the share of the population living in poverty was reported to be 6.4 percent, which increased up to 9.9 percent in 2009 and then decreased to 9.2 percent in 2011. Regarding the standard of living, there are some indications of an improved situation, including improved access to natural gas, clean water and electricity. Providing adequate support and assistance to internally displaced persons (IDPs) was a serious challenge for the government of Georgia and the situation was worsened as the number of IDPs from the 1990s increased as a result of the war with Russia in 2008.



According to the World Bank, the reported Gini index in the year 2008 stood at around 41. According to the inequality indicators published by the National Statistics Office of Georgia, the share of the population under 60 percent of the median consumption has decreased from 24.6 percent in 2004 to 21 percent in 2009 and then increased to 20.3 percent in 2011, with more improvements observed in urban areas.

## 2. Challenges, Bottlenecks & Problems

The recent transition of the government's legislative power from one party to another is expected to change approaches to economic and social policy in Georgia. Currently, the economy of Georgia faces some major issues that could be thought as problems and challenges, including the following:.

Foreign direct investment: a very significant factor for sustainable economic development of Georgia, for a country having a significant trade deficit. Sustainable growth and a continued inflow of foreign direct investments are of vital importance for the Georgian economy that government is trying to facilitate by ensuring the adequate business climate and offering favorable conditions.

Social pressure: the increasing demand on social spending is another significant challenge for the government. Signals of the new political situation gives a sound basis for forming expectations that substantial changes to social policy will be coming. While the government is willing to further decrease the level of public expenditure, the political pressure will be a significant burden. While social expenditures were increasing over the last decade, there is still a big gap to be filled in this area, which pushes up public spending.

Unemployment, which despite the successful structural and administrative reforms, economic liberalization and improvements in the overall macroeconomic situation, continues to be one of the biggest challenges of the country.

Property rights, the rule of law and legal systems are the areas where Georgia was not performing well enough over the last decade and that remain as one of the key burdens for the development. The same is true for the region as well.

One of the most significant factors that literally effect the overall economy and the social environment is a political stability of the country itself and the region, which over the last two decades was seriously starving from stability and was plague by negative signals. Despite the government's huge efforts in creating an attractive business climate, political stability is still a major burden in changing the big picture. Regarding Georgia's political stability, the country has two conflict regions, territorial disputes with Russia over Abkhazia and South Ossetia, which continue to be a source of huge concern for business and general society. The risk from unpredictability is

translated in everyday business and general decisions that impact long term development of the country. However, it is worth to mention that recent the parliamentary election was a significant step forward in Georgia's political stability when the country's legislative power was transferred as a result of elections-a good signal of being committed to democracy and a sound basis for political stability.

Regarding regional stability, the territorial disputes over Nagorno Karabakh between Armenia and Azerbaijan is also a major threat to the regional stability. On top of that, the unfavorable relationship between Armenia and Turkey plays a negative role as well. The lack of regional cooperation in a number of areas has a negative impact on the parties involved and artificially pushes down overall welfare. As of regional political stability, the coming years are also very important as Armenia, Azerbaijan and Georgia are going to hold presidential elections, that may naturally have its impact on the regions overall environment.

It is very important to further develop the fields of energy, infrastructure, transports and communications, agriculture and manufacturing, which could be a challenge for the government. The real sector in Georgia is at a low level of development. Georgia's geographic location brings challenges but it also brings advantages as a transit country connecting countries in the region and giving excess to Europe and Central Asia, the shortest route. This advantage should be further facilitated and encouraged by the Georgian government by creating favorable environment and responding to the demand. **The fields of agriculture and food processing are at low levels of development in Georgia as well, with only 9.3 percent of added value in agriculture of GDP that is one of the biggest challenges as the big part of the self-employment comes from this industry.**

### **3. Priority Reform Areas**

There are several areas where strong commitment from the government is necessary to achieve desirable results. The overall goal of the government should be the further improvement of the

business environment, which depends on various interrelated factors. As a small economy without substantial natural resources, Georgia should increase its attractiveness on a regional and international level for investors. The environment is directly and indirectly effected by the factors out of the government's competence but the state should strive to improve areas under their control and make significant efforts to weaken these influences.

Georgia has implemented a number of reforms to facilitate regional integration but more attention should be given to it. The government should be committed to the economic openness, scaling up the economy and hence increasing regional integration, which will eventually increase the overall welfare and benefit all parties involved.

Another important success would be to achieve more competitive input prices via increasing competition and greater openness of the economy. The government has successfully implemented economic, structural and administrative reforms but more in-depth analysis of this challenge is required, followed by the efficient policy and activities. Georgia is trying to expand new and/or nontraditional markets to increase country's export and in parallel, attention should be placed on the facilitation country's export potential. Working on increasing bilateral and multilateral trade agreements in order to further facilitate the international trade should be a priority for the country.

The continuous strengthening of public institutions is another activity that the government should be committed to. Despite the successfully implemented and widely acknowledged structural and administrative reforms, the capacities of public institutions should be further developed. Their effectiveness could be a sound basis for country's economic development.

The rule of law and a good legal system should be the goal of any government and this area is of a particular interest for Georgia as it was lagging behind compared to the improvements in other fields.



The government's strong and credible commitment is very important in this area and there is a best time for a newly elected government to implement rapid but sustainable reforms in these fields. If the will of achieving success is in place, than only technicalities are left that are easy to implement.

Developing the energy sector: during the last five years Georgia has achieved high reliability in the energy sector and significant improvements have been observed in this field. It is very crucial to further develop the system, increase electricity generation in order to meet the increasing domestic demand and trade with the neighbor countries.

Developing the transport sector: developing a transport sector and improving the infrastructure have been one of the key priorities for the government of Georgia since 2004. Geographically, the country has a favorable location as it offers the shortest route between Asia and Europe. The further development of the sector is very crucial and the government should continue its commitment to it, ensuring that high quality infrastructure is in place to meet the future demands.

Developing the fields of agriculture and food processing: these sectors are at very low stages of development, creating a low number of value added and significant efforts needs to be undertaken in this regards.

#### **4. Socio-economic developments 2013-2018**

According to the ministry of finance of Georgia,<sup>8</sup> the forecasted key macroeconomic parameters for Georgia is as follows:

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<sup>8</sup> Ministry of Finance of Georgia - Key Economic and Financial Indicators 2013 - [www.mof.gov.ge](http://www.mof.gov.ge)

## Key Economic and Financial Indicators of the Ministry of Finance of Georgia

	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>
Real GDP Growth Rate	7,0%	6,0%	7,0%	7,0%	7,0%
GDP Per Capita in US dollars	3586,0	3972,2	4505,3	5109,9	5795,6
CPI e.o.p.	2,5%	5,5%	6,0%	6,0%	6,0%
Export (% of GDP)	20,6%	20,8%	22,3%	22,6%	22,6%
Import (% of GDP)	18,0%	14,5%	17,2%	17,2%	17,2%
Current Account	-11,3%	-10,5%	-9,0%	-7,3%	-5,3%
Trade Balance	-24,4%	-23,9%	-23,5%	-23,0%	-22,2%
Gross International Reserves					
in month of imports	4,3	4,3	4,3	4,3	4,3
mIn US Dollars	3325,5	3857,6	4513,4	5280,7	6178,4
General Government Debts					
Government debt, as percent of GDP	35,8%	32,8%	30,0%	27,8%	25,8%
Foreign debt, as percent of GDP	28,4%	26,1%	23,9%	22,3%	20,8%
Domestic debt, as percent of GDP	7,3%	6,7%	6,1%	5,5%	5,0%
Consolidated Budget (% of GDP)					
Revenues	28,0%	26,3%	24,8%	24,4%	24,0%
Expenses	23,1%	22,9%	21,8%	20,8%	20,2%
Net Operating Balance	5,0%	3,4%	3,0%	3,6%	3,8%
Net Lending/Borrowing	-1,3%	-1,7%	-1,7%	-1,6%	-1,2%
<i>Source: Ministry of Finance of Georgia</i>					

The ministry of finance of Georgia has estimated figures up to the year 2016. With regards to the alternative source of forecasts the figures estimated by the International Monetary Fund<sup>9</sup> (IMF) is as follows:

International Monetary Fund – Work Economic Outlook Data

<b>Parameter</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>
GDP, current prices (in US mIn Dollars)	17 284	18 318	19 803	21 935	24 306
GDP, deflator	222,61	235,96	250,12	265,13	281,03
GDP per capita, current prices (in US Dollars)	3 824	4 042	4 370	4 853	5 404
Total investment (Percent of GDP)	24,80%	24,30%	24,30%	24,30%	24,30%
Gross national savings (% of GDP)	13,64%	15,33%	16,50%	16,95%	17,62%
CPI, e.o.p. (% of change)	6,00%	6,00%	6,00%	6,00%	6,00%
Unemployment rate	13,82%	13,35%	12,81%	12,22%	11,43%
Population (in millions)	4,52	4,53	4,53	4,52	4,49
General government revenue (% of GDP)	27,74%	27,38%	27,15%	26,94%	27,00%
General government total expenditure (% of GDP)	29,86%	29,51%	28,86%	28,34%	28,25%
General government net l/b (% of GDP)	-2,12%	-2,13%	-1,71%	-1,39%	-1,25%
General government gross debt (% of GDP)	32,15%	31,56%	30,14%	28,65%	26,84%
Current account balance (% of GDP)	-11,16%	-8,97%	-7,79%	-7,35%	-6,68%
<i>Source: International Monetary, World Economic Outlook</i>					

<sup>9</sup> International Monetary Fund – World Economic Outlook - <http://www.imf.org/external/data.htm>

## **5. Recommendations for economic policies**

According to recent developments and current challenges, it is advisable that the Georgian government will improve the above listed priority areas, summarized below:

- Further improve the business environment;
- Scaling up the economy – further integration;
- Increase competition, achieving competitive input prices;
- Strengthen public institutions, improve public finance management, and improve the rule of law and judiciary;
- Keep the size of the government at a sustainable level and ensure the fiscal and macro stability of the country.

# CHAPTER III

## CROSSROADS FOR ENERGY SOURCES AND ROUTES: TRENDS AND SCENARIOS



# **ENERGY SECURITY IN ARMENIA: CHALLENGES AND OPPORTUNITIES**

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The issue of energy security is directly linked to the issue of security of the state, while the latter cannot work effectively without the existence of modern energy security systems. The energy crisis, which started in Armenia in the 1990s, was a result of mistakes made in the development of energy security strategy rather than the Nagorno Karabakh war.

Against the background of the collapsing Soviet Union, the energy crisis in newly independent Armenia was a possible, but not a compulsory condition in Armenia; the Republic of Armenia would escape the lasting energy crisis if there was a knowledge-based approach on national security, in general, and energy security, in particular. Armenia's energy security system has always been closely connected with relations with Russia, since that country continues to be the main source of energy imports for Armenia. The collapse of the USSR negatively affected all republics, but the impact on Armenia was even greater, as the country found itself in energy blockade. The Armenian economy was generally working on the basis of imported raw materials (about 80 percent). The suspension of imports resulted in the collapse of the economic system.

These were the lessons that subsequently served as a ground for the creation of a modern energy security system in Armenia. One can insist that Armenia's current energy system is based on the exclusion of recurrence of the energy crisis of 1990s. The energy crisis of 1991-1995 fully revealed the main reasons of energy crisis in Armenia. The new energy strategy, which was worked out with consideration of this experience, continues to be successfully implemented up until today.

## 1. Recent Trends in Energy

Armenia's energy is a key branch of industry of the republic, which continues functioning under the condition of scarcity of natural resources. The country has a well-developed electric network and ensures a 24h/365 days combination to cover the demand of electricity. Today, Armenia is a large regional energy center with a diversified system of energy carriers and substantial export potential. According to the predictions of the Ministry of Energy and Natural Resources, the expected demand for electricity may reach 23,214 GWh by 2030 (exports included). To provide the predicted demand for electricity the Armenian government has worked out the strategic priorities and directions of the development of the energy system, at the same time, indicating the investment programs allowing the realization of that strategy.<sup>1</sup> In the long-term, special attention is devoted to Armenia's expanded integration with regional energy markets.<sup>2</sup> Armenia's energy system has considerable potential both to supply base-load power to neighboring countries and ensure transit overflows.

The construction of a new power block meets the long-term strategy of the country, as it will allow Armenia to cover its domestic demand and expand the export basis of inter-regional cooperation, primarily with Iran, Georgia and Turkey.

The activity of Armenia's energy system is largely dependent on imports, the continuous growth of which over the past three years is connected with the unprecedented growth of the volume of energy consumption, which comprised only about 10 percent in 2010-2011; this trend continued in 2012. This, in turn, is a result of the economic growth in Armenia, which is closed 2012 with over 6 percent economic growth.

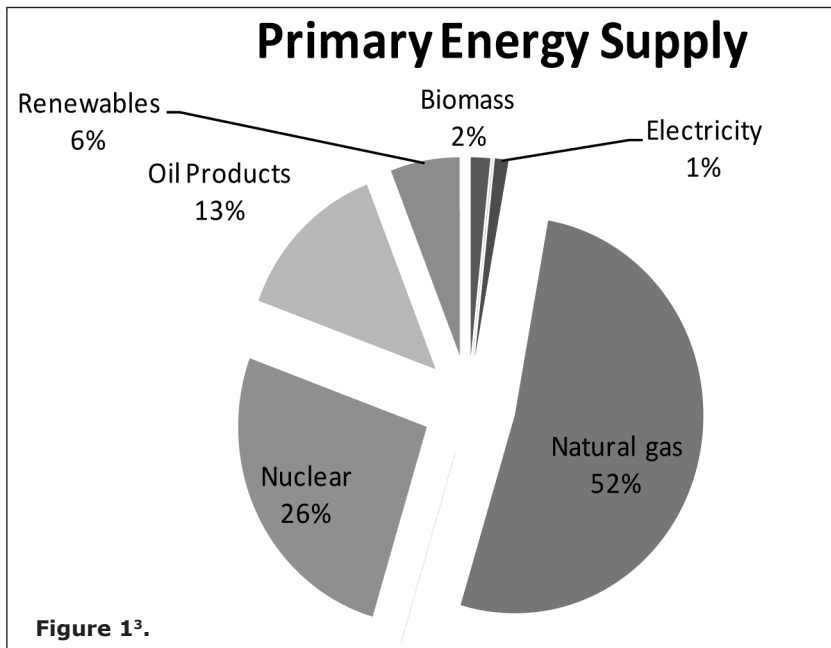
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<sup>1</sup> Development Strategies in the Context of Economic Development in Armenia. Adopted by the Government of Armenia at June 23, 2005 session.

<sup>2</sup> В.О. Саркисян, Т.С. Гнуни. Армянская энергосистема: современное состояние, перспективы развития, вопросы региональной интеграции. Евразийская экономическая интеграция, № 4(5), ноябрь 2009



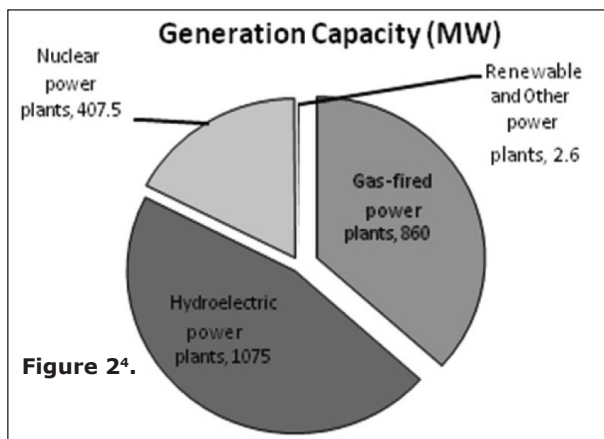
The main energy imports for Armenia are gas (52 percent), followed by nuclear fuel (26 percent) and oil products (13 percent), etc. (see Figure 1).



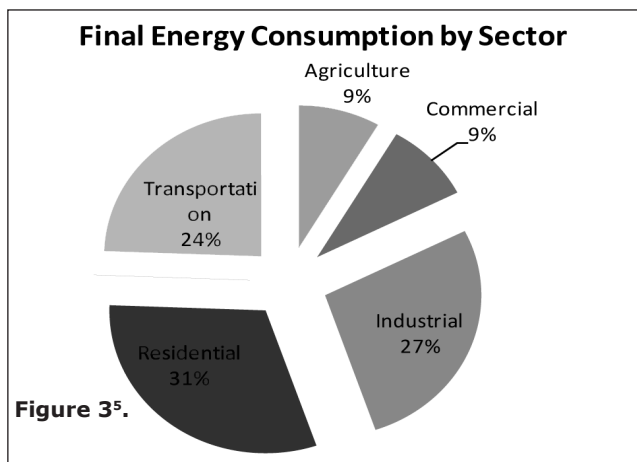
Among the energy capacity in Armenia (the question refers to the currently functioning capacities), the capacity of thermal power plants is 860MW, the currently functioning nuclear power plant has a capacity of 407MW, while the capacity of hydroelectric power plants reaches about 1,075MW (see Figure 2).

<sup>3</sup> USAID. REGIONAL ENERGY SECURITY AND MARKET DEVELOPMENT. Energy Policy Analysis with the MARKAL-Armenia Energy System Model. Energy Strategy Center of Scientific Research Institute of Energy (ESC/SRIE), Yerevan, Armenia. 13 November, 2012

## Primary Energy, Generation Capacity, Final Energy Consumption (2006)



The population remains the number one consumer of energy in Armenia (31 percent). The unprecedented economic growth in the field of industry over the past three year has caused the growth of consumption of energy in that sphere, which currently reaches about 27 percent (see Figure 3).



<sup>4</sup> USAID. REGIONAL ENERGY SECURITY AND MARKET DEVELOPMENT. Energy Policy Analysis with the MARKAL-Armenia Energy System Model. Energy Strategy Center of Scientific Research Institute of Energy (ESC/SRIE), Yerevan, Armenia. 13 November, 2012

<sup>5</sup> USAID. REGIONAL ENERGY SECURITY AND MARKET DEVELOPMENT. Energy Policy Analysis with the MARKAL-Armenia Energy System Model. Energy Strategy Center of Scientific Research Institute of Energy (ESC/SRIE), Yerevan, Armenia. 13 November, 2012

## 2. Energy challenges & Opportunities

On the assumption of the logic of diversification of energy, Armenia started active talks with the Islamic Republic of Iran. As a result, on September 8, 2004 the parties signed an agreement on construction of Iran-Armenia gas pipeline.<sup>6</sup> Under the terms of the agreement, the Iranian side undertakes to supply 36 billion cubic meters of gas to Armenia over the course of 20 years.

The strategic importance of the Iran-Armenia gas pipeline lies in the fact that it is an alternative source of gas for Armenia and can serve as an alternative in case of any interruption in the gas supply from Russia; at the same time, to some extent, it restrains the raising of gas prices by Gazprom.

According to some experts, the current average price of gas supplied from Iran under the “gas for electricity” program is \$215-230 per 1,000 cubic meters, while Armenia imports gas from Russia at the price of \$180, which will probably rise to \$200. The further raise of gas price by Russia will provide an opportunity to Armenia to buy gas from Iran as well, which will help to strengthen Armenian energy security. However, in this price struggle Armenia can not import gas at a relatively low price for a long time, the price of Russian gas will grow, and the bilateral negotiations will show at what price the Islamic Republic of Iran will sell gas to Armenia. Iran has been consistently strengthening its energy cooperation with Armenia over the past several years. The total volume of Iranian investments in Armenia’s energy sector stands at \$571 million today.<sup>7</sup> Since 2009, Iran and Armenia have been exchanging electricity under the “gas for electricity” swap deal at the rate of 3 kWh per cubic meter of gas. By 2020, Armenia expects to increase the volume of electricity supply to

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<sup>6</sup> Երկկողմ հարաբերություններ. Իրանի Իսլամական Հանրապետություն. «Իրան-Հայաստան գազատարի կառուցման պայմանագիր. 2004թ. (Bilateral relations. Islamic Republic of Iran “Treaty of Iran – Armenia gaz pipeline counstruction”) <http://www.mfa.am/hy/country-by-country/ir/>

<sup>7</sup> Ключевыми инвестиционными проектами являются строительство ЛЭП 400 кВ до 5-го блока Разданской ГРЭС и гидроэлектростанции «Мегри»

Iran to 6.9 billion kWh. Iran, in turn, undertakes to supply 2.3 billion cubic meters of gas<sup>8</sup>.

The key joint Armenian-Iranian investment program includes:

- Construction of the third transmission line TL-400 KW starting from Hrazdan city to Akhar and Khoy cities in Iran with a capacity of up to 1000 MW. The share of Iranian investments in the project will reach 108 million euros. The transmission line is expected to be put into commission in 2013.

- According to the Ministry of Energy of Iran, the construction of a new additional gas pipeline is also planned.

It is significant that with the volume of bilateral energy cooperation, Iran is considered the most promising strategic partner of Armenia. By 2020, Iran will definitely import over 6.9 bln kWh of electricity, and in the future, it may become a transit route for the export of Armenian electricity to the promising markets of the Middle East. One of the prospective projects between Armenia and Iran is the Meghri hydro power plant (HPP). On November 8, 2012, the foundation laying ceremony of the Meghri HPP took place in Meghri, in Armenia's southern Syunik region, with the participation of Armenian and Iran delegations.

The Meghri HPP will support the economic development of the administrative zones, as well as increase the efficiency of different ongoing economic projects between two countries. The Meghri HPP will have an installed capacity of 130 MW, and annual electricity output about 800 million kWh. For that purpose, along the Armenian-Iranian border, from the place named Apricot Valley, the pressure tunnel will be built with the following parameters: length about 18 km, diameter - 8.5 m, the intake capacity of water - 160 m<sup>3</sup> / sec and the design head-90m. Moreover, the building of Meghri HPP will be structured, in which there will be placed two hydroelectric generators with 63.5 MW capacities and other hardware.

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<sup>8</sup> По данным Министерства энергетики и природных ресурсов Республики и Армения и иранского оператора «Sanir, 2012

This investment project is the first of its kind in Armenia. According to the agreement, the Iranian investment company will unilaterally manage all financial and organization problems concerning the construction and the exploitation of the Meghri HPP. The construction will be implemented in five years, after which the energy produced by the Meghri HPP will be transferred to Iran by the 230 kW transmission line being constructed by the investor.

After 15 years, the Meghri HPP is to be transferred to the Armenian side without indemnity. Moreover, it must be founded jointly that at the transmission time the electromechanical and hydro mechanical devices have resources for the 10-year effective operation, and the tunnel and engineering structures have resources for 30 years. Almost 2,000 professionals and workers will be included in the various stages of the Meghri HPP construction.

In 2007 and 2008, two intergovernmental agreements on building and exploiting power plants on the Arax River were signed between the governments of Armenia and Iran, and were later ratified by both parliaments. On the basis of a Memorandum of Understanding (MOU) signed in 2001 between the Armenian and Iranian ministries of energy, technical and economical assessment (TEA) works of the construction of the HPPs ordered by “Water and Energy Development” company of Iran were completed by the “Mahab Ghods” consulting company. The process of the TEA work was coordinated and controlled by the Armenian-Iranian Joint Technical Committee. According to the TEA, two HPPs will be built on the Arax River: the Meghri HPP on the Armenian side and the Gharachilar HPP on the Iranian side.

According to the TEA, the general technical and economical characteristics of the Meghri HPP follow:

Intake capacity	160 m <sup>3</sup> /s
Capacity of power plant	130 (2x65) mW
Energy output	793 million kWh/year
Length of transmission tunnel	18200 m
Tunnel inner diameter	8.5 m
Design head	90 m

On April 14, 2009, during Armenian President Serzh Sargsyan's visit to Iran, a Memorandum of Understanding on the financing of the Meghri HPP construction was signed. The Iranian side expressed its readiness to buy the total volume of electricity produced by the Meghri HPP from the Iranian investor through the entire period of repayment of investments.

### **The Armenian Nuclear Power Plant in the energy security system**

One of the important directions of Armenia's energy security is the issue of the construction of a new energy block of the Metsamor Nuclear Power Plant (NPP). It is no secret that the NPP covers some 42 percent of electricity demand in Armenia. Therefore, the functioning of the NPP is of strategic importance. However, the European Union demands the closure of the NPP, setting 2016 as a deadline.

The issue of closing down the Nuclear Power Plant is on the agenda of Euronest, as well.<sup>9</sup> However, Armenia's energy system will face new challenges in the case of the closure of the NPP; therefore, the construction of a new facility is of great significance. It should be noted that as a result of the replenishment over the past several years, the capacity of the Hydro Power Plants of Yerevan and Hrazdan have been strengthened. Nevertheless, the NPP is one of the most important components not only of the energy sector, but also of the security strategy of Armenia, in general, the closure of which does not meet the interests of the Republic of Armenia even in the case of the existence of alternative energy supply. As mentioned above, the Metsamor NPP provides 42 percent of the electricity produced in Armenia, and its closure will reduce the level of self-sufficiency of the Republic of Armenia, thus posing a threat to the country's energy security. The Armenian government has made a decision to substitute the second block with other producing capacities after its

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<sup>9</sup> COMMISSION OF THE EUROPEAN COMMUNITIES Brussels, SEC(2008) 2974/3  
COMMISSION STAFF WORKING DOCUMENT COMMUNICATION FROM THE  
COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL. Eastern  
Partnership {COM(2008) 823}

decommissioning.<sup>10</sup> Experts say that the preferable option of replacing the second block with minimal expenses is the construction of a new energy unit.<sup>11</sup>

According to the “Law on Construction of New Nuclear Energy Unit(s) in the Republic of Armenia” adopted on October 27, 2009, the government has decided to build a new nuclear energy block with a general capacity of 1,200 MW.<sup>12</sup> To implement the program of construction of a new energy block METSAMORENERGOATOM OJSC has been established, which, as an owner and operating company, is the elaborator of the project.<sup>13</sup> The company has proposed to build the Russian NPP-92 with a capacity of 1,060 MW as a model for the new energy block, which is an improved version of the VVER-1000, supplied with additional passive and active security systems, which combine the functions of secure and normal operations.<sup>14</sup>

Currently, the only functioning energy block of the Metsamor NPP has a capacity of 407.5 MW. The Russian side declares that the new energy unit will cost approximately \$4-5 billion. The implementation of the program will raise the level of Armenia’s energy security and Armenia will be able to increase the export potential. Today, Armenia has only one direction for exports, which is the Islamic Republic of Iran.

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<sup>10</sup> Տես ՀԱՅԱՍՏԱՆԻ ՀԱՆՐԱՊԵՏՈՒԹՅԱՆ ԿԱՌԱՎԱՐՈՒԹՅՈՒՆ. ՈՐՈՇՈՒՄ. ՀԱՅԱՍՏԱՆԻ ՀԱՆՐԱՊԵՏՈՒԹՅԱՆ ԱԶԳԱՅԻՆ ԱՆՎՏԱՆԳՈՒԹՅԱՆ ՌԱԶՄԱՎԱՐՈՒԹՅԱՆ ԴՐՈՒՅԹՆԵՐՈՎ ՆԱԽՏԵՍՎԱԾ ՀԱՅԱՍՏԱՆԻ ՀԱՆՐԱՊԵՏՈՒԹՅԱՆ ԷՆԵՐԳԵՏԻԿԱՅԻ ՆԱԽԱՐԱՐՈՒԹՅԱՆ ԳՈՐԾՈՒՆԵՈՒԹՅԱՆ ԾՐԱԳԻՐԸ ՀԱՍՏԱՏԵԼՈՒ ՄԱՍԻՆ: 1 նոյեմբերի 2007 (Resolution of the RA Government: On the Conformation of the Working Program of the Ministry of Energy of the RA Notions of the NSS RA) <http://www.dpf.am/uploads/MoEn%20NSS.pdf>

<sup>11</sup> Ibid.

<sup>12</sup> <<Հայաստանի Հանրապետության նոր միջուկային էներգաբլոկի(ների) կառուցման մասին>> օրենք: Law “On the construction of the New Power Plant of the RA” <http://www.parliament.am/drafts.php?sel=showdraft&DraftID=3201&Reading=2>

<sup>13</sup> ՀԱՅԱՍՏԱՆԻ ՀԱՆՐԱՊԵՏՈՒԹՅԱՆ ԿԱՌԱՎԱՐՈՒԹՅՈՒՆ ՈՐՈՇՈՒՄ. <<ՄԵԾՄԱՍՈՐԷՆԵՐԳՈՍՈՍՈՒՄ>> փակ բաժնետիրական ընկերության ստեղծման մասին: 2009թ. “Resalution of the RA Government “Metsamorenergoatom”” <http://www.gov.am/files/meetings/2009/4406.pdf>

<sup>14</sup> Հայաստանի նոր միջուկային էներգաբլոկի բնապահպանական (շրջակա միջավայրի վրա ազդեցության) հաշվետվություն: “The ecological report on the new Nuclear Power Plant of Armenia”<http://www.minenergy.am/hy/en/atomhashvetut>





Construction of the new energy block and the development of corresponding infrastructure will allow Armenia to maintain the existing scientific and human potential in the nuclear sector and create more than 5,000 new jobs.

Construction of the facility at maximal localization will considerably reduce the expenses of construction and will expand the industrial base, which is also important from the point of the view of the economic expediency of the project.

To date, preparatory steps have been taken towards the realization of the project: the construction site of the new energy block has been determined, seismic and geological studies conducted on the Metsamor site have concluded that it corresponds to the main technical parameters set by the International Atomic Energy Agency (IAEA).

The construction of the NPP new energy block meets the general strategy of inclusion of Armenia in regional energy markets, which will strengthen the positions of the country and will ensure its energy security and independence in the long-term perspective.

Today, the move towards the practical phase of realization of the project of the new energy block is hampered by the unsolved issue of financing of the project.

## **2. Future scenario for energy strategy**

Today, Armenia has a promising potential for the integration of its electricity system into regional markets. The existing interconnections with all neighboring energy grids, the availability of free capacities, as well as Armenia's participation in regional investment programs and the membership in the CIS Electric Energy Council, the Energy Charter Treaty, the Black Sea Economic Cooperation Organization (BSEC), and the TACIS and OPET projects, are the basic mechanisms of integration.

According to the assessment of experts, the potential capacity of the electricity markets of neighboring countries, as promising importers of electricity, reaches over 400 TWh annually. Even the availability of considerable hydrocarbon resources in a number of countries and the introduction of new industrial facilities in the energy sectors of Georgia, Turkey and Iran are unable to cover the projected demand for electricity. Obviously, the power energy sector of Armenia has a high export potential and has a competitive advantage in the region, despite the lack of its own raw materials.

The most promising scenario of regional integration is the organization of the parallel activity of the Armenia-Georgia-CIS and Armenia-Georgia-Turkey power energy systems, with consideration of the simultaneous functioning of the Armenia-Iran energy system. Currently, the integration of Armenia's energy system with the regional market is realized on a bilateral basis through Armenia's participation in a number of investment projects of organization of energy flow to Iran, Georgia and Turkey. In the context of cooperation between CIS countries, Armenia is a member of the CIS Electric Energy Council, which aims to form a common electric energy market and ensure the parallel functioning of the power energy systems of CIS participating states.

The preliminary assessment of Armenia's export potential supports the view of the country as a key supplier of base-load power energy to neighboring countries.

The results are confirmed by research conducted by the USAID, which prove that power energy is one of the most dynamic and promising directions, and that Armenia can become the main supplier of electricity to its neighbors in the South Caucasus.

The unprecedented growth of electricity consumption over the past three years shows that the analyses and schemes presented predict a much slower rate of growth than in reality. However, even these charts and graphs suggest that Armenia holds a large potential for

the development of the energy sector and its continuous development should lie in the basis of its regional policy (see Figure 4 and 5).

### Reference Scenario – Electricity Sector Evolution<sup>16</sup>

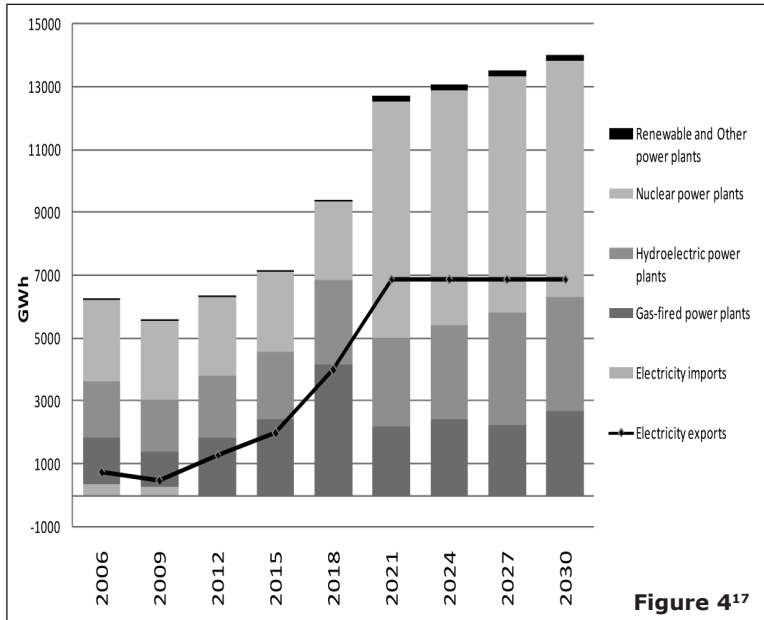
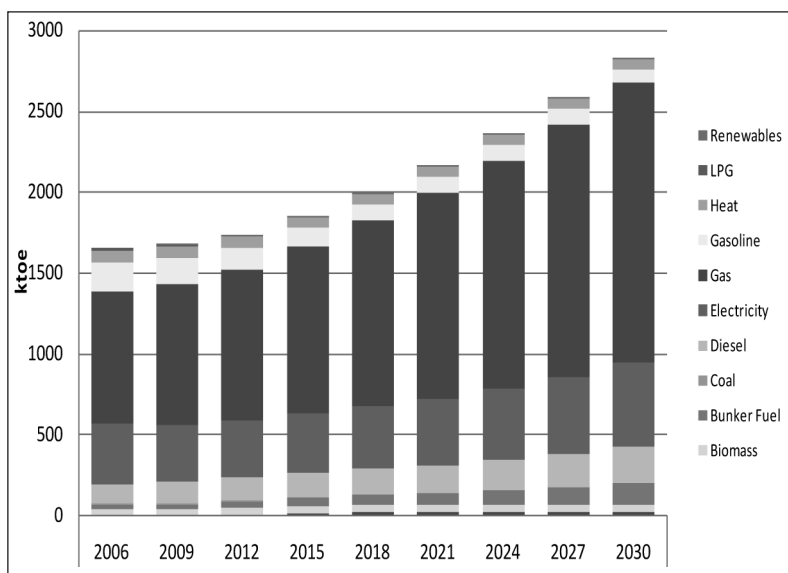


Figure 4<sup>17</sup>

- 687MW of thermal capacity already added (in 2012) on existing 810MW
- After 400MW plant retires 1,000 MW of nuclear capacity adds (in 2021)
- New Hydro capacity of 650 MW added which provides 1.8GWh electricity
- 25MW of geothermal capacity added in 2021
- Electricity exports reach over 7 billion KWh in 2030 in accordance with the intergovernmental agreement regarding electricity/gas exchange (no exports on other directions)

<sup>16</sup> USAID. REGIONAL ENERGY SECURITY AND MARKET DEVELOPMENT Energy Policy Analysis with the MARKAL-Armenia Energy System Model. Yerevan, Armenia. 13 November, 2012

<sup>17</sup> USAID. REGIONAL ENERGY SECURITY AND MARKET DEVELOPMENT. Energy Policy Analysis with the MARKAL-Armenia Energy System Model. Energy Strategy Center of Scientific Research Institute of Energy (ESC/SRIE), Yerevan, Armenia. 13 November, 2012



**Figure 5<sup>18</sup>**

- Total final energy consumption grows 70% over the planning horizon
- Share of natural gas in final energy rises from half to over 60% by 2030
- Electricity consumption increases by 40%

## Conclusion

The construction of the new energy block of the Armenian Nuclear Power Plant is considered to be a rational and promising project, which will contribute to the development of the country's economy and will allow it to maintain a reliable energy system based on the stable production of large volumes of electricity.

There is no alternative to the new energy block, as other types of generation will not ensure the coverage of the basic, long-term and economically acceptable domestic demand for electricity.

<sup>18</sup> USAID. REGIONAL ENERGY SECURITY AND MARKET DEVELOPMENT. Energy Policy Analysis with the MARKAL-Armenia Energy System Model. Energy Strategy Center of Scientific Research Institute of Energy (ESC/SRIE), Yerevan, Armenia. 13 November, 2012

The implementation of the project will have a decisive importance for Armenia's integration with the regional market as a supplier of electricity and its participation in regional energy projects. The given process is impossible without the creation of an export-oriented energy system. Today, Armenia has a developed system of network infrastructure with neighboring countries, allowing it to reliably export supplies of excess capacity. It is expected that export relations will develop most dynamically in the north-south direction with Iran and Georgia. In turn, the wide opportunities for the export of electricity to neighboring countries will increase the investment attractiveness of the project and will guarantee its profitability.

The analysis of the current rate of demand and the volume of imports to neighboring countries – Iran, Georgia and Turkey – leads to the conclusion that the strengthening of regional integration with a view of covering the growing demand for electricity in the long-term perspective until 2030 is an inevitable process with the energy systems of all countries of the region involved. Respectively, the capacity of the new energy block of the NPP in the long-term will be demanded both inside the country and on the regional market.

The diversification of Armenia's energy resources based on the maintenance of nuclear energy is of strategic importance, as it allows Armenia to guarantee its energy independence and security, which is necessary against the background of the existing geopolitical challenges.



# **RECENT TRENDS IN ENERGY AND OIL REVENUE MANAGEMENT POLICY IN AZERBAIJAN: CHALLENGES & FUTURE SCENARIOS**

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In November 1997, the first oil was extracted as a result of joint exploration activities conditioned by the "Contract of the Century" and a bit later Azerbaijan started to get her profit oil, and subsequently oil dollars, from those activities. But even before the oil money entered the country, IMF and World Bank were among the first involved in the long-term discussion for the efficient and transparent use of those monetary resources with the Government of Azerbaijan. The suggestion was to create a separate non-budgetary fund which would make it easier to monitor the entrance and management of the revenues. At the beginning the revenues from oil contracts were collected in the accounts of the National Bank (now Central Bank) and that made the public supervision of the revenues almost impossible.

On December 29, 1999, the presidential decree numbered 240 formalized the establishment of the State Oil Fund of the Republic of Azerbaijan, from where on we can talk about the revenue management system of Azerbaijan. The objectives of the fund were stated as "securing accumulation and efficient management of currency and other revenues generated from sale of profit oil produced as a result of joint development of oil fields with foreign companies, application of such proceeds to development of primary areas and performance of projects of socio-economic significance". As obvious from the decree, the primary purpose of the establishment of the Fund was neither fiscal stabilization, nor currency stabilization or accumulation for future generations. This was intended for the socio-economic development and therefore a development fund. But later the Statute of the Fund also includes the interests of future generations as the one to be considered in the Fund's activities.

Revenues generated from implementation of the agreements on the, development and production sharing of oil and gas fields in the territory of the Republic of Azerbaijan including the Azerbaijani sector of the Caspian Sea, as well as other agreements on oil and gas exploration, development and transportation entered into between the State Oil Company of the Republic of Azerbaijan or other authorized state bodies and investors are accumulated in the Fund.

In order to efficiently manage the accumulated oil revenues generated from the development of country's oil fields on December 29, 1999, the State Oil Fund of the Republic of Azerbaijan was established by presidential decree. By definition The Fund's exact activities should have been directed to the achievement of the following objectives: 1) preserving macroeconomic stability, 2) financing major national scale projects to support socio-economic progress, 3) ensuring intergenerational equality with regard to the country's oil wealth and accumulate and preserve oil revenues for future generations.

### **But has this been the case for the past few years?**

Looking back, we can see that although the issue about the national-scale projects has been followed more or less, the main philosophy of creation of the fund – ensuring fair allocation of oil wealth across generations, has been neglected so far and the priority was given to spending resources instead of accumulating them. This in its turn also affects and has an enormous potential to affect macro-stability in the near future.

Let's turn to a few numbers first:

For realizing above stated goals, 32 billion 666 million dollars has been accumulated since the establishment of the fund as of July 01 of 2012. Table 1 gives more detailed information about revenues and assets of the Fund.



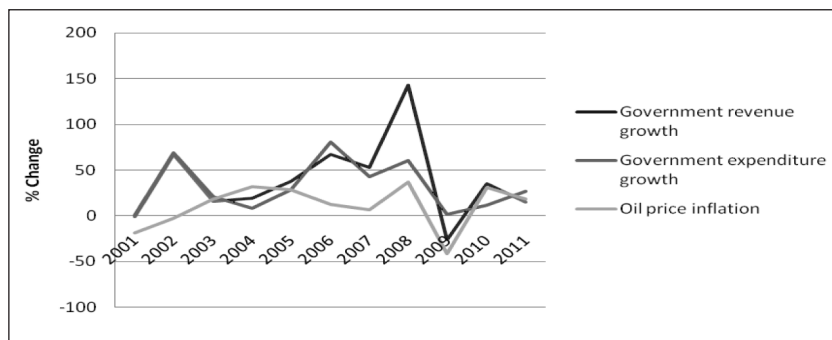
## Revenue and assets of State Oil Fund

**Table 1.**

Years	Revenue of State Oil Fund (mln. AZN)	Assets remaining at the end of the year (mln. USD)
2001	248.0	492.0
2002	295.0	692.0
2003	364.0	816.0
2004	317.0	964.0
2005	660.0	1394.0
2006	986.0	1454.0
2007	1 886.0	2475.0
2008	11 865.0	11219.0
2009	8 177.0	14900.0
2010	13 089.0	22 767.0
2011	15 628.0	29 800.0
2012 (6 months)	7 099,8	32 666.0 <sup>1</sup>
Total	60614,8	-

It can be easily spotted that until July 1, 2012, Azerbaijan received 60614,8 million AZN revenue (including management revenues) from oil and gas sales obtained from production sharing contracts. Calculations show that 54.6 percent of this amount was spent during the period. In addition to everything above, pro-cyclical fiscal policy has been implemented during the last 10 years, as can be seen from Figure 1 below:

**Figure 1: Percentage changes in government revenues, expenditures and oil prices**



Although the issue is open to debate and there can be lots of arguments in favor of higher spending, we need to post the question of whether this spending track can be kept for a long time, or better expressed, is it sustainable?

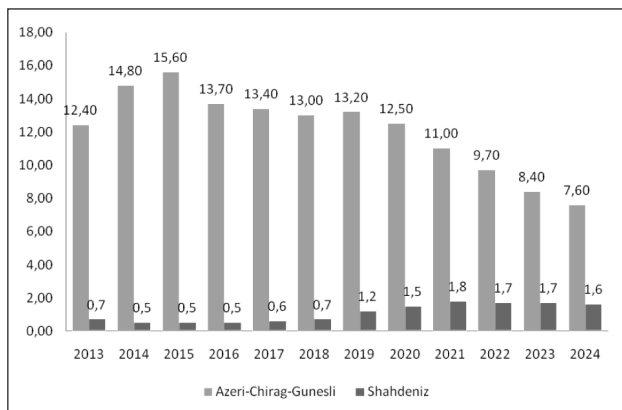
**Table 2: Transfers from SOFAZ to the state budget (million AZN)**

<b>Years</b>	<b>Transfers from SOFAZ to the state budget (million AZN)</b>	<b>Growth rate</b>	<b>Share in the State Budget</b>	<b>Share in the expenses of SOFAZ</b>
2003	100	--	8.2%	41%
2004	130	30.0%	8.6%	77%
2005	150	15.4%	7.2%	70%
2006	585	290.0%	15.6%	59.6%
2007	585	0.0%	9.7%	55.1%
2008	1100	88.0%	35.3%	88.5%
2009	4915	346.8%	40.4%	92.8%
2010	5915	20.3%	51.4%	90.5%
2011	9203	55,6%	59,7%	92.6%
2012 (planned)	9905	7,6 %	60, 5 %	93,7%

According to SOFAZ, during 2012-2024 the Fund's incomes from the Azeri-Chirag-Guneshli and Shahdeniz deposits will decrease to USD 9.2 billion from the current \$13.1 billion. The peak level of incomes from Azeri-Chirag-Guneshli deposits is expected in 2015 (\$15.6 billion), during the following years revenues will decrease and make up \$7.6 billion in 2024.

Peak level of revenues from the sale of Shahdeniz gas will be achieved in 2021 (\$1.8 billion) and in 2024 revenues will decrease down to \$1.6 billion.

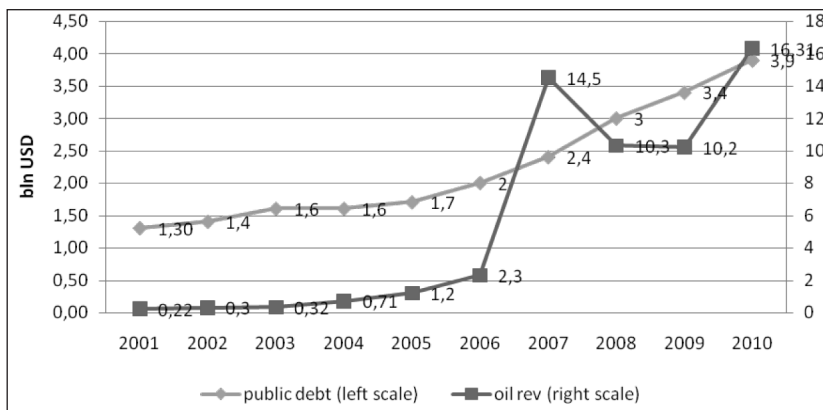
**Figure 2. Government revenue from the profit oil and gas of Azeri-Chirag-Guneshli and Shahdeniz deposits, years of 2012-2024. In billion USD (oil price \$80 per barrel)**



Thus, the coming 12 years will much depend on the world market prices of oil. If the price for Azeri Light oil is \$80 per barrel during the next 12 years, revenue forecast for sale of profit oil of Azeri-Chirag - Guneshli will make revenue forecast for gas sale of Shahdeniz deposit will make \$13 billion for the same period. This means, Azerbaijan economy will receive USD 12.1 billion oil revenues and \$1.1 billion gas revenues during the next 12 years. Average oil-gas revenues for mentioned period will make \$13.3 billion. Oil revenues in 2024 will be less for \$8 billion compared to 2015. Increase of gas revenues for the mentioned period will make \$1.1 billion, which will cover just 15 percent of loss from oil revenues. This means, the government should seriously work on the compensation of mentioned loss from oil sector through other sectors. Otherwise, preventing diminution of economy starting from 2016 will be impossible. For keeping state expenses at their current level, the government should get into debts, which may turn into a serious problem both for national economy and next generation. Even now the government debt levels keep rising although not at the high level. The correlation between public external debt of the country and oil revenues is almost 0.9. But when we check the correlation between the growth rates of those two indicators, it simply drops to 0.14 which is very low. Although the public debt is not closely following the oil revenues, it is hard to say whether the increase in the debt is due to oil

revenues or some common trend component for both of them, because we have a sample of 10 years only. Further visual analysis is provided in the graph below (outlier is mostly due to BTC opening).

**Figure 3. Comparing oil revenues and public debt in Azerbaijan**



Following the implementation of the cautious government policy on the management of hydrocarbon revenues, a total of \$32.6 billion of wealth have been accumulated at SOFAZ, the state oil fund, as of July 1st, 2012. That amount is several times higher than the foreign debt of the country recorded at \$ 4.5 billion as of July 1, 2011; the debt itself is roughly equivalent to 8.1 percent of GDP only. Azerbaijan’s monetary reserves are twice the level of its budget revenues and exceed the imports worth by a factor of 4.5, thereby providing a substantial safeguard for the economy against external shocks. Therefore, Azerbaijan didn’t seem to be interested in going beyond the established fiscal framework during the European debt crisis or the global financial meltdown. The filling in the non-oil budget gap with direct transfers from SOFAZ remains a core pillar of the government’s fiscal policy. As a matter of fact, such approach poses a great threat to fiscal sustainability.

### Challenges & Future Scenarios

Problems in the revenue management system of Azerbaijan arise just after the profit from exploration activities is stored in the accounts of

State Oil Fund of Azerbaijan (SOFAZ). From here on, the funds are divided by (between saving and spending, among different expenditure items) by a decision of a very few. According to the statute of the Fund, Article 4.1, "The Fund's assets are utilized in accordance with the main directions (program) approved by the President of the Republic of Azerbaijan". That is the only rule involving revenue items and there is no specific rule which would stipulate different expenditure items of the Fund. Considering that this makes the president of the country the person de-facto and de-jure responsible for such a decision making is, it is easy to see where it could lead. As a supporting argument, we have seen that there is a huge amount of budget transfers from the Fund every year and resources of the Fund are used for specific projects without proper grounding.

The lack of rules can be looked upon from several aspects.

The first and foremost problem, as mentioned above, concerns the process of withdrawal from the oil revenues from the SOFAZ, the only fund where the nation's wealth is accumulated. There is no rule or document which would stipulate:

- What percentage of the annual revenues can be withdrawn;
- What must be long term save-spend strategy;
- Specifically which expenditure items can be financed from the Fund (although some vague idea about mid- and long-term development goals).

As a result we have procyclical spending and overspending, as stated in the previous sections, in addition to expenditures serving popular political purposes.

There are also potential problems which could arise from discretionary policy in this regard which could be grouped into two major blocks:

- 1) Revenue trap: it is a human nature to spend more when money keeps coming. But recent financial crisis proved that there are

times when revenues can be restrained due to price shocks and possible other shocks (excess supply, technological development, terror attack, etc.). If by any means the negative shocks persist for a little while, the government would have to reduce the expenditures which could result in unrest (even political) in the country. So, here it is, the situation which resembles being subject to the “fork” tactic of chess: if you continue with the previously taken expenditure path, you will have to save less and this would deteriorate the situation in the near future, but if you cut, this results in unrest. Therefore it is better to have some predefined rule, say, estimated from permanent income approach, which the government would follow easily and that would only be subject to changes in case any structural changes happen in the economy.

- 2) Power curse: this usually concerns the political power of the country, but results can hugely affect the overall economy. People in power are easy targets of judgement from population. Therefore, assigning the ultimate role of revenue management to small group of persons would simply make the person guilty in their eyes if anything goes wrong. This means, even if intentions of the manager are good enough, the people always remember the bad things better, which might be catastrophe for any government. The better way again, is some sort of long-term rule, which would relieve the people in power from immediate guilt.

**The second** problem for Azerbaijan would be the lack of rules in the formation of the government budget. Ideally the governments try to concentrate on sustainable revenue items, which is usually tax. In the resource rich countries, advanced practices pay attention to the proportion of the budget which could come from the taxes and resource revenues.

But Azerbaijan seems to have complete lack of rules in this regard which results in huge transfers from the SOFAZ to the budget. The

draft budget is prepared by the Ministry of Finances for approval by the parliament. Usually the huge part of it is investment budget. The investment budget has usually very restricted content which is criticized even by the Parliament. Therefore, it would be very efficient and growth-contributing to have:

- 1) Proportional limits on resource revenue items;
- 2) Limits on non-oil budget deficit;
- 3) Complete disclosure (at least of items not involving national security);
- 4) Plausible limits on investment budget.

Although we slightly talked about it, the last bit is very important to be discussed in detail, from which we could get a qualitative rule.

It is world known fact that infrastructure investment activities usually result in resource waste all over the world (including the developed world, eg Millennium Park of Chicago). And that waste is done on the individual and junior management level and there is no way to anyone can stop that, it is a basic human nature. So, investing more in them, would reduce the efficiency and increase unnecessary concern of the population. The best way out of the situation is to shift some of the investment from budget to companies by creation of favorable environment and implement necessary infrastructure projects after the companies are ready and willing to invest in production somewhere (so that must be a qualitative criteria, rule). But investing in infrastructure blindly without proper cost-benefit analysis simply reduces resources and diminishes efficiency.

The third issue with regard to which specific rules do not exist is SOCAR's social expenditure. Although this is minor compared to the previous two, SOCAR is a huge part of Azerbaijani revenue management system and it is diversifying and becoming the biggest part of Azerbaijani economy in general. Therefore, there must be some rules guiding, at first, the social activities of the SOCAR, so that they would not follow some political agenda and be waste of resources. Instead

there should be rules directing those resources to more important social projects.

### **Scenario 1 (status quo)**

Production sharing agreement signed with the foreign companies for operation of "Azeri-Chirag-Guneshly" (ACG) oil field, which provides good funding for Azerbaijan, has been in implementation for 18 years. As of July 1, 2012, the Government of Azerbaijan earned 60618,4 million manats from this agreement. 56.4 percent of this amount has already been spent. 30457,5 million manats or 92 percent out of the spent 33109,3 million manats have come through January 1, 2008 to July 1, 2012 so that this means the spending of average 6768,3 million manats over the last 4.5 years. According to the predictions by the State Oil Fund, the expenses of the Oil Fund's budget for 2013-2016 years will comprise of \$424,379.3 million or 33367,5 million manats per the rates of July 25, 2012. So, to the predictions, the average spendings of the state oil fund for the next 4 years will comprise of 8341,8 million manats. As seen, the predicted spendings of the oil fund are expected to be 1573,5 million manats or 23.2 percent higher than its actual spendings during the last 4.5 years. If both spendings for the last 4.5 years and the predicted spendings for the next 4 years are assumed as a basis, it will be clear that the average annual spending of oil revenues during 8,5 years comprises 7555 million manats.

If the Government of Azerbaijan will not make a change in its policy regarding its spendings, then the expected oil revenues in the amount of \$145.3 billion could have been spent in 15 years based on the calculated predictions in the rate of one barrel oil in \$80. Keeping on this policy serving the balancing of the state budget in the next 15 years will make a serious problem with the implementation of recommendations made by IMF on reduction of the share of non-oil budget deficit in non-oil GDP. So, IMF recommended by 2017-2018 years the special weight of non-oil budget deficit in non-oil GDP should decrease up to 20 percent. The current policy excludes the major



changes to happen to this direction. On the other hand, such fast spending of oil revenues will lead to the break of inter-generational equity principle. Thus, the scenario 'status quo' will make serious challenges for efficient use of oil revenues.

Besides, the implementation of spendings through the budget of oil fund, which is not subject to the recommendation by the Chamber of Accounts, and financial auditing, as well as parliamentary debates will ruin the opportunities of supreme auditing and parliamentary control and keep the decisions on spendings again under monopoly of the executive power. Furthermore, no representation of civil society organizations at Supervisory Board of the Fund, in case the article 5.4 of the Regulations of the Oil Fund<sup>1</sup> is not observed, will restrict the opportunities of civic participation and social control over its management. The Supervisory Board will keep on acting formally.

So, fast spending of oil revenues in preserved status quo condition will make impossible its fair distribution among future generations, and meantime leaving aside the Chamber of Accounts, Parliament and civil society organizations out of the process will lead in one hand to keeping decisions on spendings under monopoly of executive power, and on the other hand to the increased transparency and no providing social control.

## **Scenario 2 (ideal)**

In this scenario, the government of Azerbaijan makes corrections with its current policy on spending of oil revenues and conforms it to the existing rules. So, the principles of "Long-term strategy on management of oil and gas revenues"<sup>2</sup> get started to observe. Primarily, no less than 25 percent of oil incomes are accumulated and preserved for future generations by 2016. More pro-active and profitable investment policy is pursued during management of the accumulated amount.

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<sup>1</sup> <http://www.oilfund.az/uploads/status.pdf>

<sup>2</sup> <http://www.oilfund.az/uploads/5-eng-long-term.pdf>

The accepted spending rules of oil and gas revenues remain unchanged within the period covered by the long-term strategy on the management of oil and gas revenues, and in this case the limit of expenses is followed on the basis of the fixed actual expenses principle. Here, relevant calculations are conducted for every 5 years. Calculations are conducted twice during the timeframe of the strategy implementation on the background of sustainable development of national economy and on the basis of changes observed on the pattern of GDP, and they cover 2013-2018 and 2018-2024 years. Henceforth, sharp fluctuations between the expenses of the previous and the next year are corrected. The dependence of economy on oil incomes gets balanced on a regulated way. By this way, no sharp fluctuation is allowed at non-oil budget, and also the amount of expenses during mid-term period gets defined on the non-oil deficit taking into account the limits set for the long-term period. As a result, the economy will not face with over – spending challenge for this period, but on the contrary positive effects like budget smoothing, save for future generations and mitigation of Dutch Disease<sup>3</sup> are observed.

Meantime, investment projects financed by the Oil Fund are implemented within mid-term Public Investment Program, which is developed per each year, and the incomes section of the Oil Fund’s budget is expressed in income of receipts on the sources of income and the expenses section in expenditure only that contains annual estimate costs of the Fund.

In this case, the budget deficit for interim period gets restricted with 3 percent at GDP based on the Maastricht treaty<sup>4</sup>, and the level of external public debts with around 10 percent at GDP. The inflation rate gets balanced by reduced below 5% and bank rate below 6 percent.

By this scenario, transparency and accountability are promoted much more with the operations of the State Oil Fund. The Chamber of Accounts<sup>5</sup>

<sup>3</sup> <http://www.investopedia.com/terms/d/dutchdisease.asp#axzz225DyZbiF>

<sup>4</sup> <http://www.unc.edu/depts/europe/euroeconomics/Maastricht%20Treaty.php>

<sup>5</sup> <http://www.ach.gov.az/index.php?/en/content/344>

each year provides recommendation to the draft budget of the Fund and conducts its financial examination with the order of relevant bodies of parliament. The presidential decrees on the budget of fund for the next year, additions and changes made on it, and the implementation of the previous year's budget are implemented within time-limits fixed at the Regulations on design and implementation of the annual incomes and expenses of the State Oil Fund of the Azerbaijan Republic<sup>6</sup>.

Finally in this scenario, the representatives of civil society organizations are represented at Supervisory Board in order to provide social control in accordance with the Regulations of the State Oil Fund. As a result, civil participation is ensured for providing general control over Fund's operations. Supervisory Board starts operating in conformity with its functions, and transparency and accountability get improved.

So, the spendings on this scenario get balanced by taking into account the real needs of national economy and current perspectives, and general control, parliamentary control, supreme auditor's control and social control are ensured over Fund's operations; oil revenues are managed on a more transparent and accountable manner, and stability and inter-generational equity principles are observed.

### **Scenario 3 (medium)**

In this scenario, public policy setup on the spendings are formulated on the second scenario by taking into the recommendations of the international organizations. In this case, the level of spendings constantly remain stable and it gets conformed to the principles of decreased non-oil budget deficit. Transfers from the State Oil Fund to the state budget get limited and in so decreasing way the dependence of the incomes of state budget on oil revenues gets reduced to that extent of no risk to the stability. Total budget deficit gets balanced in conformity with Maastricht treaty. Budget incomes from non-oil sector are given preference for financing the deficit. So, macro-financial stability is secured, and over-spending problem is resolved.

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<sup>6</sup> <http://www.oilfund.az/uploads/4-eng-programofrevenues.pdf>

But in this scenario, the present rules are not followed again. The President signs the decrees on the approval of Fund's budget by violating the regulations. Again, allocations are made from the budget of Oil Fund to financing of certain investment projects as before. The access to information on those projects remain limited. The Chamber of Accounts does not provide recommendation on the draft budget of Oil Fund, and does not hold financial inspection of the Fund. Functional, administrative and economic breakdown of costs at investment projects financed by the Fund's budget are not disclosed. This scenario also does not follow the present requirements for providing transparency and civic participation. The activity of Supervisory Board of the Fund again bears formal nature as it does now. The Board does not ensure the participation of representatives of civil society organizations.

So, despite over spending problem is resolved at spendings on this scenario, transparency, civic participation and poor spending problem in spending of oil revenues remain challenging at the Fund's management. Despite current risks for macro-financial stability are neutralized in this scenario, the financing of additional costs, which are required after a while as a result of poor spending of oil revenues increases the public external debt. And this finally enlarges the external debt payment load of future generations. Same time, no transparency and civic participation, poor spending problem reduce the trust of the present generation to the correct management of oil incomes too.

#### **Scenario 4 (poor)**

In spite of being close to status quo, this scenario is much worse than that. By this scenario, the government pursues the policy of spending oil revenues completely. In this case, the national economy keeps on immediate rise in consumption and/or investment. Economic growth rate remains positive. As over spending vø poor spending problems with spending of oil revenues are not resolved on this scenario, negative effects like nothing for left future generations, possible wasteful spending and strong Dutch Disease effects are observed. By this scenario, the present rules are not only improved, but also are not

followed even. Therefore, shadow falls on achievements that the Oil Fund made in transparency, and Fund's reputation deteriorates.

The impact of policy alternatives can be shown the tables below:

Indicators	Policy Scenarios (alternatives)			
	Status-quo	Scenario I (Ideal)	Scenario II (Medium)	Scenario III (Poor)
Sustainability	1.Share of non-oil budget deficit in non-oil GDP would increase; 2.The public external debt would increase;	1.Macro-financial stability is secured, and over-spending problem is resolved; 2. The level of spending remains stable and it gets conformed to the principles of decreased non-oil budget deficit; 3. Mitigation of Dutch Disease	1.Total budget deficit gets balanced in conformity with Maastricht treaty; 2.Budget incomes from non-oil sector are given preference for financing the deficit. 3. Spending problem is resolved.	1.Poor spending problem in spending of oil revenues remain challenging at the Fund's management
Inter-generational equity	Fair distribution among future generations becomes impossible.	Save for future generations	Fair distribution among future generations depends on the "mood" of the government.	Nothing for left future generations
Volatility	The volatility of the expenditures remains the same (high) which is going to create quite big ups and downs in the economy. The volatility might even get bigger if the government develops higher expenditure appetite.	The volatility would probably shrink if the "permanent income" –like hypotheses applied and would make the economy more predictable for economic agents. That would mean economic stability and growth.	The outcome would be more volatility than the ideal case as the president still would have all the power to approve the expenditure items which can be politically popular. But apart from that, due to decreasing oil-revenue dependence of the state budget we could expect a substantial volatility decrease over status-quo.	This probably would result in much higher volatility in absolute value terms as we see increasing spending of oil revenues and if the situation worsens it is more reasonable to expect further unprecedented changes.
Accountability	1.Transparency, civic participation in spending of oil revenues remain challenging at the Fund's management.	1. Civil participation is ensured for providing general control over Fund's operations; 2.Supervisory Board starts operating in conformity with its functions, and transparency and accountability improve.	1. The access to information on SOFAZ projects remain limited; 2. Transparency, civic participation in spending of oil revenues remain challenging at the Fund's management.	1. Shadow falls on achievements that the Oil Fund made in transparency, and Fund's reputation deteriorates.



# **GEORGIAN ENERGY SECTOR: TRENDS AND PROSPECTS FOR DEVELOPMENT**

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## **Introduction**

Significant success has been achieved in terms of the integration of Georgia with international political and global economic structures during the recent years. The situation has positively improved in Georgian energy sector which is one of the strategically important sectors of the country's economy.

The problem of energy security of the country has been mainly resolved at this stage, after putting the transnational trunk gas pipelines and high-voltage power transmission lines into operation. Despite of all above mentioned, it is strong need to satisfy the increasing energy demand for country's recovering economy, strengthen the processes of further market liberalization and integration into regional energy systems, reducing at the same time reliance on the imported fuel.

## **1. Recent Trends in Energy Consumption, Supply and Demand**

Annual energy consumption has been significantly reduced in Georgia as compared to the data of the early 1990s. Deficiencies in management, financial control, maintenance, and rehabilitation works on energy infrastructure, played a significant role in the near collapse of the energy supply systems. The disintegration of the centralized economic system and the drastic increase in prices for energy resources after collapse of the former Soviet Union, as well as drastic reduction of consumption by industrial and household sectors working by inherited energy-wasting technologies under market conditions, was

followed by a serious energy crisis in Georgia. From the early 1990s, primary energy demand was in free fall and only resumed growth from 2004, reaching roughly 4,5 btoe<sup>1</sup> in 2007.

In 2008 Georgia faced external shocks - Russian invasion and influence of global financial crisis. However, Georgian energy sector demonstrated resilience to these challenges, which was supported by the substantial aid of the foreign partners. The recovery process started shortly after the 2008-2009 slowdown and significant economic growth reached in 2010-2011 years resulted increase of average annual TPES for 6 percent roughly. Figure of total primary energy supply (TPES) below reflects broadly the dynamics of the economic development and political instability in Georgia.

In the early 1990s, each Georgian resident consumed nearly the same amount of energy as an European living in similar geographic-climatic conditions (averagely, citizens of Italy, Spain, Austria, Portugal, Greece, Turkey), however, spent 3-4 times more total energy on a unit of production and by the GDP value per capita was significantly below the average European value.

The Georgian power system was once part of an integrated Caucasian regional system that allowed for the balancing of the seasonal deficit of hydropower in winter with power imports, and the export of surplus power in spring and summer due to the seasonal character of production of hydro power plants. Total power consumption was significantly reduced after desintegration of the Soviet Union and respectively, the economic systems managed from the center of the Empire. Acute situations have developed over the high rates of losses and the non-collection of bills precipitated a crisis in supply.

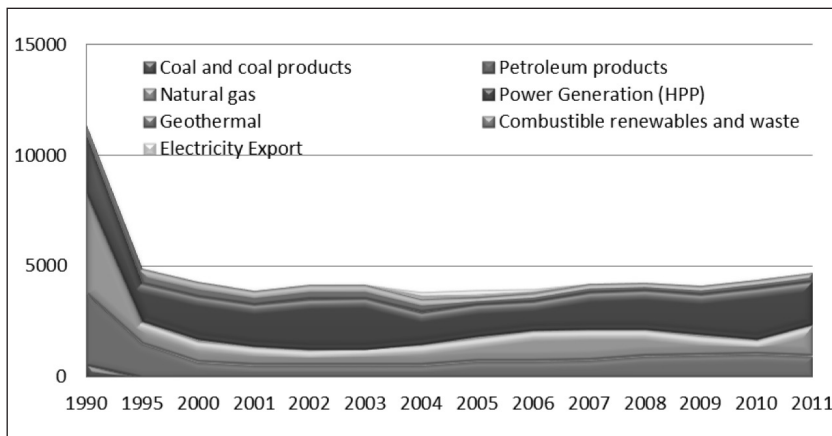
Beginning from 2004, reform efforts in power sector regulation and governance and large scale refurbishment and renewal of critical infrastructure became high on the county's list of priorities. Conse-

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<sup>1</sup> Energy view of BSEC Countries 2008, Georgia, Athens, 2009



quently, supply has gradually increased from 7 to 10 TWh in 2010 as well as consumption of electricity, which rose approximately by 10 percent annually during the last three years.

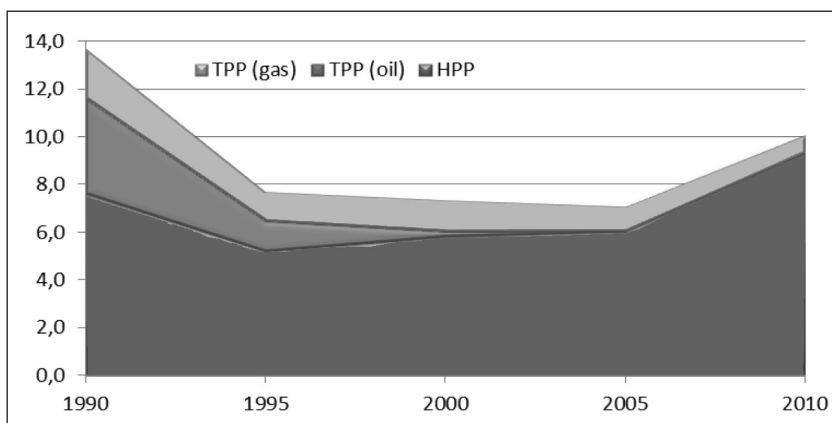


**Figure 1. Total Primary Energy Supply, ktOE²**

Georgia is a net exporter of electricity, with sales and/or swap arrangements to Russia, Armenia, Turkey and Azerbaijan. Power export is conducted by and through different market entities. Any Georgian entity can export power from Georgia - no export license is required.

Following to the state energy policy, main priority is given to supply the consumers with electricity generated from vast local renewable resources, namely through utilization of hydro power potential of Georgia. As a result share of power generated at HPP's during the last three years increased to nearly 85 percent instead of 55-60 percent in yearly 90<sup>th</sup> (Figure 2).

<sup>2</sup> Sources: In-depth review of the energy efficiency policies and programmes: Georgia, Energy Charter Secretariat, Brussels, 2012 and IEA, MENR of Georgia and GOGC statistics (Note: For conversion of generated electricity to toe it is assumed that one million tons of oil produces about 4000 GWh of electricity in a modern power station. Supply of primary energy sources (except electricity) for temporarily occupied territories of Abkhazia and South Ossetia are not considered).

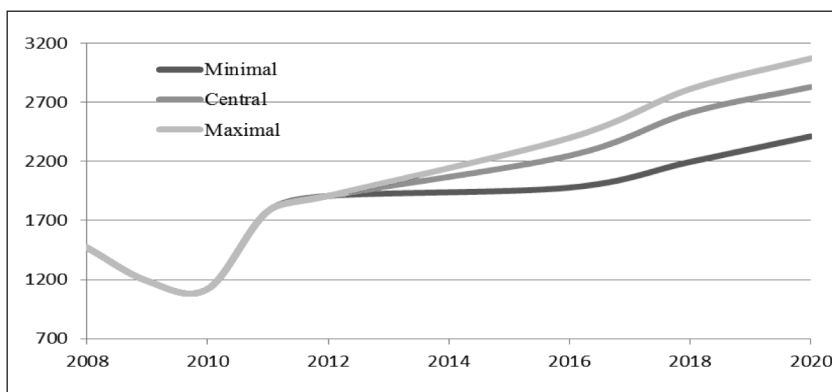


**Figure 2. Structure of power generation (generation in TWh)<sup>3</sup>**

As for fuel resources, mainly imported oil products, gas and local bio resources (firewood) are consumed in the country. Supply and consumption of gas, which is easy for consumption, ecologically clean and one of the cheapest primary resource under conditions of Georgia, is characterized by increase from the period of revival of economy of the beginning of the last decade, except the crisis period of 2008-2010 (Figure 3). However, supply and consumption of gas has been reduced from the peak value of 5-6 billion m<sup>3</sup> in the early 1990s to 1.5-1.8 billion m<sup>3</sup> in the recent years. The main reasons for the reduction of supply and consumption of gas are the significant decrease of gas consumption share in the power generation due to dominance of power energy produced from hydro resources and the liquidation of enterprises working by energy-wasting technologies and introduction of energy-efficient heating systems in the domestic sector.

The total consumption of petroleum products in Georgia equaled 800-950 thousand tons during the last years. Petroleum products are not produced in Georgia and demand of the country is fully satisfied by imports.

<sup>3</sup> MENR of Georgia statistics, [www.minenergy.gov.ge](http://www.minenergy.gov.ge)



**Figure 3. Trends for natural gas consumption, Mm<sup>3</sup>/y<sup>4</sup>**

Local bioresources, mainly firewood, play a significant role in formation of the energy balance of Georgia. According to the experts estimation, the actual volume of wood consumption along with other non-accounted biofuel resources (residues of timber recycling and agricultural production, peat, etc) reaches about 350-400 thousand toe annually.

Coal production and consumption has significantly increased in Georgia during recent years achieving some 360 th.tons in 2011 (from 5 th. tons in 2006).<sup>5</sup> At the same time, imported coal has been mainly replaced by local products and according to plans, local production will be increased to 450-600 th tons by 2014-2016. Further development of coal industry can be acceptable only if it takes place in accordance with internationally recognized environmental standards by use of modern technologies. Coal is mainly used for production of cement and for metallurgic purposes, relatively in small volumes – for supply of TPP with installed capacity 13.5 MW, for household sector, railway transport and export to Armenia.

<sup>4</sup> GOGC statistics (historical data) and author's projections (2014-2020)

<sup>5</sup> Statistical data and projections provided by management of Tkibuli-Shaori coal mines

## **2. Challenges & Problems**

Georgia's energy sector faces significant challenges. As all other countries in transition, Georgia needs to meet the increasing energy demand, at the same time reducing the reliance on imported fuel and carbon emissions, that requires further modernization of the energy sector, integration in the regional structures and implementation of new technological solutions. The transition into an energy efficient and low-carbon economy, based predominantly on utilization of local resources, will require substantial investments in energy production, transport and storage. Moreover, the complex and costly transition will have to take place in a time of a global economic crisis when the available public and private capital is limited.<sup>6</sup> Besides, despite a significant economic recovery, Georgia faces high unemployment and poverty problems, which bears on public finances through the growing needs for social protection.

### **2.1. Energy Security**

Despite the fact that significant progress has been achieved in terms of modernization of the energy sector of the country on the basis of institutional and legislative reforms implemented in the recent years, energy intensity is still high as compared to the leading industrial countries, while the process of the full market liberalization and integration into regional systems has not been finalized yet. As a result, energy sector of Georgia may face significant hazards in certain situations, which is facilitated by fragile political stability of the region and high probability of economic sabotage from outside.

The principles of energy policy of the independent Georgia were developed as early as in 1990s within the EU "TACIS" program. The economic situation of the country of that period and ambiguity of the future political orientation predetermined many uncertainties and complicated correct forecasting of future trends of development of energy for the middle and long term periods. The recommended

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<sup>6</sup> Energy Strategy of the Energy Community, Energy Community Documentation, Ref: 10thMC/18/10/2012 – Annex 19/27.07.2012

policy was mainly oriented at restoration of the inherited from the Soviet period energy system. Besides, naturally, it could not reflect the significant political and economic processes of the following period, which were connected with development of international transit projects in the region and substitution of the dominant north-south vector of the energy transport flows passing through the Georgian territory with the priority east-west direction.

The main directions of the state policy were developed for the energy sector of Georgia in 2006, whose main goal is the maximum supply of power energy to the industrial, household and commercial consumers of the country by means of full utilization of hydro resources and diversification of supply of imported fuel resources.<sup>7</sup> The main directions of the policy also stress the suitability of using local, renewable resources and necessity of integration of the country's energy sector into the regional structures.

The processes developed in the world economy in 2007-2008, including the drastic increase of prices on hydrocarbon resources, natural and technogenic disasters and negative impacts of the global warming processes required immediate reorientation of production processes and commercial and household sectors to energy-efficient technologies and energy-saving means. The situation became especially complicated within the context of drastic aggravation of relations with Russia by 2006-2008, which had an impact on the energy sector as well. In particular, after explosion of 2 main supply pipelines and high-voltage power transmission line on the Russian territory in the coldest period of winter 2006, Georgia faced the hazard of the heaviest social and political disaster.

Besides, by establishing the highest price on gas in the South Caucasus for Georgia by Russia (so-called "political price")<sup>8</sup> which was

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<sup>7</sup> Main Directions of Georgia's State Energy Policy, Adopted by Parliaments Resolution # 3190-Is on June 7, 2006

<sup>8</sup> T.Gochitashvili, R.Gotsiridze, Georgia: Blue Fuel Levers In The Regional Politics, Central Asia and The Caucasus, #3 (21), 2002, Lulea, Sweden, p.p. 42-52

generally 30 percent higher as compared to the price on gas supplied to Armenia, which receives gas via our territory and logically, the cost of gas transit should be added to the price, a “hotbed” was created for enterprises operating in Armenia which were managed by Russian companies. This drastically narrowed competitiveness of similar Georgian companies producing the same products. For instance, due to the fact that the cement, metallurgical and chemical plants and TPPs of the neighbor countries received the fuel resource (gas) at a much cheaper price, unacceptably large segment of the Georgian consumer market was occupied by foreign-made products, while the price of imported power energy became cheaper than the price of power energy produced on domestic TPPs.

The newly aroused problems of guaranteed supply of the country with energy resources and the energy security and the necessity of making adequate adjustments of the factual condition in the action plans were also predetermined by the Russian aggression in August 2008 and the further course of events. Additional risks associated with the energy security of the country and implementations of prospective transit projects were expressly identified.

It is evident that Russia will again attempt to continue destructive actions in detriment to the transit routes of energy resources passing through Georgia and will push Azerbaijan and Central Asian countries to reconsider the transit policy against diversification of European markets. Under the created circumstances, political decision-making and facilitation of appropriate measures for the purpose of integration of the country into regional structures and maximum involvement in international transit projects, acquires a particular significance.

As a result, the necessity arose, and on the other hand, the facilitating preconditions were created<sup>9</sup> for Georgia to initiate active actions in order to ensure sharp rise of energy security.

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<sup>9</sup> In 2007 gas supply from Azerbaijan by an alternative route begun and rehabilitation-modernization works of a significant part of energy generation facilities have been finalized etc.

Intensive implementation of the recognized priority of the energy policy - power energy generation projects for construction of several tens of HPPs with total capacity up to 2500 MW and planned investment of approximately \$4.1 billion were activated, EBRD, EIB, WB and other IFIs are involved in the process of implementation of large scale HPP projects.<sup>10</sup> As a result, significant increase of generation during the next few years is planned, which will significantly increase export potential of electricity to neighboring countries and Europe.

## **2.2. Energy efficiency and environment**

The implementation of energy efficiency measures may become one of the main instrument for significant improvement of energy supply and increase of competitiveness of products produced by the local industry, as it is known that, generally, the average cost of energy efficiency measures is assumed to be approximately 75 percent of the cost of the primary fuel being displaced<sup>11</sup>. By introduction of energy-effective household appliances and heating systems, acceptance of mandatory standards of thermal isolation for buildings etc., significant saving can be ensured in the household and commercial sectors.

The results of modeling of development scenario as reported in Georgia's Second National Communication to the United Nations Framework Convention on Climate Change<sup>12</sup> show that the greenhouse gas reductions attributable to new energy efficiency measures and renewable energy are 6 percent of projected future demand in 2025 with respect to the business as usual case, and 12 percent under the alternative aggressive energy efficiency policy scenario.

From the EU's standpoint, Georgia needs to implement the relevant provisions for improving the energy efficiency and where appropriate,

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<sup>10</sup> V. Khavtasi, Energy sector review. Proceedings of the International Conference: Utilization of Renewable Energy, March, 2012

<sup>11</sup> Energy Strategy of the Energy Community, Energy Community Documentation, Ref: 10thMC/18/10/2012 – Annex 19/27.07.2012

<sup>12</sup> www.unfccc.int, Georgia, II National Communication to UNFCCC, 2009

implement concrete policies and measures to reduce greenhouse gas emissions, in particular in the energy and heavy industry sectors. The EU has also observed that to enhance strategic planning, implementation and enforcement of environmental legislation, Georgia needs to strengthen administrative capacity in particular at regional and local levels and to coordinate between the relevant authorities.<sup>13</sup>

The EU assessment found that environmental legislation was in place in several areas, but still needs further development, in particular with regard to implementing legislation. In the view of Transparency International, legislation is scattered and at times contradictory, and despite recent attempts at mainstreaming climate change issues, it is not fully factored into national planning and policy. Public participation in discussions about environmental protection issues is minimal and the subsequent influence on the decision making process is limited.

### **2.3. Potential for Nontraditional Renewables**

Apart from hydro energy potential, Georgia is rich in non-traditional, renewable energy resources as well. The primary stimulating factor for wide-scale development of such resources is sharp reduction of harmful impact of fossil fuels on the environment, as well as development of decentralized, autonomous energy systems based on utilization of local sources and ensure effective and reliable functioning of economy of high-mountain, hardly accessible Georgian regions. At the same time, Georgia is also distinguished for uncommon diversity of climatic zones – according to the existing data, discharge of rivers, solar radiation and wind intensity, their frequency markedly differ in various parts of the country, which allows a rich choice of development technologies of renewable energy resources utilization.

Currently, Georgia has abundant, practically undeveloped wind energy potential. It is established that the country possesses significant

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<sup>13</sup> In-depth review of the energy efficiency policies and programmes: Georgia. Energy Charter Secretariat, Brussels, 2012



theoretical<sup>14</sup> and commercially feasible potential of wind energy.<sup>15</sup> The preliminary estimations show that in case of development of the wind energy potential only on the most prospective regions (Rioni and Mtkvari river basin, Sabueti mountain, Paravani Lake in Samtskhe-Javakheti etc.) it is possible to arrange highly effective wind farms with installed capacity of up to 2000 MW.

Up to 250 natural and artificial (from boreholes) sources of geothermal waters are registered on the territory of Georgia<sup>16</sup>, with total debit of 160000 m<sup>3</sup>/d. According to the estimation, for the fields of Tbilisi, Kindgha-Mokvi-Ozurgeti, Zugdidi-Tsaishi, Khobi, Kvaloni, Vani, Samtredia, the cost of heat obtained from thermal waters is less than the cost of heat obtained traditionally, by fossil fuel combustion.<sup>17</sup>

Annual hours of sunshine on the most territory of Georgia range between 1800-2600 hours, while radiation by regions vary within 1250-1800 kWh/m<sup>2</sup>. Utilization of solar energy is especially favorable for hot water supply, using solar concentrators for generation of low potential heat (<100 °C), primarily for residential, industrial and resort-recreational zones, as well as thermal recycling systems for agricultural products processing with the intensive seasonal load in summer period. Besides, solar energy is practically a single source for supply of high-mountain villages, border-posts remote from settled areas, temporary camps of migratory animal farms, churches and monasteries, technological communication systems of trunk pipelines, roads and railways etc. with power generated by solar photo-electric systems.

Biomass is an important source of energy in Georgia - use of firewood for heating and cooking is widespread in rural areas. According to experts estimations several hundreds of cubic m of wood, equal to

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<sup>14</sup> Wind Energy Atlas of Georgia by "Qarenergo Ltd", Tbilisi, 2009

<sup>15</sup> Georgia. German Development Agency (GTZ) report, 2009

<sup>16</sup> G.Buachidze, O.Vardigorelli, N.Tsertsvadze. Proceedings of World Geothermal Congress 2000, Tokyo, 2000

<sup>17</sup> www.unfccc.int, Georgia, II National Communication to UNFCCC, 2009

some 400 ktoe/y has been already utilizing in recent years in Georgia for energy purposes. Georgia should develop a robust strategy to achieve greater efficiency of biomass for heating in household sector to achieve long-term renewable energy objectives, for example through the deployment of high efficiency firewood burning stoves on the basis of the existing case studies, supplemented by the aid of donor organizations. Besides, according to the evaluation, relatively low-calorific biogas can be obtained by recycling of residual biomass, which will be used for replacement of imported natural gas.<sup>18</sup>

The lack of information at all levels of society, including policymakers, and legal framework for protectionist policy to develop renewable energetics remain to be the crucial problems to be addressed through the efforts of government,<sup>19</sup> international donors and civil society.

## **2.4. Transit Infrastructure**

Georgia's international policy envisages facilitation of new transit projects and restoration and development of energy links with the neighbour countries, simultaneously ensures diversification of sources and routes of supply of energy resources.

Significant role is playing by the policy of privatization of state-owned power facilities, facilitation the formation of the private ownership institute and stage-by-stage liberalization of market. At the same time, it is required to make balanced decisions in the process of privatization of energy infrastructure facilities of strategic importance. The existing policy should be eradicated which does not prohibit the possibility of control of the power and gas supply and transmission/distribution systems by one subject. Supply and distribution functions should be really unbundled which could be the best means of facilitation of competitive market formation.

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<sup>18</sup> In-depth review of the energy efficiency policy of Georgia 2010, Energy Charter Protocol – PEERA, Brussels, 2011, pp.69-89

<sup>19</sup> M.Margvelashvili, Renewable energy development problems in Georgia. Presentation at the International Conference: Utilization of Renewable Energy, Tbilisi, March, 2012, 8 p-s

The strategy facilitating the energy security of the country - transition to liberal market relations in oil and gas sector and integration into regional structures, as well as improving reliability of the infrastructure functioning have to be realized step by step. In order to succeed following policy should be implemented:

- increasing reliability of the transport infrastructure through rehabilitation-development of trunk gas pipelines and modernization of their operating facilities and methods;
- diversification of supply sources by ensuring long-term contracts with suppliers, as well as corresponding preparation of the domestic market through liberalization and adaptation of the regulatory legislation;
- planning of strategically important facilities, including pipelines connecting various sources of supply (interconnectors) and the underground gas storage, as well as diversification of types of energy for the purpose of supplying the remote and mountainous regions of the country with various products of transformation of natural gas and oil having high specific energy density;

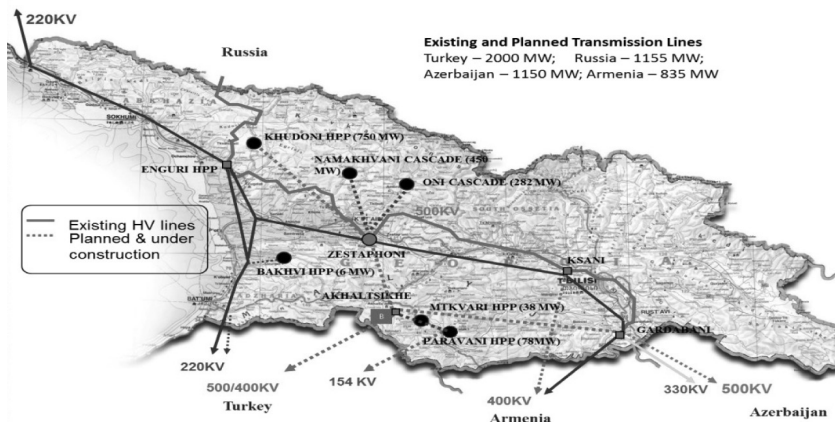
Considering the growing export potential of gas from Azerbaijan and the strategic cooperation established among the two countries, Azerbaijan is considered as the priority source of gas supply of Georgia. Delivery of gas from Azerbaijani Shah Deniz field is ensured on the basis of long-term contracts with the operator consortium through the South Caucasus Gas Pipeline System (SCP), according to which the country can receive up to 5 percent of the volume of gas transported via the pipeline as a transit fee, in-kind (or the equivalent monetary compensation) and supplemental gas supplied at a preferential price. Taking into consideration Shah Deniz Stage II development plans, the volume of gas delivered via SCP to Georgia will be equal to at least 1,300 bcm/y after 2018.

By the intergovernmental memorandum with Azerbaijan and the long-term, strategically important commercial agreement signed between Georgian Oil and Gas Corporation (GOGC) and State Oil Company of

Azerbaijan (SOCAR), the guaranteed supply of the required volume of gas from Azerbaijan to socially vulnerable consumers (household sector and power generation) is ensured, provided that stable tariffs are maintained within the following several years. At the same time, the contract ensures rational management of the sharp seasonal imbalance between gas supply and demand in Georgia.

Significant work is performed in order to balance the production and demand of electricity. In line with the increase of the power generation, it became possible to significantly increase the export as well, through modernization-expansion of high-voltage power transmission lines connecting with the neighbour countries. In this regard, the “Black Sea Power Transmission Line” (500/400 KW line connecting to the Turkish power system, which is connected to the European system) is considered to be the most significant project. Implementation of the project whose main objective is to export the excess power produced in the country and generally, continuously carry out the transit, import and export of power to Turkey and the EU countries, will also enable to increase the reliability of operation of the Georgian power system and ensure continuous power supply across the country.

**Figure 4. HV Transmission network development plan<sup>20</sup>**



<sup>20</sup> www.minenergy.gov.ge, Power Supply of Georgia, Advisory assistance to the Ministry of Energy of Georgia, USAID supported project in Georgia, 2006

The implementation of the projects of rehabilitation/development of the infrastructure connecting with the neighbouring countries allows to connect the Georgian energy system (except the Turkish and European markets) to the southern regions of Russia (the North Caucasus-Volga economic region), Azerbaijan, Armenia and Iran (via the Armenian or Azerbaijani system), which will ensure the more effective performance of the function of the main transit country of the region.

Significant facilitating factors are established for implementation of projects of construction of new transit oil and gas main pipelines via the territory of Georgia. An active review and processing of various alternative projects of delivery of gas from Azerbaijani and Central Asian fields to Europe through the Southern Energy Corridor, which will ensure the further diversification of the market and reduce the negative consequences of the possible dictate of the monopolist producers to minimum.<sup>21</sup>

It is foreseen to deliver the natural gas from Shah Deniz field in Azerbaijan and later possibly from the Central Asian countries to the Balkans and/or Central Europe via the Southern Gas Corridor, utilizing the capacity South Caucasus Pipeline and the planned pipelines (TANAP, NABUCCO West, TAP)<sup>22</sup>. Construction of Transcaspien pipeline (TCP) is planned for delivery of the Turkmen natural gas via this route.

Azerbaijan-Georgia-Romania Interconnector (AGRI LNG) project is considered as one of the possible options of delivery of Azerbaijani gas to the European market. It envisages construction of an LNG (Liquefaction Natural Gas) terminal at the Georgian Black Sea coast and transportation of the produced liquefied gas to the western coast of the Black Sea via tankers, where regasification, off take and dis-

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<sup>21</sup> The EU dependence on import has reached 90% for oil, approx. 64% for natural gas, and 40% for coal

<sup>22</sup> T.Gochitashvili, T.Javakhishvili, Oil and Gas Trunk Pipelines, "Meridiani", Tbilisi, 2012. pp. 242-253

tribution systems will be arranged. A new interconnector connecting SCP to the Georgian trunk pipeline system or the existing Georgian East-West trunk pipeline will be used for implementation of AGRI LNG project on the Georgian territory.



**Figure 5. Southern gas corridor<sup>23</sup>**

The restoration-development work of the East-West trunk pipeline system are underway, which will significantly increase the area of operation and technological reliability of the unified gas supply system of Georgia, guaranteed gas supply of population and enterprises of rural regions, free industrial zones of Poti and Kutaisi and the recreational zone of the Black Sea coast. Environmental impact of the projects includes elimination of leaks from the unserviceable and damaged pipelines and replacement of firewood by gas in the household sector, for the purpose of protection of forest resources. At the same time, population will receive the fuel of the lowest unit cost – natural gas, which is one of the factors contributing to significant saving of the family budget and implementation of the state program for overcoming poverty on the basis of stimulation of intensive development of production through increase of employment of the local population.

The Euro-Asian Oil Transportation Corridor (EAOTC) project is intended for delivery of the Azerbaijani and possibly, Kazakh oil mainly to

<sup>23</sup> T.Gochitashvili, T.Javakhishvili, Oil and Gas Trunk Pipelines, "Meridiani", Tbilisi, 2012. pp. 193-200

markets of the East and Central Europe. Preliminary Study of the project confirming feasibility of the route has been prepared. At the first stage it is envisaged to transport up to 5 mln. tons of oil from Azerbaijan to Europe, by Azerbaijan-Georgia railway and Georgian Black Sea ports mainly to refineries of Ukraine, Belorussia or Slovakia annually. At the next stage it is envisaged to increase the throughput of the system up to 20, possibly 40 million. tons per year, for which a new oil pipeline will be possibly built in Georgia and Azerbaijan.<sup>24</sup>

Apart from being involved in AGRI LNG and EAOTC projects as a transit country, Georgia also is a shareholder in the international project implementing companies AGRI LNG Project Company and SARMATIA together with the oil companies of Azerbaijan, Romania, Hungary, Poland, Ukraine, Azerbaijan and Lithuania.

The analysis shows that commercially most viable routes of delivery of increased volumes of gas from Caspian fields and to the international markets pass through the Azerbaijani and Georgian territories. Accordingly, there are good prospects for implementation of planned infrastructure projects, which will contribute to significant increase of transit volumes of Caspian hydrocarbons delivered via territories of Georgia and Azerbaijan.

### **3. Reform Areas in the Energy Sector**

Georgia has chosen the path of integration into the European political and economic structures. Accordingly, one of the primary goals of the energy policy of the country is to achieve similarity to the EU energy policy principles and directions through harmonization of the relevant legislation.

The process of harmonization of energy legislation and institutional structures intensively began since 2004, after Georgia joined the EU Neighborhood Policy and later the Eastern Partnership Program. In November 2006, the so-called Road Map was adopted within the ex-

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<sup>24</sup> EAOTC Feasibility Study (main Report), Granherne Limited (UK), 2009

tended energy cooperation with the EU.<sup>25</sup> One of the main reference points of the road map is convergence of energy markets on the basis of domestic energy market principles when peculiarities of the partner countries will be considered. The long-term objective is to create integrated regional energy markets and their maximum integration into the unified energy market of EU.

The process of market liberalization and harmonization with the EU energy legislation became particularly important after Georgia joined the Energy Community with the status of an observer in December 2007. The main purpose of joining to the Community generally is to implement the EU standards and regulations and join to European unified energy network.

The integration process has entered the new phase from 2010, after starting negotiations on association with the EU whose one of the main objectives is consistent convergence and harmonization of principles of arrangement and regulation of Georgian internal markets with the EU ones. The recent changes on the Georgian energy market are analyzed below. The existing legal frameworks and the nature of the local market operation are compared with the principles of the EU market operation and the legislation, including the energy packages requirements<sup>26</sup>.

The Law on Electricity and Natural Gas is the main legal document governing the activities in the power and gas sectors of Georgia.<sup>27</sup> This law was adopted in 1997 and it is regularly amended to reflect the current tasks of development of competitive markets of electricity and natural gas. The law expressly defines the roles and functions of two main state institutions – the Ministry of Energy and Natural

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<sup>25</sup> Road map for the energy co-operation between the EU, the Littoral States of the Black and Caspian Seas and their neighboring countries, Annex 1, Astana, 30th November, 2006

<sup>26</sup> V.Jankauskas, T.Gochitashvili, G.Abulashvili, Development of Georgian Electricity and Gas Markets in Line with the EU Energy Policy, Georgian Economic Trends, GEPLAC, Quartelry Review, February 2008, pp. 55-62

<sup>27</sup> Law of Georgia on Power Energy and Natural Gas



Resources and the National Energy Regulation Commission which are responsible for development and operation of electricity and gas markets.

As compared to the applicable in the EU members' states legislation on electricity and gas, the Georgian law points out rather significant importance to identification of the roles and functions of the Ministry and especially, the Commission, but does not describe the rules and conditions of activities of markets.<sup>28</sup> However, sometimes such approach is considered more acceptable, because of powers of various state institutions are clearly defined, they are enabled to develop and/or approve such implementing provisions which will ensure sustainability and flexibility of the market operation on the basis of clear and transparent principles.

The main signs distinguishing the law from the European Directives can be established as follows: the final and main objective of formation of liberalized competitive energy markets is not clearly established; the obligation of consumer protection and providing social services to the socially vulnerable layer by the state are not properly identified; the definition of supply is not properly outlined and accordingly, competitive activities in Georgia are mixed with the distribution activities of monopolist nature; the requirement on separation of various regulated activities should include unbundling not only of accountability but also of operation and management (functional and legal unbundling) which may be followed by a request for the demarcation of property recommended by the European legislation at a certain stage.

Another significant legally binding document is "The main directions of Georgia' state policy in the energy sector" (2006).<sup>29</sup> The document identifies the main objectives of the long-term energy policy. The

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<sup>28</sup> T.Gochitashvili, M.Krakauskas, G.Abulashvili, Georgia in the context of EU energy policy, GEPLAC, Georgian Economic Trends, Quarterly review, June 2006, pp. 59-66

<sup>29</sup> Main Directions of Georgia's State Energy Policy, Adopted by Parliaments Resolution # 3190-Is on June 7, 2006

document also defines the schedule of consistent opening of the market for competition, but it is desirable to consider in this document the relevant provisions of the 3<sup>rd</sup> Energy Package of the EU, which may become mandatory in case of compliance with the requirements of the European Community Association Agreement and/or joining the Energy Community. At the same time, it is recommended to reflect the terms and principles of opening the energy markets in a corresponding law, similar to the EU directives, which ensures more guarantees for potential investors.

Besides, under the Georgian legislation, distribution companies are obliged to supply electricity to the existing consumers, while authorized consumers can purchase electricity for own consumption. The European legislation identifies independent licensed suppliers who have a right to purchase electricity from any supplier and sell it to any authorized consumer but they are not involved in distribution, which allows to differentiate the competitive (supply) and monopolist (distribution) activities and avoid cross-subsidisation of these two activities.

Various types of activities are partially unbundled on the Georgian energy market (except supply). As a rule, companies of various functions have different owners. However, for instance in case of "Energo-Pro" and "Telasi," one and the same company supervises the generation and supply, as well as distribution activities, which is considered to be a deviation from the competitive market principles. The Georgian legislation requires separate accountability of generation and distribution in such companies, though, the EU legislation gives an advantage to the functional and legal unbundling in such case.

The requirement of opening the Georgian natural gas market and differentiation of its activities is also partially completed. In particular, the new activity – "transit" is considered among the activities covered by law in the gas sector, which implies the obligation to transport a third-party owned gas through the network of the distribution license holder and governs the technical, commercial and financial issues

related to it. At the same time, similar to the power energy market, the distribution and retail supply activities are not separated. The further opening of the market and the real separation of retail supply and distribution activities will create favorable conditions for the most consumers to conclude direct contracts with any suppliers and achieve optimization of the tariffs of retail supply and distribution.

The crude oil and petroleum products market is entirely liberalized in Georgia and the prices reflect the international market tendencies more or less. At the same time, it should be mentioned that regulation of prices on petroleum products, which are rather high as compared to the price on natural gas in Georgia, as well as market prices of petroleum products in neighbour countries, can be facilitated by transition of part of transport utilities to consumption of significantly cheaper compressed gas, which on its part, will ensure reduction of harmful emissions by about 30%. Armenia serves as a good example of such strategy, which is entirely dependent on imported petroleum products similar to Georgia and has switched approximately three-quarters of the car fleet to gas consumption for the purpose of significant reduction of transportation expenses.

On the basis of comparison of the legislation governing the European energy markets with the Georgian energy legislation, their implementation possibilities on the local market can be identified. Generally, the main purpose of EU Energy Directives and Regulations is to establish an unified energy market based on a competition, with agreed tariffs, which will facilitate the trans-boundary movement of energy resources, free trade under conditions of maximum transparency, continuous and non-discriminated access of any third party to the existing infrastructure, energy security of each country and the entire Community. As the analysis shows, the applicable legislation of Georgia partially does not correspond to the main provisions specified in the directives, some of which are totally new for the Georgian legislation and require detailed and comprehensive study for preparation of final recommendations for their introduction.

It is noteworthy that in some cases, the European Regulation allows to establish certain compromises for newly joined states on the basis of a corresponding rationale, including the conditions when the issue is related to the likelihood of arising of additional risks to the energy safety of the country. In case of association/integration of Georgia with the relevant structures of the EU, the country must necessarily consider such possibility as well as the provision of non-application of several requirements of the Regulation to the earlier signed international agreements (e.g. transit related agreements of South Caucasus Pipeline or Baku-Tbilisi-Cheyhan oil pipeline etc.).

In addition, it is important for Georgia to reserve the right to hold negotiations with stakeholders on the types and amounts of transit tariffs (including, in-kind compensation) separately, for each new project, as the European legislation practically annuls the concept of transit fee and does not consider the political consequences of implementation of new transnational projects for Georgia. Simultaneously, one of the aims of the Russian aggression in 2008 was to damage the reputation of Georgia as a reliable transit country as well.<sup>30</sup>

Probably, Georgia will necessarily finalize the process of harmonization with the EU energy legislation and obtain the positive results brought to Europe by liberalization of markets. But as the analysis shows, there are certain inconsistencies in the institutional arrangement and the governing legislation of the energy sector of the country in comparison with the requirements of the corresponding European regulations and their preparation for painless adaptation is a rather important and urgent task. The problem mainly concerns the identification of legal mechanisms for maintaining of preferential conditions of the existing contracts of the transit projects, issues of effective unbundling of competitive and monopolist activities on the energy market etc.

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<sup>30</sup> T.Gochitashvili, T.Javakhishvili, Oil and Gas Trunk Pipelines, "Meridiani", Tbilisi, 2012. p. 140

#### **4. Priorities of energy sector development strategy**

Water is a primary local energy resource in Georgia. By concentration of potential hydro resources, Georgia is one of the top territories in the world. With 60,000 km of rivers and a combined annual water supply of 96.5 km<sup>3</sup>, the country ranks a top the world's hydropower resources per-capita. Currently only 20-25 percent of total generation potential is realized while HPP Greenfield potential total roughly 20 TWh.

Hydroelectric generation will continue to play a major role in Georgia's energy policy and planning for the reasonable foreseeable future. Georgia's strategic location in the region supports creation a range of new opportunities for full satisfaction of industrial and domestic demand and export of excessive electricity to the neighboring countries and European markets.

Policy for rational utilization of increased generation based on local hydropower potential focuses on<sup>31</sup>:

- Attraction of investments for construction of new small (<13 MW)-, medium-sized (<100 MW) and large hydropower plants by means of initiating of simplified, transparent and competitive tender and licensing procedures, deregulation of small HPPs sector. All new "greenfield" sites for HPPs are planned to award to investors on a "Build-Own-Operate" basis;
- Various support measures, including protectionist policy in stimulating investment for development of renewable energy should be implemented and the effectiveness of energy efficiency measures and utilization of the non-traditional resources for sustainable development regularly addressed to the stakeholders;
- Phasing down thermal generation and imported power in base load, and replacing with hydro generation for base load demand, including capacities of new HPPs;

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<sup>31</sup> Source: [www.minenergy.gov.ge](http://www.minenergy.gov.ge)

- Implementation of the projects of new high-voltage power transmission lines to neighboring countries predetermines technical conditions for creation of unified regional system and providing operation of the systems of neighboring countries in parallel mode, also third party access to the transmission and distribution networks, if there exist multipartite political readiness of all countries and consistent qualitative parameters of produced electricity is provided;
- Promoting bilateral and regional cooperation implementing electricity exchange with the systems of neighboring countries, ensuring long-term cooperation with electric system operators of neighboring countries in order to support surplus electricity export, and imports as may be required, initiate harmonization and implementation of the relevant legal framework in order to create a regional power market, promote the advantage of geostrategic location of Georgia as the most effective regional energy hub;

Besides further development of oil and gas transportation infrastructure between Europe and Asia, using East-West and North-South energy corridors have to be considered that allows diversification of natural gas supply to EU and supports to maintain a status of the most suitable transit country for Caspian hydrocarbon resources in the region.

In the view of the global financial-economic crisis, significant and sharp increase of prices on energy resources, real hazards entailed by global warming and the outcomes of the Russian aggression against Georgia in August 2008, it is expedient to carry out the following recommendations contributing to increase the energy security and sustainable development of the country:

- Primary facilitation of utilization of local energy resources, including rich hydro resources and formation of a stable and competitive market on that basis, are the priorities of the

energy policy of Georgia both in the short- and long-term perspective of its development;

- Significant means of increase of reliability of energy systems and commercial competitiveness are restoration/modernization of the existing transmission and transit systems and construction of new lines connecting to the neighbor countries, which will resolve the problems of integration of regional energy systems in general and sustainable energy supply of Georgia in particular;
- Maximum increase of share of nontraditional renewable energy resources in Georgia and energy efficiency in the consumer side is a factor of a significant potential, not sufficiently developed yet. In case of ensuring a relevant protectionist policy and availability of information, foundation for development of a secure and cost-effective energy sector can be laid on the basis of hydro and other (nontraditional) renewable resources and simultaneously, the problems of environmental protection, unemployment (which is critical for the country) and sustainable development in general can be resolved;
- Facilitation of diversification of imported fuel supply through realization of planned oil and gas pipelines projects on the territory of country, should remain one of the main priorities of the Georgian energy policy for facilitation of increase of the energy security and common economic progress of the region;
- Rational planning of utilization of strategic reserves of energy resources will ensure mitigation of possible imbalance between the seasonal supply and consumption and significantly increase the energy security of the country;
- Introduction of modern technologies of liquefaction, compression, storage and distribution of natural gas allows to sup-

ply the territory of the country which is not covered by the gas pipeline system (about 30 percent of the entire territory), with relatively cheaper, easily consumable and ecologically clean fuel;

- Legislative amendments contributing to the clear and transparent, sound competition of supply-distribution of energy resources and market regulation, harmonized with the international legislation ensure improvement of the investment climate and market structures, interest of investors and stimulation of wide involvement of the private sector in the energy sector of Georgia. In this regard, it is necessary to real unbundling of the retail supply and distribution functions, which will be the best means to prevent creation of monopolist structures and facilitate competition in the sector;
- Transparency of the political initiative and decision-making process on issues of development of the energy sector of Georgia, import and transit of main fuel resources, privatization and other forms of alienation of state-owned assets, market liberalization and other strategically important issues under conditions of wide publicity is one of the necessary conditions for sustainable development, including ensuring the energy and political security of the country.



# CHAPTER IV

## SECURITY AND CONFLICTS: GEOPOLITICAL DYNAMICS AND CLASHING CONCEPTS



# **SECURITY PERCEPTIONS: THE VIEWS FROM ARMENIA, AZERBAIJAN & GEORGIA**

## **The Evolution of Armenian National Security**

**Richard Giragosian**

### **Introduction**

The evolutionary development of Armenian national security has been closely tied to the unique history of the Armenians. Driven by its long but troubled history, the fundamental concept of Armenian national security has been dominated by the most basic and essential mission: survival. Throughout history, this mission has entailed a complex strategy of managing threats from a number of competing empires and regional powers. The sole driving force of this mission has been a priority of ensuring the physical survival of the Armenian nation. Although this mission of national security was not always tied to statehood, or even to sovereignty, the imperative for national survival forged a resilient and vibrant nationalism among the Armenian nation.

Throughout the Ottoman period, with its sporadic threat of pogrom and massacre that culminated in the 1915 Armenian Genocide, the Armenian perception of national security was further equated with outright survival. With the birth of the first independent nation-state, through the formation of the Republic of Armenia in 1918, this historically defensive concept of Armenian national security adopted new elements of state security and military strategy. But the short duration of that early period statehood, which abruptly ended with the absorption of the first Armenian Republic into the Soviet Union, effectively halted the development of a more mature concept of Armenian national security.

## **The Soviet Legacy**

Although the Sovietization of Armenia ended the country's short-lived independence, the incorporation of Armenia within the Soviet Union provided an important degree of security, especially in the aftermath of a series of military attacks by Turkish forces targeting the small Armenian state. Yet while the Soviet Union offered inherent security and ensured the survival of the beleaguered state, it also impeded the course of Armenian statehood and impaired the development of a more sophisticated concept of national security. Throughout the Soviet period, Armenia was confined within the parameters of Soviet identity and policy, leading to a long period of stunted development and retarded growth. This was also evident in the misdirection of national security during the Soviet period, with its inward focus on "enemies of the state," rather than focusing outward for potential threats. For the Soviet Union, as with most authoritarian regimes, such an inward focus of national security was necessary to maintain security and stability. Yet this resulted in an institutionalization of "regime security" over national security.

Thus, the foundations for Armenian statehood and national security were seriously flawed by the inherent limitations and impediments from the country's legacy as a component of the Soviet system. With the collapse of the Soviet Union and the emergence of a new independent Armenian state, there was no reservoir of experience and maturity to draw upon in preparation for the complex challenges from such an abrupt reawakening. Moreover, its legacy as a Soviet state led to a rather incoherent combination of strategy and statecraft at times grossly ill-suited for prudent policy or national power.

Yet during the early years of post-Soviet independence, Armenia was still able to withstand war and blockade, and to adapt to externally imposed isolation while still achieving economic growth in only a few short years. And in terms of military security, Armenia was able to emerge as the dominant force in the region. But in the fifteen years since a ceasefire with Azerbaijan that essentially "froze" the Nagorno Karabagh conflict, there has been far too little adaptation to meet

the changing nature of strategic threats and the geopolitical shifts that have so profoundly altered regional security. Moreover, and most worrisome, Armenia has yet to seriously confront the dynamic pace of change in global security, geopolitics and globalization.

### **Armenia: The Process of National Security**

For all countries, not just Armenia, the process of defining national security is one of the more basic obligations of a state. The term national security is essentially used to define a state's mission to meet possible threats, both internal and external. This state mission is comprised of three main pillars: to protect its territorial integrity and state borders; to provide security for its population; and to preserve stability, in both political and economic terms. The challenge of national security, especially in today's complex environment of multiplying threats, is to ensure that both the definition and defense of national security is a dynamic, not static, process of constant vigilance and preparation.

For an infant state like Armenia, small in both size and population, national security holds an even greater role in influencing the formulation of domestic and foreign policy alike. Faced with the demands of a long-standing trade and transport blockade by two of its four neighbors, as well as the constraints of an unresolved conflict over Nagorno Karabagh, Armenian national security is endowed with a significance well beyond the traditional nature of small state geopolitics. Moreover, Armenia is now increasingly subject to several broader challenges, ranging from shifting regional geopolitical competition to new threats to the state-centered system of international security. More specifically, there are four key components to reassessing and redefining Armenian national security within the context of the country's current limitations, challenges and threats.

### **The Imperative to Reassess Armenian National Security**

For Armenia, there are obvious limitations of resources, both human and financial, to the development of a more sophisticated and

comprehensive strategy of national security. But Armenia faces a particularly challenging threat environment, with one neighboring country, Azerbaijan, that is both hostile and unhappy with its territorial and diplomatic losses in its war with Armenia over the Nagorno Karabagh enclave, and another neighbor, Turkey, which poses its own potential threat to Armenian security. Thus, this combination of scarce resources and potent security threats requires a more sophisticated strategic response. The core mission for Armenia, from this context, is to establish a coherent process of national security. This entails both organizational and ideological reforms, including a reexamination of commonly held but little questioned tenets of Armenian national security, as well as a greater effort to maximize policy options while mitigating the inherent impediments to its national power.

In terms of this imperative for forging a sophisticated strategic process of national security, Armenia needs to look for international models. One such example for Armenia stems from the U.S. model of national security planning, which offers an important precedent for Armenia mainly because it elevates the national security process to a level of equal significance with national security policy by opening the process to a higher level of policy debate and public disclosure. During the initial stage of the Cold War, for example, the executive branch of the U.S. government first instituted the practice of publicly disclosing an articulated concept of national security. The practice of an annual reporting of U.S. national security was not instituted until later, when a new law was adopted in 1986 requiring every U.S. Administration to submit an annual report on its national security strategy to Congress. This practice is more than a display of the transparency of U.S. governance, but as a legal requirement, forces the Administration to formulate and articulate a coherent concept of its national security goals and perspectives. Thus, it is the process more than the policy of national security that is enhanced by this system.

Yet the absence of an effective policy formulation process in Armenia remains unresolved, with the inactivity and inadequate authority of

each of the institutions of Armenian national security posing a serious obstacle. This deficiency is notable not only within the Armenian National Security Council itself, which as the country's principal security body is largely marginalized from any lead role in the formulation and consideration of the national security decision-making process. Although there has been a marked increase in the role of parliamentary committees with jurisdiction over defense and security policy, the sheer dominance of the executive branch has only solidified the dysfunctional nature of the national security process.

Therefore, a primary recommendation to improve the process of Armenian national security would be to reform the organization of the National Security Council. Currently, the Armenian National Security Council is rarely utilized as an effective consultative body and, even when it is engaged in the public policy process, is usually focused on the implementation of a decision already adopted. This distorted process stems from the fact that the body is headed by a politician and former parliamentary speaker, with little experience and expertise to fulfill his role as the Secretary of the National Security Council. Given the president's dominant role over much of the country's military and security policies and decisions, the practical result renders the body to be organizationally impotent.

In terms of the process of national security, Armenian officials must also recognize the fact that national security is a dynamic, not static process that must become more inclusive, incorporating a broader range of actors and input. The most basic mechanism to achieve such inclusion would be to focus on targeting three specific actors: (1) state bodies and ministries, through an emphasis on an inter-agency approach; (2) academic and civilian experts, to harness critical input from those beyond the confines of political constraints or considerations; and (3) international experts and foreign officials, to utilize "best practices" for national security decisions and to leverage the input from other stakeholders in the process, such as experts from the US, Russia and NATO, for only a few examples.

## **The Impact of the Georgian-Russian War on Armenia**

Even before the August 2008 war in Georgia, there were several dangerous trends in the region already evident. These regional trends, ranging from a regional “arms race” to a shift in the fragile military balance of power in the region, posed new and very serious threats to Armenian national security. Yet even today, the outlook for security and stability in the South Caucasus remains far from certain. But the August 2008 war further demonstrated a dramatic shift in the region’s delicate balance of power, which has already reconfigured the threat perception and military posture of the region. More specifically, the changing nature of the regional military balance of power is compounded by two factors: a virtual “arms race” in the region, driven by sustained increases in defense spending, which have only impeded and subverted the course of reform and development in the region, and an overall shift in the regional “balance of power,” matched by a deeper trend of “militarization” in the region, with the amplification of militant discourse and threats of war heightening tension and increasing the danger of renewed military hostilities or war.

### **A Regional Arms Race**

For several years, there has been a marked increase in a regional competition over defense spending. As Azerbaijan escalates its defense spending on a massive scale, Armenia is compelled to keep pace, fueling a new “arms race” in the region. Over the medium term, the danger for Armenia is not simply to match Azerbaijan’s military spending and rearmament, but to prepare for a possible emergence of a much stronger Azerbaijani military. In addition, there is a related worry over Azerbaijan’s militant rhetoric to “resolve” the Nagorno Karabagh conflict by force, which bolstered by several years of billion-dollar-plus defense budgets, now poses one of the most serious threats to regional security and stability.

The emergence of a virtual “arms race” in the region first started in 2004, as annual defense-related expenditures increased annually. Al-



though the precise composition of military spending differs among each of the three countries of the region, the defense spending has steadily and consistently increased over the past five years, with each country devoting an ever-larger share of limited revenue and resources to defense spending. Most notably, Azerbaijan has increased its defense budget from \$175 million in 2004 to \$4.4 billion for 2012. But given the extent of corruption within the country, the increase in the annual defense budget has not been used to either invest in developing or training a more capable armed forces, or for procuring modern military weapons. A similar, but less substantial, increase in defense spending has also been underway in Armenia, largely due to the pressure of feeling compelled to keep pace with Azerbaijan. But Armenian defense spending has been the lowest in the region, with Azerbaijan spending roughly ten times more than Armenia on its military for 2012.

### **The Shifting Military Balance of Power**

Since the August 2008 war in Georgia, the shift in the region's already delicate balance of power has become apparent, actually presenting an even more serious challenge to regional stability and security. In light of the virtual "arms race" in rising defense spending, the danger of a new wave of rearmament, amid an overall climate of militarization, suggests that any change in the fragile military balance of power in the region could pose a serious threat to security. And with Nagorno Karabagh now the sole unresolved or "frozen" conflict in the region, any new imbalance of military power threatens the capacity for maintaining relative peace and stability in the region.

### **Azerbaijan's Military Aspirations**

But the larger problem stems from Azerbaijan's military aspirations, as Baku has repeatedly asserted a commitment to building a modern, self-sufficient armed forces on its own terms, rejecting the patronage of both NATO and Russia. Yet the course of military reform in Azerbaijan has been particularly difficult in recent years and, despite a sharp increase in its annual defense budget financed by its energy

wealth, the outlook for Azerbaijan's rise as a regional power is far from certain.

Despite several consecutive years of multi-billion defense budgets, Azerbaijan has accomplished little to date in terms of procuring advanced weapons systems or investing in modern equipment. Of its three branches of service, both the army and air force have continued to suffer from neglect, with continued shortages of spare parts and poor equipment maintenance. In addition, the Azerbaijani Air Force continues to suffer from shortfalls in munitions, ordnance and even aviation fuel, making the service the least combat-ready force. The Azerbaijani army, traditionally the core service of the armed forces, also lacks power projection capabilities and is far from attaining even a minimum level of combat-readiness. Thus, the real potential for building a modern armed forces in Azerbaijan remains little more than a distant promise at this stage. And even with the enormous state budgets for defense, a relatively small proportion of defense spending has actually been spent on arms, training and essential equipment. Moreover, although the future of Azerbaijan as a regional military power seems certain, it will require at least a decade of sustained and serious military reform before Azerbaijan can even begin to realize its potential as the dominant military power in the region.

### **Threat Perception**

For Armenia, the continued threats of war and sizable defense spending by Azerbaijan loom large in the minds of Armenian defense planners. Faced with the possibility for renewed war, Armenian officials see a crucial strategic benefit from the security umbrella of the Collective Security Treaty Organization (CSTO) and are convinced of the advantage of collective defense for CSTO members, including Armenia. And for Nagorno Karabagh, which after Russia's recognition of the independence of Abkhazia and South Ossetia from Georgia, is now the sole remaining "frozen" conflict in the region, the threats posed by a re-armed and re-assertive Azerbaijan can not be ignored. For the time being, Nagorno Karabagh remains fairly secure, mainly

due to the impressive professionalism and high state of readiness of the Karabagh military, in contrast to the generally poor state of affairs within the Azerbaijani armed forces. Most crucially, the tactical advantages of the Karabagh military's well-entrenched defensive fortifications also deter Azerbaijani aggression in the medium-term.

But Armenia should not be the only one concerned over such a threat to regional security. The international community should also be worried, especially since the August 2008 war in Georgia only demonstrated the vulnerability of the region's oil and gas pipelines from renewed hostilities. In addition to the fragility of the regional energy infrastructure, there are also several broader economic considerations, of even greater and longer lasting concern.

### **The Fallacy of Economic Deterrence**

First, it is now clear that the war in Georgia has revealed that the flow of oil and gas from the Caspian through the region is hostage to the inherent insecurity of the countries of the South Caucasus. But such vulnerability is certainly not a new development, as Western attempts to develop Iraq's oil sector have failed repeatedly in the face of incessant instability, for only one example. What was different in the Georgian case was the utter failure of the "economic deterrent" that was presumed to underscore Western commitments to security in the region.

More specifically, although the war in Georgia interrupted the flow of oil and from the Caspian and halted pipeline operations, the response was surprising. Prior to the August war, many analysts expected that by virtue of the sizable Western investments in the regional energy sector, which included the massive Baku-Tbilisi-Ceyhan oil pipeline, Western oil companies would do all in their power to pressure their governments to take immediate steps to end the conflict. Yet there was no concerted pressure, neither from the Western oil companies nor the states often thought to act on their behalf. The lesson of such empty "economic deterrence" suggests that in the event of a future conflict in the region, such as a war initiated by Azerbaijan, there should be no real expecta-

tion of an immediate or effective Western response. So much for the fallacy of British Petroleum exercising its influence over Azerbaijan to prevent war in order to maintain the flow of its oil supplies.

### **The Risk of Hostilities & the “Hostilities of Risk”**

The second factor of defense economics is the relationship between the risk of hostilities and the “hostilities of risk.” Notably, there is an inverse relationship between an increasing level of the risk of hostilities and an increasingly hostile level of risk, affirmed by the fact that international capital may pull out of a region once it becomes too dangerous to operate or too unstable to protect investments.

Ironically, this rather basic business maxim poses more of a threat to Azerbaijan than to Armenia. It also means that by aspiring to replace Armenia as the region’s dominant military power and threatening to retake Karabagh by force, Azerbaijan may soon face a worried group of investors who may decide that the risk outweighs the profit in Azerbaijan. And Azerbaijan is especially vulnerable to any downturn in investor confidence because of its over-reliance on foreign capital amid falling oil prices and due to a lack of industry beyond its energy sector.

Against the backdrop, it is clear that the military balance of power has returned as one of the most crucial considerations for regional security and stability. But at the same time, the real imperatives for regional security and stability are, nevertheless, internal in nature and depend far more on institutional legitimacy, the rule of law and good governance, and on local economics and politics than grand geopolitics.

### **Threats to National Security**

Armenia faces several new internal developments that compound the need to reexamine its concept of national security. These internal challenges, in many ways the hardest to overcome, range from a worrisome trend in authoritarianism and a widening deficit of democracy, to an erosion of self-sufficiency and independence stemming from a dan-

gerous over-reliance on Russia. In many ways, the most serious threat to Armenian national security comes not from Azerbaijan, nor Turkey, but comes from within. It is posed by the internal threat of corruption and all of its derivatives, from the rise of the powerful oligarchs to a "rule of law" that has degenerated into a "law of the rulers."

The real threat to Armenian democracy is most clearly demonstrated by the tendency for governance by strong individual leaders over strong institutional leadership. This dominance of "strongmen over statesmen" has emerged as one of the most formidable obstacles to conflict resolution and regional reintegration. The challenges of a mounting social divide, marked by widening disparities in wealth and income constitute "economic security." These economic and social components of national security, exacerbated by a cancer of corruption, constitute a threat to Armenia's internal stability and security that has been ignored for far too long.

Despite the serious problems and deficiencies with Armenian politics, there is, nevertheless, a widening "democracy divide" between pluralist Armenia and its more autocratic Azerbaijani neighbor. And although there is a troubling need to bolster the institutions of Armenia's infant democracy and address the serious social inequalities, this advantage should not only be highlighted, but must also be exploited.

### **The Blockade of Armenia**

One of the more immediate challenges driving Armenian national security has been the blockade imposed by Azerbaijan and Turkey. Although the term blockade usually refers to the maritime interdiction, interference and denial of trade and transport to a nation's port and coastline, in the case of the blockade of Armenia, it has encompassed a total East-West closure of Armenian land borders with both Azerbaijan and Turkey. The blockade of Armenia was especially powerful as it included a full disruption of trade, transport and energy links, and its effects were magnified by the landlocked nature of the Armenian state.

While the imposition of the blockade by Azerbaijan was a natural result of the conflict with Armenia over Nagorno Karabagh, its initial impact resulted in an immediate and devastating shortage of foodstuffs and basic commodities, an abrupt and severe energy crisis, and a period of isolation. Armenia was forced to quickly adapt to the sanctions and strove to accommodate the social and economic demands of crisis by concentrating on its sole remaining external trade link northward through Georgia. The structural effects, however, of such adaptation fostered a degree of mounting dependence on Georgian territory as its sole source for Russian energy and goods. This dependence was quickly exploited by the Georgians as transit and tariff fees quickly exceeded normal market rates. The second external trade route, consisting of a small border crossing point southward through Iran, was without the infrastructure necessary to provide an immediate alternative. The long-closed border with Iran through the Soviet period, the nature of the Iranian market and political regime, as well as the "rogue" state status of Iran all complicated Armenia's use of the Iranian option.

Overall, the blockade of Armenia has long surpassed its utility. Not only was Armenia able to adapt, it has achieved impressive rates of economic growth. In some ways, the effect of the blockade actually unified the Armenian (and Karabagh) population. This "siege mentality" also withstood internal divisions and enhanced outward unity far beyond that of its neighbors. Although the structural effects of such an artificial economic situation tends to foster economic development that does not correspond with an economy's natural comparative advantage or conform to a country's normal direction of trade, the lasting impact of the blockade on the Armenian economy was far less than originally anticipated.

### **The Threat of Isolation**

In addition, there is also a new threat matrix facing Armenia, mainly from the danger of isolation. This threat involves the danger of becoming isolated and disconnected from the globalized marketplace. This threat is rooted in the economics of isolation, and is a shared threat throughout the region that involves a need to keep pace with

technological and economic changes inherent in the process of globalization. Although from a regional perspective, Armenia benefits from increasing rates of foreign investment that are not resource-based like Azerbaijan nor aid-driven as with Georgia, but are attracted by the openness and opportunity offered by the Armenian economy. The Armenian IT sector holds another important advantage over its neighbors and demonstrates the necessity for interoperability with global markets and knowledge-based development.

In terms of global security it is now accepted that “national security depends less and less on territory and natural resources and more and more on the ability to adapt and integrate into the global economy.” And for a country like Armenia, that is faced with traditional limits of demography and geography, “economic issues are increasingly linked to security.” Yet this recognition has yet to be embraced by Armenian national security, as the current confines of Armenian nationalism have as yet failed to expand to include the demands of “economic security.”

## **Conclusion**

Traditional regional players in the region, Russia, Turkey and Iran, are now also competing for influence with the United States and the European Union. But the most significant factor for Armenia is not the role of outside players in the region, but the challenge of addressing Armenia’s unresolved domestic political crisis. Without the foundation of resilient democracy, a population whose needs are met and an economy based on opportunity, Armenia will not be strong or stable enough to resist the outside influence of external actors. In this way, Armenia needs to tackle these internal challenges in order to strengthen its own sovereignty and statehood.

As an arena for both cooperation and competition, the region is strategically significant, by virtue of its geographic and geopolitical vulnerability as a region where the national interests of Russia, Turkey, Iran and the United States all converge. Over the long-term, in order to acquire durable security in the South Caucasus, however, the real im-

peratives are internal in nature, stemming from several key challenges: the need to graduate from the political school of elections driven by power not politics, and for leaders to be elected, not simply selected. Legitimacy is the key determinant for durable security and stability, while the strategic reality of the region is defined less by geopolitics, and more by local politics and economics. But most crucial is the lesson that institutions matter more than individuals for real democratization.

For Armenia, there seems to be a dangerous lack of appreciation of these trends, however, and more seriously, is compounded by an incomplete Armenian strategy for national security, only matched by a lack of a coherent process of national security. Specifically, the course of Armenian national security has failed to evolve beyond the parameters of the Karabagh conflict and has only led to a hardening of Armenian political thinking in recent years, fostering an increasingly rigid nationalist posture, a closed system of politics and limited political discourse. But again, it is also the absence of the process more than the policy of national security that is most worrisome.

Thus, the redefinition of Armenian national security reveals the need for not only for a clear and coherent redefinition national security, but for a new recognition of national security as a dynamic, not static, process beyond policy. But the imperative for overcoming Armenia's national insecurity is to first address the underlying military, political and economic trends. The overwhelming focus on so-called external threats to Armenian national security has been both misplaced and mistaken. Such "threat misperception" is rooted in a rigid nationalism has been compounded by the closed and subjective nature of national security and defense policy-making.

The overwhelming need, therefore, is to institute a process of national security and defense that elevates Armenia's true national interests over more parochial partisan interests and that recognizes that the core challenges to Armenian national security come not from Turkey or even Azerbaijan, but from within. Only then, can Armenia attain real security and lasting stability.



# Azerbaijan's Threat Perception and Hierarchy of Security Threats

Zaur Shiriye<sup>1</sup>

## Introduction

More than twenty years have passed since the three South Caucasian states, Azerbaijan, Armenia and Georgia, regained independence in this physically small but geo-strategically significant region. Since the dissolution of the Soviet Union, they have sought to independently protect and promote national security, rather than slipping back under the Soviet shadow. After the end of a vast, single, comprehensive security system and its common implementation structure, the newly independent states were faced with the challenge of identifying new national security concepts and finding the means to provide them. The main difference between these tiny South Caucasus states and the other post-Soviet countries emerged during the first half of the 1990's, as South Caucasian enmities led to various conflicts that ran parallel to these countries' respective state-building processes, which arguably protracted the security dilemmas and cemented the interrelationship with nation-building.

In addition to the common disputes inherited as part of the post-Soviet legacy (for example, the status of Soviet military bases, contested status of the Caspian), each country has its own security dilemmas. Inter-regional conflicts, notably, became a serious security threat with the wars of the early 1990s: the Azerbaijan-Armenia Nagorno-Karabakh war, and the Georgia-Ossetia and Georgia-Abkhazia conflicts. Concerns about the possible outcomes of these conflicts have significantly influenced not only intra-regional relations, but also relations with the external powers, including strategic alliances. As stated above, each state has a subjective perception of security issues, as well as their common concerns (notably the post-Soviet questions mentioned above, human trafficking, migration and others).

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## Security Perception of Azerbaijan

Due to its geostrategic location, Azerbaijan occupies a sensitive area that presents itself as a “defensive shield” for the Caspian Sea: it opens or blocks access to many significant extra-regional actors to oil and gas wealth. This situation is best described by Elin Suleymanov, the Azerbaijani Ambassador of Azerbaijan to the United States: “The only way, from the Arctic to the Indian Ocean that you can transport eastern Eurasia energy resources to Western Europe without passing either through Russia or Iran is via the Republic of Azerbaijan.”<sup>2</sup>

On the other hand, from a geopolitical perspective, Azerbaijan finds itself sandwiched between Russia to the north and Iran to the south. Azerbaijan’s allegiance on the East-West axis is hard to establish, due to the fact that the realization of all strategic energy and transportation projects on the Silk Road are subject to occasional threat by the geostrategic North-South ‘alliance’.

Generally, Azerbaijan’s national security policy and threat perception developed only during the mid to late 2000’s as government policy, under which the main aim was achieving and strengthening national interests, according to National Security Concept of Azerbaijan (NSC),<sup>3</sup> which states the primacy of protecting “independence and territorial integrity, ensuring inviolability of its internationally recognized borders.” Especially after the Georgia crisis in 2008, regional security has become more complicated and fragile, and Baku responded by developing its Military Doctrine. In both strategy papers, country has broad range of aims on protecting national interests, but given the limited space for analysis, Azerbaijan’s security perceptions can be reviewed by classifying threats as either military and non-military security threats.

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<sup>2</sup> Ambassador crisscrosses U.S. in bid for Eurasian pipeline, EnergyWire: Wednesday, October 10, 2012, <http://eenews.net/public/energywire/2012/10/10/6>

<sup>3</sup> National Security Concept of Azerbaijan Republic, 23 May 2007, p.1-3

## **Military Threats:**

*Nagorno-Karabakh conflict; Continuation of occupation and the possibility of a 'new' war*

One of the most serious and long-standing conflicts in the Caucasus is the controversy between Armenia and Azerbaijan over the Nagorno-Karabakh province located in the southwestern corner of Azerbaijan. In 1991–94, Armenia's undeclared war gave rise to one million IDPs in Azerbaijan and the occupation of Azerbaijani territories: former Nagorno-Karabakh province (oblast) and its seven adjunct provinces. For Azerbaijan, the Nagorno-Karabakh conflict (NK) poses threats in several directions:

Physical Dimension: First, Azerbaijan perceives the NK conflict as threat to territorial integrity and state independence. According to the NSC, the aggression against the Republic of Azerbaijan is a major determinant of the country's security environment and is a key factor in the formulation of the National Security Policy".<sup>4</sup>The vast majority of the NSC paper that deals with the NK conflict is straightforward, with clear references to Azerbaijan's commitment to the peaceful settlement of the conflict within the framework of the OSCE Minsk Group, and a statement of Azerbaijan's desired principles for such a peaceful settlement - Armenian withdrawal of troops from occupied territories, re-establishment of Azerbaijani sovereignty, return of IDPs, definition of legal status for the two - i.e. Armenian and Azerbaijani - communities of NK, and establishment of conditions for the region's overall development and integration. However, leaked information from the U.S. State Department reveals that despite the NSC's ostensibly good intentions on NK, the draft version of the NSC document was cause for regret and surprise on the part of Western diplomats, who were disappointed that the strategy paper failed to meet NATO standards, making claims of Armenian "genocide, war crimes, and crimes against humanity". This language, felt the US,

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<sup>4</sup> National Security Concept of Azerbaijan Republic, 23 May 2007, p.2

could potentially limit its ability to strongly endorse this document.<sup>5</sup> In general, in the direction of adopting NATO's military and defense reforms, changes in Azerbaijan have so far been nothing more than cosmetic, and have little do to with units being brought up to NATO "standards." However, the Military Doctrine of Azerbaijan (MDA), adopted in 2010, stresses that "Occupied territories' by Armenian Republic temporarily remaining out of the control of government bodies of the Azerbaijani Republic damages not only national security, but has a serious negative influence on regional security as well. These situations are worsening as a result of the inefficiency of international union's efforts in the settlement of the problem."<sup>6</sup> In the MOD, Azerbaijan openly remarks that, "an act of aggression committed against Azerbaijan by any state (excluding the Armenian Republic) at the current stage is in the low level". At every opportunity, the country makes clear at the international level that it still perceives the NK conflict as a threat to the physical presence and stability of country.

Energy Dimension: The second area of conflict is in energy, and its impact on bilateral relations. Hence, the resolution of the Nagorno-Karabakh conflict is strongly linked to relations with the EU and U.S., and development of the Caspian energy strategy, where Baku has consistently used petroleum politics and pipeline diplomacy in a pragmatic manner with the primary objective of resolving the Nagorno-Karabakh issue, the "Achilles heel" of the country's security threat perception. Despite expectations that the energy card could be successfully deployed to resolve the conflict, and to keep Armenian leadership under economic blockade (the Azerbaijani leadership's explicitly stated priority) ultimately this tool was ineffective. Meanwhile, growing frustration between both nations could lead to the outbreak of war and thus put the socio-economic development of the region and energy projects at great risk. This came true during the 2008 August War between Russia and Georgia, which destroyed Baku's previously held belief that

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<sup>5</sup> Update on Azerbaijan's National Security Concept, December 2006, <http://www.cablegatesearch.net/cable.php?id=06BAKU1753>

<sup>6</sup> Military Doctrine of Azerbaijan- Analyse, Milaz.info, <http://www.milaz.info/en/news.php?id=6544>

Western countries could counterbalance Russian power, and that there was no threat of a new war, nor any threat to Azerbaijan's energy policy. But the advantage of this development is that after this crisis, Baku had facts (i.e. the Russian-Georgian conflict) to show the West, regarding the fragile nature of regional security, and that official Baku's concerns about energy security were warranted.

**Bilateral and International Relations:** The NK conflict affects bilateral relations of countries, and even poses serious challenges to alliance formations. From its outbreak, the conflict has affected Iranian-Azerbaijan relations; Azerbaijan believes that Iran holds a hypocritical position on the settlement of the Nagorno-Karabakh conflict. Due to Iranian economic support, Armenia feels economically more secure in the region, despite the fact that officially, Iran has declared Karabakh to be the historical territory of Azerbaijan. In practice, Tehran is not interested in the speedy resolution of conflict, and wants the status quo to prevail without turning into a hot war. Second, the NK conflict brought about a crisis in 2009 between two strategic allies, Turkey and Azerbaijan, namely when Turkey pushed rapprochement with Armenia. This step, taken in the absence of meaningful progress in resolving the Nagorno-Karabakh conflict between Azerbaijan and Armenia, was perceived by Baku as a betrayal by its Turkish ally.

In the case of Armenia, the NK conflict brought about a more dramatic situation in regard to bilateral relations when an Azerbaijani officer was released after returning home from prison in Hungary. Yerevan responded by cutting off diplomatic relations with Hungary.<sup>7</sup> Also, in the international arena, specifically EU and NATO, when they adopt a resolution on the conflict, or invite leaders of both countries to summits, the main question is if in the final resolution there will be mention of the territorial integrity of Azerbaijan; in that case Armenia demands that the principles of self determination be put in such documents. One practical example of this dimension was seen in the 2012 Chicago NATO Summit, where Armenia did not send high-level representatives

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<sup>7</sup> Armenia Suspends Diplomatic Ties with Hungary, Ria Novosti, 31 August 2012, <http://en.rian.ru/world/20120831/175546769.html>

after NATO stated in advance that there would be emphasis on territorial integrity in the final declaration of the summit.<sup>8</sup>

Socio-economic and Domestic Political dimension: One of the important dimensions of the NK conflict is its impact on the socio-economic development of the countries involved and the current and potential impacts on the domestic political struggle between the ruling party and opposition.

Regarding the economic impact of the conflict, its outbreak was accompanied by a sharp decline of the country's economy during the first years and macro-economic reforms, especially privatization, were delayed as they were coincided with the conflict.<sup>9</sup> Since the mid 1990s the situation has gradually stabilized, and the country has experienced a steady growth in gross domestic product (GDP) through the 2000s, due to income from oil exports. The main victims of the economic downturn were Internally Displaced Persons (IDP). International organizations estimated that about 70 per cent of IDPs are poor, with 35 per cent of these categorized as very poor, after the decade of conflict.<sup>10</sup>

Despite economic growth and stabilization of the situation of IDPs, some experts argue that the NK conflict has led some people from both sides of conflict to benefit from "shadow economies"; the beneficiaries of these "shadow economies" are mistakenly considered proponents of the *status quo* of the conflict and as a major obstacle to the peace process.<sup>11</sup> On the other hand, as mentioned before, Baku's rising economic power has increased belief among the political elite that Armenia will become more open on negotiations and will act to benefit from the economic promise of Azerbaijan's oil revenues. But

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<sup>8</sup> Armenian president not to attend NATO summit, 21 May 2012, Tert Information Agency, <http://www.tert.am/en/news/2012/05/21/sargsyan-nato-summit/>

<sup>9</sup> Jabiev, R, Azerbaijan: Privatization of State Property and its Effects. In: *Central Asia and the Caucasus*. No. 2 (14):135-142.2002

<sup>10</sup> USAID 2001 <http://www.usaid.org/ge/factsheets/fsS03laz.html>

<sup>11</sup> Phil Gamagelyan, Intractability of Nagorno-Karabakh conflict: A Myth or A Reality?, <http://www.monitor.upeace.org/documents/intractability.pdf>

this process has had the opposite effect in some sense; Armenia now, more than ever, can count on Russian help. Relative to Armenia, Azerbaijan looks very strong; relative to Armenia and Russia, it looks rather different.<sup>12</sup> However, while physical destruction may be compensated by Azerbaijan's revenues from the oil and gas resources, the Azerbaijani government plans to spend 28.4 billion dollars on post-conflict rehabilitation. Officially, Baku has shared views on the post-conflict period and its plan to attract the local population of NK. In fact, independent research suggests that \$30 billion worth of rehabilitation and reconstruction needs to be invested in basic infrastructure and services for the territories around Nagorno-Karabakh, and total reconstruction costs top \$60 billion, according to Government estimates for all affected territories.<sup>13</sup>

One of the key negative effects of the NK conflict on the economy is increased military expenditure. In 2011, the military budget was 2.5 billion manats, or about \$3.12 billion, and \$4.4 billion in 2012,<sup>14</sup> higher than Armenia's entire state budget for 2012 (\$2.26 billion). The only issue that Azerbaijan's ruling and opposition parties share views on and support one another on is the NK conflict. In this regard, the ruling party freely allocates large portions of the state budget to the military budget, and gives the argument that this money is not only for buying military equipment; it is also used to build up the military industry, enabling Azerbaijan to export products of its military industry.

Meanwhile, the more politically aware voters are against government policy in this area, arguing that this money would have greater impact if spent on sectors that require urgent investment, education, health, etc. Meanwhile, the ruling party can easily manage the situation by

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<sup>12</sup> Paul Goble, "Ten Shattered Assumptions of Azerbaijan Foreign Policy", Azerbaijan Diplomatic Academy's biweekly, "Azerbaijan in the World." Vol. I, No. 14-15 (September 1, 2008).

<sup>13</sup> Innovative Post-Conflict Reconstruction Study for Nagorno-Karabakh Territories of Azerbaijan Launched in Brussels, June 25 2011, <http://www.istockanalyst.com/business/news/5253878/innovative-post-conflict-reconstruction-study-for-nagorno-karabakh-territories-of-azerbaijan-launched-in-brussels>

<sup>14</sup> Azerbaijan To Reform Military Conscription, RFEL, 21 February 2012, [http://www.rfel.org/content/azerbaijan\\_to\\_reform\\_military\\_conscription/24491577.html](http://www.rfel.org/content/azerbaijan_to_reform_military_conscription/24491577.html)

saying that opposition is against the resolution of the NK conflict, and in its turn, the opposition can easily put pressure on government by saying that despite its claims that the military is developing and economy has had a big impact on this process, Karabakh and adjunct territories are still under occupation. Such rhetoric can also be found in Armenia, where claims that one party is trying to 'sell NK' is good maneuver for politicians, especially during election period.

## **Terrorism, Military Use of Nuclear Weapons**

Terrorism was a key challenge for Azerbaijan mainly during the first years of independence (1989-1994), when Armenian-backed terrorist groups attacked the civilian population of Azerbaijan. The special intelligence services of Armenia organized and committed terrorist actions in locations populated by peaceful Azerbaijanis, far from the territories where battles were being waged, and as a result hundreds of innocent people were killed and wounded. Since the ceasefire agreement was reached in 1994, it has been fundamentalist Islamic groups that have begun to pose new terrorist threats to national security.

Following the September 11, 2001 attacks, the main targets of the Azerbaijani special services were international terrorists from Middle Eastern countries, and starting from 2004, the U.S. government was concerned that the Iranian special services were expanding their influence in Azerbaijan, possibly in order to gain leverage over the United States should Washington decide to attack Iran.<sup>15</sup> The August 2008 bombing of a Baku mosque heightened an already anxious mood in Azerbaijan.<sup>16</sup>

This incident caused the government to take further measures for security, notably an order titled "On additional measures to reinforce security of the pipelines, bridges, power stations and main electricity lines in Azerbaijan." According to the NSC, "132 km of the international border

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<sup>15</sup> Anar Valiyev, " Foreign Terrorist Groups and Rise of Homegrown Radicalism in Azerbaijan" *HUMSEC Journal, Issue 2 Foreign Terrorist Groups and Rise of Homegrown Radicalism in Azerbaijan, 2008, p. 5-6*

<sup>16</sup> Azerbaijan: Terror Attack on Baku Mosque Stirs Anxiety, <http://www.eurasianet.org/departments/insight/articles/eav082808.shtml>



with Islamic Republic of Iran and 733 km of the border with Armenia [...] lack of control over these borders creates fertile grounds for above mentioned crimes.”<sup>17</sup> Azerbaijan’s concerns are for the most part shared by the U.S., as seen in its annual intelligence reports on terrorism.

Since 2011, Azerbaijan has mainly received terrorist threats from Iranian financed terrorist groups, whose main aim is to threaten US and Israel. The number of security alerts issued by the US and Israeli embassies have increase. In 2011 and the first half of 2012, Azerbaijan national security services stopped a terrorist attack on Israeli and US diplomats; during the 2012 Eurovision Song Contest, the main target was the leadership of Azerbaijan. The main reason for the increasing number of Iranian financed terrorist groups is undoubtedly the increasing discussions about military interventions in Iran by Israel and US, and the same time, Iran’s aim to destabilize the country. This situation has been aptly summarized by Matthew Levitt, an analyst at the Washington Institute for Near East Policy: “The Iranians have a history of a presence there and they wouldn’t mind undermining the country, given Azerbaijan’s Western leanings.”<sup>18</sup>

The nuclear armament in and around the region poses a further security threat. The main controversy around nuclear activity Azerbaijan’s opposition to Armenia’s Metamor Nuclear Power Plant, which was built during the 1970s, and lies about 20 miles west of the Armenian capital of Yerevan. Azerbaijan’s position is based on two facts, firstly, that this nuclear station is located in a seismically active zone, which has a 11-magnitude earthquake risk and thus is a source of serious danger for all of the Caucasus region. Secondly, the Metamor plant very similar to the ones which the European Union insisted be shut down before Bulgaria and Slovakia joined the EU.

In regard to Iran, officially Baku has not raised the same concerns, and in several documents, has even stressed its support for ‘peace-

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<sup>17</sup> National Security Concept of Azerbaijan Republic, 23 May 2007, p.17-18

<sup>18</sup> Azerbaijan seen as new front in Mideast conflict, <http://articles.latimes.com/2009/may/30/world/fg-shadow30>

ful' nuclear energy. But in fact, the military doctrine stresses concern over potential military use of nuclear facilities in neighboring region. This is also mentioned in the NSC: "Possible acquisition of weapons of mass destruction or their production for terrorist activities may exacerbate these threats." However, under current political conditions, this concern might rise to the top in coming years.

### **Separatist Movements, Possible Conflicts in and around the Region**

Separatism, ethnic and religious extremism have been stated as one of the main challenges to state security, according to the NSC of Azerbaijan. In the first years of the 1990's, there was an ethnic separatism movement in the South (separatist Talysh movement) as well as in the North (separatism Lezgin movement sponsored by the Sadval terrorist group). The latter group organized terrorist attacks against civilians, notably the 1994 terrorist attack on a metro station. In the meantime, Azerbaijan deems the current regime in Nagorno-Karabakh as separatist. Therefore, Azerbaijan is struggling against the self-defined NKR on the international stage, calling upon all countries to refrain from allowing activities that would legitimize this group.

In addition, Azerbaijan perceives Southern Ossetia and Abkhazia as a source of military, terrorist and subversive threats to regional economic cooperation and security. Azerbaijan has stated that it will take hard security measures against any conflict which poses a threat to regional stability, including South Ossetia and Abkhazia.

The main challenge in the neighborhood seems to be from the North Caucasus. Azerbaijan's security has been challenged several times by the North Caucasus, where fundamental Islamic movement are operating and are trying to find traction in Azerbaijan. This movement is known to cooperate with North Caucasus militants. Arguably, Azerbaijan faces not only the territorial presence of Jamaat and other fundamental Islamic groups that sympathize with the militarized North Caucasian resistance movement, but also a more delicate issue, which is the conflict

between the Shia and Sunni branches of Islam.<sup>19</sup> The radical Islamist movement in the North Caucasus, which identifies itself as either Salafi or Wahhabi, would like to become a sovereign entity, the Caucasus Emirate. Under this objective, the jihadist-Islamic movement is becoming well-established. This situation causes security concerns in a number of directions. Firstly, it can help to reinvigorate the Lezgin separatist movement, and secondly, there is the more dangerous threat that the jihadist movement will spread in northern Azerbaijan and strengthen cooperation with already established fundamentalist groups in Azerbaijan. The government of Azerbaijan could soon find itself on the side of Russia on this particular issue. Moscow believes stabilization can come via investment in the region, and thus some business contacts<sup>20</sup> from Azerbaijan have visited the region and established contact with local authorities, to identifying possibilities for investment.<sup>21</sup>

### **Non-Military Threats**

The country's security threats in the non-military field are quite complex, as well as being difficult to separate from the military threats. Significantly, contrary to the military threats, these have no permanent solution, and are constantly changing in size and range.

### **Drug, Human and Narcotics Trafficking; Smuggling**

Drug/narcotics trafficking is a key challenge for Azerbaijan, taking into consideration that after the disruption of the Balkan Route, which was the main international narcotics transit route until the end of the 1990's, the Caucasus has become one of the main transit routes for drug and narcotics. Thus since 2001, despite the fall of the Taliban (the main 'drug mafia in Central Asia) drug trafficking to Europe has increased. Reports by several international organizations mention

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<sup>19</sup> Mairbek Vatchagaev, Azerbaijani Jamaat Cooperates with Caucasus Emirate, Eurasia Daily Monitor Volume: 9 Issue: 73, August 2012

<sup>20</sup> Reference made here to businessmen, oligarchs

<sup>21</sup> Why is Azerbaijan investing in volatile North Caucasus?, December 2011, <http://news.am/eng/news/84298.html>

that the main challenge for Azerbaijan in terms of drug trafficking is the 132-kilometer territory under occupation, which is not sufficiently controlled, either by local governments or international organizations. The Autonomous Republic of Nakhchivan represents another major drug route on the Iranian-Azerbaijani border<sup>22</sup>, a region which is under blockade by Armenia, and for which Iran and Turkey offer the only outside links for its impoverished citizens.

However, the increase of drug smuggling through Azerbaijan is cause for concern not only for Western countries; it poses considerable threat to Azerbaijan's domestic situation. If a few years ago the internal consumption of drugs in Azerbaijan was relatively low, now the situation has changed and the use of illegal substances has rocketed. In the meantime, since the 2000s, due to the health system's limited capacity for proper treatment for drug addicts, and a dearth of facilities for proper medical treatment in the regions. According to the national Narcotics Dispensary, drug use has increased substantially in the last fifteen years; drug use prevalence per 100,000 people was just thirteen in 1988, but had risen to 200 by 2011.<sup>23</sup>

Human trafficking to neighboring countries for sexual exploitation and labor exploitation is another key concern. In 2005, Azerbaijan passed the Law on the Fight Against Human Trafficking, which established the legal and organizational grounds for fighting human trafficking, defined the legal status of victims of human trafficking, and regulates issues of protection of victims. Despite this, under the U.S. State Department 2011 Trafficking in Persons Report<sup>24</sup>, the Republic of Azerbaijan received a Tier 2 Rating. Tier 1 is the best rating and Tier 3 is the worst. The report cited a lack of prosecution and law enforcement within Azerbaijan pertaining to human trafficking and the high level of sex trafficking within the country.

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<sup>22</sup> Fariz Ismayilzade, Azerbaijan becoming popular drug trafficking route, *Eurasia Daily Monitor* Volume: 3 Issue: 190, October 2006

<sup>23</sup> Ministry of Health of Azerbaijan, Official Data of Drug Smugglers, [http://www.gfaids.az/index.php?i\\_id=32&do=aidsinazerbaijan&lang=e](http://www.gfaids.az/index.php?i_id=32&do=aidsinazerbaijan&lang=e)

<sup>24</sup> See: <http://www.state.gov/documents/organization/164453.pdf>

## **Immigration, Illegal Migration and Lack of Human Capital**

Since 1991, Azerbaijan has experienced many changes regarding internal migration, as well as migration flows in and out of the country, due to the decade long economic hardship in the country, people emigrated to other post-Soviet countries, particularly to Russia in order to find better jobs and better social conditions. After the financial crisis, which had a significant impact on the Russian economy, by early 2009, the official number of migrants from CIS countries had dropped, but it is still unclear what impact the crisis has had due to large numbers of unofficial migrants.<sup>25</sup> IDPs from Nagorno-Karabakh, particularly, face difficulties in the labor market, and many IDP men also go to Russia to work while their families stay in Azerbaijan to maintain their IDP status.<sup>26</sup> In recent years, however, there has been a tendency of decreasing flows of migrants to neighboring countries.

On the other hand, the number of foreign workers in Baku has been increasing, although the official numbers are still low. Azerbaijan is not only exporting migrants, but also attracting them in. The NSC perceives immigration and any form of migration to Azerbaijan as a 'security threat', arguing that "Improvement of the mechanisms for regulating migration processes in the country requires formulation of effective immigration policy, strengthening international cooperation".<sup>27</sup> The State Migration Program was adopted in 2006 to achieve migration goals. The program identified priority areas in migration policy, reflected improved legislation, and established institutional mechanisms. The State Migration Service was established in 2007 to implement public policy on migration as an integral part of institutional reforms, to develop management, to manage migration processes and coordinate the work of the relevant government agencies dealing with migration. Despite this, the critical challenge in managing migration is having ac-

<sup>25</sup> Ina Ganguli, *Migration in Azerbaijan: Transition to the Destination country?*, 2010, IREX Paper, pp. 2-3, <http://www.irex.org/system/files/Ganguli.pdf>

<sup>26</sup> United Nations High Commissioner for Refugees (UNHCR), 2009. "Azerbaijan: Analysis of Gaps in the Protection of Internally Displaced Persons (IDP)," October 2009.

<sup>27</sup> National Security Concept of Azerbaijan Republic, 23 May 2007, pp. 17-20

curate data on the numbers of migrants entering and leaving a country.

Human capital, or the lack thereof, constitutes another challenge, where the failure to develop and effectively manage a modern education system capable of ensuring education and training at all levels necessary for the development of the national professional workforce “may have negative consequences for the overall development of the Republic of Azerbaijan in a long-term perspective”, according to the NSC. Unfortunately, the level of human capital now fails to meet even the demand of the currently small non-energy sector, let alone those of a largely diversified economy. As several international institutions report, the current state of the educational system is poor, and at the same time, there is a serious mismatch between degrees granted by local universities and skills demanded by the changing economy. To combat this problem, over the past few years, the government has built or renovated more than 1200 schools, and in 2007 it launched the State Program on Education of Azerbaijani Youth Abroad. These efforts have resulted in some progress. In addition, according to the 2010 UNDP Human Development Report, Azerbaijan is now in the category of “high human development.” Indeed, over the past five years, Azerbaijan has achieved the most rapid development of all of the 169 countries covered by the UNDP report.

### **Information-Cyber Security**

From Azerbaijan’s perspective, until recent years there was no clear distinction between information and cyber security. Legal and national security documents state that the key issues here are increasing the coherence and effectiveness of the intelligence and counter-intelligence capabilities and ensuring coordination in protecting classified information. Meanwhile, after “cyber-freedom” has become increasingly important in the course of democratic uprisings across the Arab and Middle Eastern countries, some countries have committed to improving their internet security systems. There have been cyber attacks launched against several national security systems. Despite fact that some attempts at democratic uprisings in Azerbaijan were initiated via cyber space, the government does not consider this as a

serious threat. The West have been disappointed and alarmed by the way in which the government has taken measures to silence or block internet users who are speaking out against the current regime.

Only after the Iran-Azerbaijan cyber war, in which Iran-based hackers repeatedly targeted the websites of Azerbaijani ministries and information agencies, did the country start taking measures to protect information security, and therefore in September 2012. The Special Communication and Information Security State Agency was created on the basis of the Security Department of Special Communication and Information of the Special State Protection Service.

In this context of uncertainty, even just on the theoretical level, cyber security is of growing importance for Azerbaijan. In light of the variety of threats that are continually emerging, local experts argue<sup>28</sup> that one of the most significant challenges of cyber security for Azerbaijan is the so-called "information war". At this point, it is crucial for Azerbaijan to maintain an appropriate level of cyber security to protect its critical infrastructure such as energy grids, financial networks, industry, and defense.

### **Economic Meltdown**

As Azerbaijan is an oil-export country, and its main income is from the oil and gas sector, any development (e.g. decline of prices) seriously affects the economy. True, Azerbaijan has not been as seriously affected by the world economic crisis of 2008 as many other countries, but it has not been entirely immune, due to drops in the price of oil, Azerbaijan's major export earner. Though the country has grown by 212.3 % with steady prices when compared to its 1991 GDP, the dependency of the national economy on the income provided from petrol industry has further increased in recent years.<sup>29</sup>

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<sup>28</sup> Kamal Makili-Aliyev, Growing importance of cybersecurity for Azerbaijan, News.az, 12 October 2012

<sup>29</sup> Geray Musaev, The Performance of Azerbaijan Economics, the Effects of Global Economic Crisis and the Expectations for the Future, Eurasia Critic, July 2010, <http://www.eurasiacritic.com/articles/performance-azerbaijan-economics-effects-global-economic-crisis-and-expectations-future>

The main security threat in the economic sphere is the country's heavy dependence on the oil-gas sector (more than 90 percent), and the fact that the underdeveloped non-oil sector has no significant impact on the economy. Transferring part of the income obtained from the petrol industry to these sectors in previous years has brought some positive developments, and there are also positive growth rates in all sectors except petrol, but the non-oil sector is not expected to grow significantly in coming years. But eradicating the dependency on the petrol sector and the shifting of growth dynamics to other sectors requires strategic thinking on how to achieve short term development of an efficient non-oil sector, keeping in mind the importance of long term sustainability of growth. According to the NSC, the government sees the occupation of Azerbaijan's territories as having trans-regional implications that represent a major economic threat to national interests. Contrary to this argument, and given the fact that Azerbaijan has pledged to use its financial resources for post-war reconstruction in Nagorno-Karabakh, the availability of resources over the next decade remains unclear. In fact, the one-sided development of the economy has begun to show its symptoms. As a result, the country's economic growth rate both in the first quarter of 2012 and in 2011 has decreased to its lowest level since 1996.<sup>30</sup>

## **Conclusion**

The abovementioned security challenges for Azerbaijan are gradually increasing due to the new security threats emerging in neighboring countries. Thus security complexes cannot be limited to state and interstate relations or to political-military issues; other types of security issues (economic, social, environmental and so on) as well as new units, such as nations, societies and communities, must be accounted for. Until now, neither Azerbaijan nor its neighboring countries in the Caucasus have perceived security challenges as a common threat, nor have they cooperated on this issue. This must change, as current

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<sup>30</sup> "Azerbaijan Economy in the first quarter of 2012", Center for Economic and Social Development (CESD), April 2012, [http://cesd.az/new/wp-content/uploads/2012/04/Azerbaijan\\_economy\\_first\\_quarter\\_20122.pdf](http://cesd.az/new/wp-content/uploads/2012/04/Azerbaijan_economy_first_quarter_20122.pdf)



and emerging threats require cooperation and a common strategy. It is true, of course, that some, especially military threats come from the neighboring countries themselves.

In this respect, until the resolution of the various regional conflicts, the 'cold peace' will continue, so will the militarization of the region. It is also possible, as happened with the 2008 August War, that a new war will damage stability in the region. At this point, the only achievement in the region is stable insecurity.

# Georgia - Security Perceptions & their impact on foreign policy

Kornely Kakachia

## Introduction

Since its declaration of independence from Soviet Union in 1991, Georgia has been a weak small state confronted with issue of survival and choice of strategic orientation.<sup>31</sup> Nestled between the Black Sea, Russia, and Turkey, and surrounded by the Caucasus Mountains occupies a unique geographic space, which gives it strategic importance far beyond its size. Hence, it is no surprise that Geography and identity define Georgia's political options and determine many aspects of its state behavior. As a Black Sea and South-Eastern European state, the country has historically claimed to be a geographic, political and cultural part of greater Europe. Like other Eastern European nations in the middle of transition, Georgia is trying to construct a collective identity oriented toward the international arena. However, with an inherited political culture lacking democratic tradition, inexperienced foreign policy elite, scarce financial resources, and hardly definable competing social forces, initially, Georgia was unable to develop a viable foreign and security policy.

## Georgia's Foreign Policy and Security treats after independence

As a weak state, Georgia had to rely on foreign policy as a means establishing its presence within the international system. In order to compensate its weakness small, conflict ridden Georgia developed close relations with the regional actors and great powers in and outside of the region and align with them in hopes to achieve political stability, as well as internal social cohesion. Hence, Georgia's, national security has been

<sup>31</sup> Alexander Rondeli. *The choice of independent Georgia* in: The security of the Caspian Sea Region / edited by Gennady Chufrin. Oxford : Oxford University Press, 2001 p. 195

tied to several inter-related goals, including completing a transition to a political democracy and a market economy, rebuilding the state and restoring territorial integrity. A leading Georgian analyst<sup>32</sup> identified six major goals of Georgian foreign policy after its independence, which small Caucasian state intended to tackle. These goals included:

- Seeking Western mediation of the conflicts in the Georgian regions of Abkhazia and South Ossetia;
- Courting Western investment;
- Seeking Georgia's participation in European and Euro-Atlantic security structures;
- Promoting Georgia as a transit country for commerce between the West and the states of Central Asia and the South Caucasus; and
- Pursue direct political, economic, and security ties with the United States.

However, in the first years of independence it became clear, that small country with considerable internal problems (a coup, civil war, and two wars of secession) was unable to focus on its development and meet all its foreign policy goals. International observers have repeatedly questioned the ability of newly independent Georgian state to overcome the threat of anarchy and to establish sovereign statehood.<sup>33</sup> Beyond its domestic difficulties, Georgia's problems have been aggravated by Moscow's policies, which have helped weaken and fragment the country in hopes to rebuff Georgia's Euro Atlantic aspiration or if that not possible, minimum compel it towards "*Finlandization*."<sup>34</sup> As a result, Georgia felt

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<sup>32</sup> Archil Gegeshidze. Georgia in the wider Europe context: bridging divergent interpretations. GFSIS. Tbilisi. 2006 Available at: [http://www.policy.hu/gegeshidze/Wider\\_Europe.pdf](http://www.policy.hu/gegeshidze/Wider_Europe.pdf)

<sup>33</sup> Bruno Coppieters. Locating Georgian Security. In *Statehood and Security: Georgia after the Rose Revolution*. American Academy Studies in Global Security. (ed. Robert Legvold& Bruno Coppitiers.) The MIT Press (September 1, 2005)

<sup>34</sup> *Finlandization* or "Policy of silence"-the term has been defined as a process by which a democratic nation living in the shadow of a military powerful totalitarian state gradually submits to the political domination of its neighbor and finally loses its internal freedom. For Georgians finlandization is believed to reveal a limitation of sovereignty, an abdication from pursuit of the national interest.

threatened by Russia, whose formal recognition of Georgia's political independence and sovereignty was not enough to bring long-lasting security to the country. This, in turn, minimized the chances of creating favorable conditions necessary to resolve the conflicts and develop the strong Georgian state. Georgian society hoped that step-by-step inclusion of Georgia in the Wider Europe and the broader trans-Atlantic community would settle its security fears and act as a deterrent to future conflicts. It was strongly believed that Georgia's close bonds with the West lies in the values powered by shared vision, values and aspirations.

### **Current Security Environment**

International and regional developments of the last few years have significantly changed the security environment in Georgia. The August 2008 Russian invasion of the Georgia and the unilateral recognition of the independence of Abkhazia and South Ossetia fundamentally worsened Georgia's security environment and indefinitely postponed the prospect of Georgia restoring its territorial integrity. The war has created a new strategic situation in the region. By sending forces over its borders for the first time since the 1979 Soviet invasion of Afghanistan and forcibly redefining the border with Georgia, Moscow raised concern among other countries about its future intentions.<sup>35</sup>

The 2008 Russo-Georgian war also demonstrated that the Russian Federation does not accept the sovereignty of Georgia, including Georgia's choice of democracy and its independent domestic and foreign policy. With Russian forces based in Abkhazia and South Ossetia and Moscow saying the Georgian government should treat the regions as nations, security is fraught. Positions remain intransigent, insecurity and a lack of trust continue to underpin attitudes, and belligerent rhetoric reinforces a conflict dynamic that leaves little room for engagement with the other side, let alone compromise. While an EU-brokered ceasefire remains in effect, several hundred thousand refugees and internally displaced persons (IDPs) have yet to return

<sup>35</sup> Kornely Kakachia. The Russo-Georgian "Five-Day War," The Price to be paid and unintended consequences. *Central Asia and The Caucasus, Journal of Social and Political Studies*. CA& CC Press Sweden, 1(55)

home. As war produced a new generation of IDPs in Georgia, until recently there was a common view that sooner or later another conflict is inevitable. While the continuation of the fighting might have negative immediate and long-term consequences for all parties and civilian populations within the region, the goal of sustainable peace and justice with regard to Georgia's conflicts has yet to be discussed.<sup>36</sup>

Despite the complex internal and international situation after the conflict and the West's diminished interest in Georgia since 2008, its foreign policy course did not change much. Georgia still aspires to become part of European and EuroAtlantic structures, and pursues foreign and now internal policy aimed to disassociate itself from Post-Soviet space and "escape" from Russia's historic, geographic and civilizational space. Subsequently, Georgia's major foreign policy objective has been balancing Russian power and influence, which is seen as key to enhancing the country's national security. Ultimately, forging close ties with the United States and acceding to NATO are the two preferred foreign policy outcomes - as well as the means of achieving that balance. The majority of Georgia's political elite share these goals.<sup>37</sup> For Georgia, NATO and EU, are important institutions to which it aspires to belong and with which it seeks mutual and complementary political, economic, and security benefits.

### **Georgia's Foreign policy: possible modifications after the Parliamentary Elections**

Recent parliamentary (October 1, 2012) election marked an important point in the country's history, as it signposted a first ever peaceful transfer of power that reflects positively on consolidating its democratic transition. Among the many questions as to what comes next, the country's geopolitical direction under Bidzina Ivanishvili's Georgian Dream coalition has become the subject of extensive inqui-

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<sup>36</sup> Kornely Kakachia. Russia-Georgia Today: An Illusory Stability. PONARS Eurasia Policy Memo No. 109. Available at: [http://www.gwu.edu/~ieresgwu/assets/docs/pepm\\_109.pdf](http://www.gwu.edu/~ieresgwu/assets/docs/pepm_109.pdf)

<sup>37</sup> CRRC

ry and supposition. Present Georgian leaders may not agree among themselves on many issues, but so far it seems that on one core goal related to defend national interest they may have shared stance. Like Saakashvili's government, Ivanishvili has repeatedly claimed before and after the elections that he will keep Georgia on the course towards NATO membership and integration with EU while also continuing efforts to integrate the self-styled republics.

However, it still unclear how new government could do that without sacrificing Georgia's national interest. Citing some of Ivanishvili's more erratic coalition partners and alleged links to Kremlin authorities, critics<sup>38</sup> are framing the Georgian Dream victory as the first step toward a Ukraine-like backslide into the Russian orbit.<sup>39</sup> However, Ivanishvili's Georgian Dream does not accept that good relations with Europe and Russia are mutually exclusive. Moreover, ignoring criticism, new government is convinced that they will be able to normalize diplomatic relations with Moscow, while Georgia will continue to refrain from formal diplomatic relations with it as long as it maintains "embassies" in two separatist regions.<sup>40</sup> Meanwhile, as emerging new and sometimes contradictory foreign policy stance increases policy of uncertainty, many regional analysts claim that Ivanishvili's choice of a foreign policy team suggests he plans to tone down the heated rhetoric that marked bilateral relations with Russia. Accordingly, he will try to adopt more pragmatic, less ideologically driven and balanced line with Moscow and improve economic and cultural ties with northern neighbor. As a "pragmatic dreamer" he also realizes the economic and other benefits of normalization of relations with Russia and hopes to recover trade and transportation links with reopening the Russian market for Georgian wine and mineral water. As one

<sup>38</sup> See: Simon Saradzhyan. Rebalancing Georgian Foreign Policy. The National Interest. November 8, 2012 Available at: <http://www.nationalinterest.org/commentary/rebalancing-georgian-foreign-policy-7705>

<sup>39</sup> Michael Cecire. For Georgia's Ivanishvili, Interests Will Guide Russia Policy. World Politics review. October, 8 2012. Available at: <http://www.worldpoliticsreview.com/articles/12397/for-georgias-ivanishvili-interests-will-guide-russia-policy>

<sup>40</sup> RFE/RL. Tbilisi Says No Diplomatic Ties With Russia While It Occupies Georgian Territory. Available at: <http://www.rferl.org/content/georgia-foreign-minister-russia-occupies-territory-no-diplomatic-relations/24752066.html>

analyst pointed out: "an initial turn to Russia with Ivanishvili would bring a more immediate economic benefit than a re-engagement with the non-committal West under any Saakashvili-inspired system."<sup>41</sup> Moreover, Ivanishvili believes that there is still deal to be had with Kremlin as establishment of relations may facilitate the integration of South Ossetia and Abkhazia into Georgia. As a first step towards this direction, Ivanishvili placed Georgia's former ambassador to Moscow Zurab Abashidze in a new post, Special Representative for Relations with Russia who will report directly to Georgian Prime Minister.<sup>42</sup> Ivanishvili also expressed hope that Moscow would reciprocate. It seems that with such steps Tbilisi will be able to test whether or not Russia changed its approach towards Georgia in the new political reality. Overall, Ivanishvili's ascendancy will mark an important shift in Georgia's relationship with Russia and with the West, while providing an example of democratization for other post-Soviet states mired in autocratic regimes. Whatever, the real outcome might be the result of political flirting with Kremlin, finding middle path between confrontation and capitulation will be one of the toughest tasks for Ivanishvili's government.

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<sup>41</sup> James Nixey. Update: Georgia Post-Election Analysis. Chatham House Expert Comment. October 2, 2012 Available at: <http://www.chathamhouse.org/media/comment/view/186067>

<sup>42</sup> Civil Georgia. PM Appoints Special Envoy for Relations with Russia. November 12, 2012 Available at: <http://www.civil.ge/eng/article.php?id=25407>





# **SOUTH CAUCASUS 1918-2018: ONE HUNDRED YEARS OF HOSTILITY?**

**Mikayel Zolyan**

*Freedom is often the first casualty of war*  
*Gabriel García Márquez*

## **Age of Maturity? 21 Years of Independence**

If we imagine that the deputies of the “Transcaucasian seim,” who declared the independence of the three republics in late May 1918, were able to travel in time and found themselves in the South Caucasus today, they would not have a hard time understanding the contemporary geopolitical situation. Indeed, the realities on the ground in the South Caucasus today bare many similarities to the situation in 1918-1920. Not only the fault lines that divide the South Caucasus today are strikingly similar to those that emerged in 1918, but also the forces that shape positions of the outside actors. It is tempting to subscribe to the famous saying “history repeats itself” and stress the similarities between the conflicts. However, it may be more efficient to focus on the differences between post-tsarist and post-Soviet periods.

In 2012, the states of the South Caucasus (three internationally recognized and one non-recognized) celebrated the 21st anniversary of independence. This is quite an achievement if we compare the contemporary states of the South Caucasus to their short-lived predecessors, who came onto historical stage in 1918 and were gone by 1921. Of the post-tsarist or pre-Soviet independent South Caucasus republics Azerbaijan, the most short-lived, existed less than 2 years (May 1918-April 1920) and Georgia managed to keep its independence for the longest period of time (May 1918-February 1921). One of the factors that contributed to the demise of these short-lived states were the ethnopolitical conflicts that emerged after 1918 and continued to shape the nature of relationships between various actors in the region, until the Russian “reconquista” carried out under the red banner of Bolshevism. These were typical post-World War I conflicts, which

emerged in almost all of Eastern and Central Europe, after multi-ethnic empires desintegrated and were replaced by nation-states.

Whatever one thinks of the incorporation of the South Caucasus into the Soviet state, it is impossible to deny that Bolsheviks imposed a sort of "Pax Russica," which lasted until the late 1980s. However, when the Soviet system started to desintegrate, new faultlines appeared, which often repeated the lines that emerged in 1918. However, it is important to remember that the so called "post-Soviet" ethno-political conflicts in the South Caucasus actually predate even the "post-Soviet" independent states. In a sense the very independence of the states of the South Caucasus is inseparable from the ethno-political conflicts, as the independence movements in all three countries mobilized around agendas which involved not only struggle for independence from the "imperial center," but also a clash of interest with neighboring republics and/or with ethnic minorities within "their own" republics.

The events that occurred between 1988 and 1991 in the countries of the South Caucasus are in many ways similar to those that occurred within the same timeframe in the countries of the Warsaw pact and in the Baltic republics of the USSR. In all those cases we have seen the rise of a mass protest movement that was directed against the Soviet system and the domination of Moscow, movements that eventually lead to the ousting of the Communist partocratic elite and establishment of democratic governments. However, while the revolutions of 1989 in Central Europe largely remained peaceful (with the exception of Romania), and were followed by a concerted effort at integration with Europe, the revolutions<sup>1</sup> in the South Caucasus were followed by violent ethnic conflict that discredited the achievements of these revolutions, and later with transition to new forms of authoritarian government.

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<sup>1</sup> While the term "revolution" is rarely used with regard to events in the South Caucasus in 1988-1991, these events fit the definition of revolution, if we define it as change of the political regime as a consequence of mass protests.

While such labels as “post-Soviet states” and even “new independent states”, are still often applied to the states that emerged in the wake of the collapses of the Soviet Union, these labels are misleading. 21 years is quite a lengthy period in terms of history, at least if taken in the context of modern history. For comparison, only 21 years passed between the armistice, which ended the World War I and the German attack on Poland, which marked beginning of the World War II. In 21 years, West Germany and Japan had turned from war-ravaged post-totalitarian countries into full-fledged democracies with thriving economies. To bring an example closer to our region, the period of independent statehood of the Baltic states (Estonia, Latvia, Lithuania), lasted only 22 years, from 1918, when they declared independence 1940, when they were occupied by the Soviet army. The latter example is especially important for the post-Soviet context, since the heritage of the relatively lengthy period of independent statehood in the Baltics, is often credited for the fact that the Baltic countries have been more successful in terms of democratic transition than their counterparts from the former USSR, including the South Caucasus.

In other words, 21 years is a quite lengthy period, and it is time to realize that the “post-Soviet” transition framework, which is often used to discuss the processes in the South Caucasus is no longer relevant. The countries are no longer in transition: transition is over long time ago. Somewhere a shaky democracy has been established, somewhere a hybrid regime has emerged, somewhere a fully-fledged authoritarianism is in place. The region is much less uniform in terms of political system, economic structure, and even social and cultural trends, than it used to be immediately after the collapse of the Soviet Union. However, there are also commonalities which exist between all South Caucasus states, including internationally recognized, partially recognized and non-recognized states, and in many cases these commonalities are consequence of unresolved ethnopolitical conflicts: ironically, conflicts are today one of the bonds that hold the region together.

## **“Normalization” of Conflicts: Conflict as Part of Political System**

Ethnopolitical conflicts have become a part of the current status quo in the South Caucasus. They have become an integral part of the political and economic systems of the states of the region. Borders that have been closed as a consequence of the conflicts have shaped the way the economy works in the region, closing down certain communication links and leading to emergence of others. Monopolistic structures that have become a defining characteristic of the economies of the region to a large extent emerged as a consequence of the conflicts, and, at least to a certain extent, are dependent on the perpetuation of the conflicts for their survival. The ruling political elites have been using conflicts for the legitimation of the power, while opposition forces have been using them to attack the governments. Moreover, in a way, conflicts have become a part of the self-image of the societies of the region and played an immense role in shaping the identities of post-Soviet nations in the region.

This realization, though it seems quite obvious, is often ignored by analysts who turn to explaining the persistence of conflicts in the region. In particular, they often ignore the complicated relationship which has emerged between political systems of the states of the region and existence of unresolved conflicts.

The existing official discourse on conflict resolution in the South Caucasus is often based on the assumption that the governments of the countries involved are genuinely interested in a conflict resolution. This assumption in turn stems from the notion that the interests of the country, i.e. the interests and well-being of the majority or at least a large part of the population are mostly consistent with the interests of the ruling elite. This assumption might work in developed democracies, where the ruling elite is under strict control of the larger public through a system of constitutional checks and balances, functioning electoral institutions, and free media. Of course, even in developed democracies, it is not uncommon for leading politicians to act against the public good, if it serves their own individual interests,

or the interests of the social class that the politician represents. However, in a democratic society, policies that contradict the public good may ultimately be counter-productive, since they can lead to loss of popularity and electoral defeat.

Needless to say, most states of the South Caucasus, whether recognized or non-recognized, cannot claim to be developed fully functioning democracies, even though there are significant differences in the levels of political freedom and pluralism. Therefore, there is not much incentive here for the governments and ruling elites to follow the public good in their policies. In most states of the Caucasus, even those where governments may be changing from time to time, the system of checks and balances exists mostly on paper, media's influence is extremely limited, the ruling elite holds unchecked control over state bureaucracy and the judiciary. Thus, there are few institutional obstacles that could prevent the elite from pursuing policies, which stem from its own interests rather than interests of the public.

In these conditions, the ruling elites in the countries of the South Caucasus tend to focus on the preservation of their political and economic power, while other considerations are secondary to these vital interests. Therefore, the elites are unlikely to take steps that might present risk to its political power and material interests. In other words, the elites may become genuinely interested in a political solution to the conflict only in case it increases their political and economic power. They might also accept a solution mediated or imposed from outside, in case such a solution does not contain a risk of diminishing their political power and material well-being. However, the elites would be vehemently opposed to any solution that might pose a potential threat to their political power and economic well-being.

In other words, the political elites in the South Caucasus have adjusted to the situation of conflict. The constraints that the situation of conflict puts on civil society, media, economic freedom, etc., may be detrimental for development of the society in general, yet they may serve the short-term interests of political and economic elites. The

ways in which these elites may benefit from conflicts are numerous. Closed borders may be useful for so called “oligarchs,” who control certain spheres of export and import. Allegations of “helping the enemy’s propaganda” may be useful in silencing critical voices in the media. “Security concerns” may be manipulated in order to limit the freedom of assembly and other political freedoms, when opposition movements become a threat to the incumbent government.

Of course, such limitations are not always a consequence of cynical manipulations: often the members of the governing elites genuinely believe that their political opponents are “agents of the enemy. On the other hand, some members of the ruling elite understand quite well both the need both for political reform and conflict resolution, however they feel themselves bound by the “rules of the game,” which exist in the current political and economic systems. After all, from the point of view of analysis, how the members of the ruling elite themselves view and their actions, may not that important, since these actions are often a result of structural circumstances. What matters is that there is a structural nexus between unsolved conflicts and semi-authoritarian political systems that have emerged in the states of the South Caucasus. This nexus has become a part of the reality of the South Caucasus. Conflicts have become “normal.” Of course, it does not mean that the societies of the South Caucasus have no chance to break this vicious circle, formed by combination of “frozen” conflicts and semi-authoritarian political systems. Further, in this paper, we will try to reflect on whether this vicious circle can be broken and what will it take to break it.

## **Caucasus-2018: Possible Scenarios of Development**

### ***Scenario 1 – Bellum Omnium Contra Omnes***

Unfortunately, one can not do away with the most gloomy scenarios of development of events in the South Caucasus. Even though probably no actors in the region are genuinely interested in such scenario, is still possible either as a consequence of their own unthoughtful moves by the elites or developments external to the region. It is

possible to imagine a situation in which today's bleak but relatively stable status quo desintegrates into a series of large and small scale conflicts, reproducing the situation that existed in the early 1990s in the Caucasus itself and even more so in the Balkans.

Such developments may be triggered by developments within the region, particularly defreezing of the existing conflicts or emergence of new ones, involving current state authorities and ethnic minorities. Another unfortunate scenario is major conflict from outside of the region spilling to the South Caucasus, leading to unpredictable consequences. At this stage, a possible conflict involving Iran and the West seems the most likely threat that might lead to such a destabilization and have catastrophic consequences for the South Caucasus. However, secessionist movements in the regions close to South Caucasus also present serious risks. Parts of Eastern Anatolia and North Caucasus time after time plunge into violence, as central authorities are unable to provide lasting solutions to the issues on the ground. Tensions also grow in some regions of Iran, as minorities, unable to express their aspirations under the current political system, are turning towards secessionist political agendas.

While this scenario remains quite improbable, at least today, one cannot rule out that at least parts of this scenario may become reality. At the current stage, after the Abkhazian and South Ossetian conflicts already became "defrozen" in 2008, it is the Karabakh conflicts that seems to be most likely to lead to a new large-scale confrontation. The failure of Armenian-Turkish football diplomacy in 2008-2010 has also contributed to the deadlock around Karabakh. The "Ramil Safarov affair" and the intensification of skirmishes on the border in 2012 suggest that, unfortunately, the situation around Nagorno-Karabakh and the conflict may be closer to defreezing than we expect.

### ***Scenario 2 – "Deep Frozen" Conflicts***

Another scenario, which at least at this stage, seems to be quite realistic, is what can be called "an eternal freeze." I will not spend too

much space describing this scenario, since this is a scenario based on the assumption that conditions in the region stay more or less the same as they are now.

Such a course of events, however, may develop in at least two directions. In some cases, as in Korea, the situation of a “frozen” conflict has endured for quite a remarkable amount of time, as it reproduced divisions between various ideologies and social-political systems. The South Caucasus is unlikely to repeat the Korean case: it is hardly possible that the dividing lines between the countries of South Caucasus may also become dividing lines of different ideological camps, as it was the case in Korea during the Cold War, or that one of the countries could become as isolated from the rest of the international community as North Korea is today. However, if major powers continue pushing the regional actors towards taking sides in global geopolitical confrontations, as it has happened before and might be happening today, this may have quite uninspiring consequences for the region.

However, the chances of this happening are not very high. It is more likely that the situation in the South Caucasus would be more similar to the one in Cyprus, where the conflict does impede the development of the sides, but they are not divided by impermeable geopolitical and ideological divisions. Even though the Greek part of the island is already a part of EU, and the Turkish part is not, it is clearly moving in the same direction, as the 2004 referendum has proven. Of course, in the case of the South Caucasus the geopolitical situation is more complicated than that in the case of Cyprus, and the danger that the dividing lines of conflicts in the South Caucasus may become dividing lines of larger geopolitical entities is more pronounced. However, the political elites of the countries of the South Caucasus seem weary of this danger and are hedging their bets when it comes to political alliances. The experience of Georgia, which paid a high price for choosing unequivocally one geopolitical alliance over another one, will probably serve as a warning to the political elites in the South Caucasus, including, as the elections of 2012 have shown, Georgia itself.



### ***Scenario 3 – A Eurasian Revival: Itegration into a Neo-Soviet system***

Another scenario is the reintegration into the political space, from which the states of the region had become independent in 1991, in other words, the return to the Russian sphere of influence in one form or another. Of course, it is highly unlikely that the Soviet Union will be reproduced in any form, especially one based on Communist ideology, which is today rejected by the ruling elites of post-Soviet countries, including Russia itself. It is also highly unlikely that the former Soviet states, including those of the South Caucasus, will be incorporated into a new federal state or quasi-federal, replicating the structure of the Soviet Union, losing their formal independence. However, some kind of institutional framework, probably one resembling the so called “Eurasian Union” project currently discussed by some post-Soviet governments, might be created, and post-Soviet states will either join this framework voluntarily or be forced to join through various forms of pressure (political, economic, military, etc.).

There are numerous factors that may contribute to realization of this scenario, but I would highlight one, which in my view is the most important: existence of common interests and common “value system” among the post-Soviet elites. Whatever their declared political agendas and ideologies, post-Soviet elites share common roots, going back to the late Soviet period. The elites in various parts of the former Soviet Union also often share the same “code of conduct”, which is a combination of late Soviet party management style, adherence to an economic model of state capitalism and some elements of criminal ethics, often packaged into rhetoric of democracy and modernization. These elites feel threatened by such trends as globalization, advent of new media, democratization, and may turn to a neo-Soviet project as a tool that offers certain level of security and comfort in this volatile situation. This common “code of ethics” may act as a surprisingly efficient tool for coopting the post-Soviet elites into a new-Soviet project. Besides, the populations of post-Soviet countries, are often nostalgic about the stability of the life in the Soivet Union, as op-

posed to the volatility of post-Soviet “wild capitalism”. These nostalgic feelings, often coupled with disillusion and scepticism with regard to the period of independence of their countries, may be used by the political elites to lead their societies into the Eurasian project, if they choose to do so. Of course, this would be possible only if the elites of the post-Soviet elites are offered guarantees that they would retain their positions, and their “share of the pie” would not be threatened by a newly emerging central authority.

Certainly, such neo-Soviet integration, based on the cooperation of authoritarian elites may prove a serious setback for the democratic development of the countries of the region. However, one can not rule out that it may also have beneficial effects. It is possible that within the newly emerging neo-Soviet entity current conflicts may become more easy if not to solve, then at least to transform or concervate. The sides may agree to the arbitrage of the newly emerged “center,” especially if the center if careful enough to offer compromise solutions, in which both sides would find certain beneficial elements. In other words, this scenario will hardly bring freedom to the countries of the South Caucasus, but it may bring peace, at least temporarily.

However, whatever its positive or negative implications, this scenario is hardly the most likely one, to say the least. While it is obvious that the ideas of “Eurasian” may not find enough support among post-Soviet non-Russian republics, it is not even clear to what extent the Russian society is ready to rally behind the call for “Eurasian integration.” It is true that on the level of rhetoric Russia’s contemporary leaders often express longing for restoring the greatness of the Soviet Union and such rhetoric resonates quite well with certain audiences in Russia. However, there is little genuine enthusiasm in Russia for such projects, especially among the younger and more dynamic groups of population. New generations of Russians, who have little or no experience of life in the USSR, are less likely to be sympathetic to such projects. On the contrary, they may be more willing to create new barriers between relatively well-off and socially modern (in this sense “European”) Russian society and more poor and socially

conservative (“southern”, “oriental” or “Asian”) neighbors, including those in the Caucasus. Moreover, some in Russia are even openly advocating the idea of “separating” the North Caucasus from Russia. While this still remains a marginal position, it reflects the changes of Russian public attitudes from expansionism to isolationism, when it comes to the Caucasus in general and South Caucasus in particular. Therefore, if the Russian authorities are serious about the inclusion of the South Caucasus into any integration projects, not only would they need to convince the former Soviet republics to join it, but they would also need to convince the Russian public of the necessity for such a project, which may prove an even more difficult task.

#### ***Scenario 4 – Deus ex Machina: European Integration***

This is, arguably, the scenario, which at least on the superficial level is accepted by the political elites of the countries of the South Caucasus, as the strategy of development of their countries. Of course, in various countries the degree to which the political elites are in reality committed to this path, is different, however, the rhetoric of European integration has been accepted by the political elites as the official discourse of politics, at least in their dealings with the West. In spite of that, this scenario does not seem very realistic today. Clearly, European integration is impossible without resolution of the existing ethno-political conflicts.

However, the relationship between the conflicts with the European integration is twofold. On the one hand, conflict resolution is a prerequisite for European integration, on the other hand, European integration can be a mighty tool that could help the conflict resolution. This relationship, depending on the circumstances, might play out either as a vicious circle, or, on the contrary act as self-enforcing positive dynamic. At the current moment, the vicious circle scenario seems to be closer to reality, as the EU does not seem to consider the European integration of the region a priority, while major regional players are opposed to penetration of European or “Western” influence. However, this dynamic may change if the EU (or rather “the West”) decides to commit substantial resources,

whether political or economic, to the goal of integration of the South Caucasus into European structures, as it was done in the case of the Eastern Europe after the Cold War.

Naturally, there would still be obstacles left on the way to European integration, both within and outside region. However, as the experience of the Eastern Europe shows, these are issues that can and have been successfully overcome in the past, when there has been clear determination on both sides. Currently, neither EU, nor the countries of the South Caucasus seem to have this determination. However, situation is changing: while more than a decade ago, some European bureaucrats doubted whether South Caucasus can be considered a part of Europe, today there is an increasing perception that South Caucasus is part of Europe, at least in its wider definition. On the other hand, while the societies of the countries of the South Caucasus viewed the idea of European integration as either undesirable or non-realistic, today the situation is also changing, at least within segments of the political, economic and intellectual elites.

Of course, the determination to join European structures alone is not enough to resolve conflicts. The societies of the South Caucasus will have to go through a lengthy and painful process of compromise and reconciliation. Also, a lot depends on whether the political elites of the South Caucasus have the intellectual potential to find the solutions to the conflicts and the political will to implement them, and today it seems that they lack both. However, European integration may provide the motivation and the sense of goal, which could allow the societies and the elites of the South Caucasus to achieve what may seem impossible today.

### **In Place of Conclusion: Regional Actors and the Limitations of Political Forecasting**

Having presented these scenarios, there are important reservations that need to be made. All of these are based on the assumption that the circumstances and positions of regional actors, Russia, Turkey and Iran, are unchanged. In other words, we are assuming that in the

foreseeable future the policies of these actors towards the region, as well as the nature of the relationships between each other and with the rest of the international community stay the same.

This is an assumption, which many analysts talking about the region, both inside and outside, are making, either consciously or unconsciously, without critically questioning the bases of that assumption. Of course, in the short-term it can be a relatively safe bet to say that it is hard to expect a radical change of the policies of regional actors, let alone a complete transformation of the role these countries are playing in international politics. However, it is important to understand that foreign policy of a country depends on the way its national interests are defined, and this in turns depends on the internal political developments. In stable democracies, where the rotation of political elites is a norm, this dependence is limited: usually main priorities of foreign policy are stable, based on a consensus within the society. However, in countries where democracy is either non-existent or fragile, incumbent political elites have a much higher stake in defining the countries' national interest and priorities on the international scale. In such countries change of the incumbent political force may lead to a complete reappraisal of the way a country sees its role in the world and therefore its foreign policy priorities.

While today in Russia, Putin's government seems to be quite secure, in the wake of opposition protests that erupted after 2011 elections it can no longer claim unequivocal support of the Russian public. If one day change of government was to happen in Russia it is difficult to predict what kind of forces could come to power, and how they would define Russia's interests in the former Soviet Union in general, and the Caucasus in particular. However, the notion that the Caucasus is a region bringing more trouble than it is worth seems to be gaining currency in Russia, not only among the liberal, but even more so in certain nationalist circles. This trend refers to the North Caucasus in the first place, but certainly this will influence also Russia's policies in the South Caucasus. Whether there is change of government in Russia, these new approaches are trends are likely to influence the way

Russian political elites conceptualize their role in the “near abroad.” Russia may become more detached, less willing to commit serious resources and take serious risks in the South Caucasus, and therefore more willing to share responsibility for developments in this region with other international actors.

Another actor, whose role in the region is often taken for granted is Iran. Unlike Russia, which still sees the South Caucasus as part of its backyard, Iran has long ago resigned from the notion that the region can be made into a sphere of Iranian influence. However, it does have certain leverages and certain interests, which it guards carefully. While the general approach of Iran to the South Caucasus is unlikely to change, what matters is the nature of the relationship between Iran and the West. The conflictual relationship between Iran and the West affects the South Caucasus not only in the sense that it perpetuates the risk of major regional instability, but also deprives the region of alternative routes and markets. Had there been a more open relationship between Iran and the West, the South Caucasus would be ideally positioned to act as a bridge between these two. In turn, as a result of its confrontation with “the West”, Iran is mostly isolated from the conflict resolution process, even if the conflict is taking place on its immediate borders, as in Nagorno-Karabakh.

While today the conflict between Iran and the West seems to be insoluble, it is not hard to imagine how this confrontation may be subverted. Iran’s next president, even if he represents the conservatives, is likely to attempt to find a compromise with the West, as current president’s foreign policy has led to severe economic hardships and further isolation. It is also not difficult to imagine a rebirth of the so called “Green movement”. Even though it would be a grave mistake to picture the Iranian opposition as “pro-Western,” it could influence greatly the way Iran sees its relationship with the rest of the world. Finally, even in the unlikely case of the current Iranian government achieving its aims in the nuclear energy field, this could lead to a new dialogue between the West and Iran, as Iran would feel more secure and the West could have more incentive to resort to more soft means of diplomacy rather than “hard power.”

As for Turkey, here the foreign political priorities seem to be more stable. Until the recent decade, Turkey's civilian government had a limited say in defining foreign policy priorities, as it had to share decision making powers with the military and security apparatus. However, during the AKP years this situation has changed. Today, the personalities of the leaders have less role in defining Turkey's foreign policy, while the views of the voters mean more (which is not necessarily a cause for optimism as many Turkish voters support radically nationalist positions, especially regarding the South Caucasus). Today, Turkey is going through a process of rethinking its role in the world and in the region. It is hard to say in which direction this process could take Turkish foreign policy, however, we may expect that the Turkish positions regarding the South Caucasus may also become a subject of reassessment.

Another development, which though it refers to Turkey's internal politics, may have implications for the South Caucasus, is the complicated relationship between the central government and the Kurdish regions, which fluctuates from open confrontation to attempts to find a compromise. While it is hard to predict the path that this relationship may take in the future, it is clear that some compromise solutions will need to be found, which may move Turkey towards embracing multiculturalist and federalist approaches. The perspective of Turkey embracing a more open approach to the controversies surrounding its past, is also quite possible, as the current trends in Turkish society have shown. These tendencies, in turn, could strongly influence Turkey's foreign policy, particularly when it comes to Turkey's neighbors in the Caucasus.

All of this suggests that the larger geopolitical surrounding of the South Caucasus may undergo significant changes in the not so distant future. Such changes may create a completely new situation also with regard to development of the South Caucasus in general, and the perspectives of the South Caucasus in particular. Both the opportunities and the dangers that these transformations may create for the South Caucasus are difficult to assess at this point, but it is

obvious that implications may be huge. What if by 2018 the countries of the South Caucasus find themselves next to a democratic Russia with limited ambitions in its near abroad, a moderately Islamist Turkey with a more open approach towards ethnic minorities, and a moderately Islamist (or even secular) Iran willing to cooperate with the West? Such a picture seems to be from the realm of science fiction at this point, but let us remember that even in the mid-1980s, a prediction of the collapse of the USSR would have looked extravagant, to say the least.

However, while the positions of regional and global powers are important, it is also important to remember that the fate of the South Caucasus is ultimately determined by the citizens of the South Caucasus themselves. As trivial as it is, this idea may seem idealistic to many people in the Caucasus, where apathy and feeling of powerlessness, often accompanied by most bizarre conspiracy theories, are common not only among the “ordinary people,” but, ironically, even among the members of the elites. Some in the Caucasus may find comfort in the notion that everything is decided either by powers over which they do not have control, a notion that allows to lay the burden of responsibility over someone else’s shoulders. However, ultimately, it is the people of the Caucasus who shape the fate of their own countries, either by taking action or refusing to do so.



# A BLEAK FUTURE FOR NAGORNO-KARABAKH: MODELS, FORMATS AND PROSPECTS. AN AZERBAIJANI PERSPECTIVE<sup>1</sup>

Zaur Shiriyev<sup>2</sup>

## Introduction

The conflict between Armenia and Azerbaijan over Nagorno-Karabakh<sup>3</sup> (NK) is the longest running conflict in the post-Soviet space. The deeply entrenched and ongoing enmity between the independent republics is the most significant obstacle to peace, cooperation and stability in the Caucasus region as a whole. The Karabakh<sup>4</sup> conflict has introduced an element of fragility to the stability of the region as well as that of the parties directly involved, through waves of refugees and humanitarian and social crises.

In terms of efforts towards a peaceful resolution of the conflict, the Organization for Security and Cooperation in Europe (OSCE) began to play a mediating role during war-time, and since the 1994 ceasefire agreement, has continued to do so. The group of OSCE co-chairs, which consists of the US, Russia and France, has served as the nego-

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<sup>3</sup> Officially, Azerbaijan prefers to call it the "Armenia-Azerbaijan conflict over Nagorno-Karabakh" and defines the conflict as a bilateral interstate conflict between itself and Armenia. However, "disputed territory," or Nagorno-Karabakh Republic is not accepted by Azerbaijan logically and sometimes this issue creates additional problems in negotiations, and in conflict sides' relations with international media.

<sup>4</sup> The author will use the term "Karabakh" as an equivalent to Nagorno-Karabakh when mentioning the conflict in the text. Also, in the text, the term Nagorno-Karabakh Autonomous Oblast (NKAO) is used in reference to the administrative body which had autonomy status under Azerbaijan's jurisdiction during 1923-1991.

tiating body since 1997. Within this framework, the process has not always been consistent, and, except for several proposals for resolution and at the technical level through the monitoring of the Line of Contact (LOC), Azerbaijan has fallen into "status quo fatigue." The country is waiting to see the final position in regard to the occupation of Nagorno-Karabakh and the seven adjunct territories. It should be noted that negotiations have been confidential over the past two decades, and on only one occasion, at the end of the 1990's, did Azerbaijan hold public discussions about the OSCE peace proposals. Both the OSCE and the parties preferred not to disclose the details of formulas and proposals, which excluded the public from the process, making them more vulnerable to political exploitation and easier to manage. Year by year, Azerbaijan became wearied by the unproductive negotiations, while there was an increasingly hard-line approach pursued by Karabakh Armenians: namely the "status versus liberated land" formula, under which they argue that until the status of Nagorno-Karabakh and the security of Armenians is granted by mutual agreement, the seven adjunct occupied Azerbaijani territories shall not be part of the discussion. Later, there was a dramatic shift, and this formula was developed into a more maximalist version: the price the Armenian side demanded for the liberation of the seven adjunct territories was nothing short of the political independence of NK. The recognition of NK's independence represents an important card in the hands of the Armenian leadership in terms of leverage against Azerbaijan. This approach was fuelled by the widespread recognition of Kosovo's independence and later by Moscow's recognition of the breakaway republics of South Ossetia and Abkhazia following the August 2008 Russia-Georgia war, which only four states have recognized to date.

Meanwhile, ongoing bilateral negotiations at the official level have seen both golden moments and missed opportunities. While Azerbaijanis see the non-resolution of the Karabakh conflict as the most serious threat to national security, and take comfort in the government's increased military expenditure as a sign that the conflict could be resolved by force, Armenians see internal political developments as the greater threat. The anxiety there is about the repetition of "Ter-Petrossian's

fate,”<sup>5</sup> and, in general, the Armenian public considers the Karabakh conflict solved. Having said that, there is among some groups, a belief that “Armenia won the battle not the war, and the international community will not tolerate the long-term status quo in Nagorno-Karabakh.”<sup>6</sup>

However, for both conflicting parties, “all or nothing” represents the solution of the Nagorno-Karabakh conflict for the entire geography. This approach is very similar to the “status quo or war” concept. In this regard, the risk of war caused by a minor military incident along the line of contact is increasing. What is to be made of this kind of notion – namely that a relatively minor incident could lead to a full-scale war?

The threat of war became clearer and more tangible after the 2008 Russia-Georgia “Five Days” war, which revealed the dangerous temptation to underestimate Russia’s willingness to use military intervention. The lesson for Azerbaijan was the importance of securing Moscow’s neutrality; in this sense the signing by Azerbaijan and Armenia of the Moscow Declaration in November 2008, fourteen years after the ceasefire agreement, also concluded under Moscow’s mediation, was extremely significant in highlighting Russia’s role. Since then, the OSCE’s mediation role has become more symbolic – for instance, the Azeri media began to refer to the OSCE Minsk Group’s visits to the region as tourist excursions. Following the Moscow Declaration, the main bilateral achievement is the Madrid Principles, the latest iteration of the “Basic Principles,” which were initially proposed by the OSCE Minsk Group to the presidents of Armenia and Azerbaijan in 2007 and revised in 2009. Of the fourteen principles, only six are agreed to and publicly known.

Taking into account this short background, this article will analyze the dividing lines between the parties with a particular focus on the Azerbaijani

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<sup>5</sup> In 1997-1998, Armenia’s first post-independence president, Levon Ter-Petrosian, who, following his acceptance of a peaceful resolution plan for the Nagorno-Karabakh conflict was forced to resign by the Diaspora and other powerful political groups within Armenia.

<sup>6</sup> Former President Ter-Petrosian voiced this statement in a closed meeting with the cabinet before resigning from his post in 1998. Later he spoke about this statement to local news agencies and the evidence became available to the public.

position, then turning to the existing and possible peace formulas and future scenarios from Azerbaijan's perspective, with the aim of identifying "the tail that wags the dog" in the peace negotiations. The objective is not to provide historical background or a detailed discussion of peace proposals, but rather, to assess the current state of affairs from the point of view of Azerbaijan with regard to possible implications for the future.

## **Dividing Lines**

*"Everybody's strategy depends on everybody else's."*<sup>7</sup>

The existing dividing lines in the Nagorno-Karabakh conflict are drawn on political and legal terms. A more comprehensive look suggests that the two terms are used interchangeably; the legal arguments are used as tools for political leverage, and vice-versa. The core of the dispute is based on the competing legal principles of territorial integrity versus self determination. A legal analysis of these terms is beyond the scope of this paper, but we will assess the possibilities for a mutually satisfactory compromise towards resolving the points of conflict.

Although the dividing lines have evolved and shifted over the past two decades, they remain employed as instruments of political pressure or blame. In general, uncompromising stances on both sides make it nearly impossible to move toward the long-awaited peace treaty. Agreement on the basic principles has not been reached, and the "Madrid Principles" have been under discussion for a long time. The following is an evaluation of the contested ground contained within the Basic Principles – essentially, the political dividing lines, and Azerbaijan's position on them:

### *Question of Representation in the Negotiation Process*

Since the 1994 ceasefire agreement between Armenia and Azerbaijan, the de-facto (Armenian) authorities of Nagorno-Karabakh have been involved in negotiations, especially in the Bishkek Protocol, of which they are a signatory. There is an element of controversy sur-

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<sup>7</sup> Kenneth Waltz in "Man, the State and War".

rounding the Bishkek Protocol. The de-facto authorities were part of the process until 1998, when Robert Kocharian, former leader of the Karabakh Armenians, became president of Armenia, at which point his personal role in the peace process was accepted as representation for both Armenia proper and the Karabakh Armenians.

The de-facto authorities of Nagorno-Karabakh took part in the negotiation process, but until 1998, Azerbaijan refused to consider the NK authorities as a genuine party to the negotiations. International documents support this position. According to a decision at the March 1992 Helsinki meeting of the Commission on Security and Cooperation in Europe: "Elected and other representatives of Nagorno-Karabakh will be invited to the [Peace] Conference as interested parties." In fact, the OSCE Minsk Conference never acted on this, and in the later peace efforts of 1992-1994, the OSCE Minsk Group co-chaimanship was established in December 1994. Prior to that, the Azerbaijani and Armenian leadership agreed on the "interested" and "principal parties," rules which became known as the "Baker Rules," named after the then-US Secretary of State James Baker who headed the 1992 CSCE initiative. At that time, there was full agreement. The Baker Rules recognize two principal parties (Armenia and Azerbaijan) and two interested parties (the Azerbaijani and Armenian communities of Nagorno-Karabakh). Azerbaijan and Armenia agreed to held negotiations according to these principles at the 1992 CSCE Helsinki summit meeting.

The problem was that during the 1990's, Azerbaijan preferred to discuss the Karabakh solution with Armenia via international mediation; also, Karabakh Azerbaijanis were not able to participate in the negotiations, mainly because they were not ready. The government needed humanitarian assistance for the temporary resolution of their social problems, and focus was not on keeping Karabakh Azerbaijanis as a part of process. Therefore, the Karabakh Azeris could not participate in direct talks, and consequently their interests have been largely ignored throughout the negotiation process.<sup>8</sup> The Azerbaijani leadership was

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<sup>8</sup> Tabib Huseynov, 'A Karabakh Azeri Perspective', *The Limits of Leadership: Elites and Societies in the Nagorny Karabakh peace process*, Accord, Issue 17, 2005, pp.26-27

not eager to bring Karabakh Azeris into the negotiations until recent years. This denial of access by the leadership in Baku was based on a political strategy. The Azerbaijani leadership thought that the Karabakh Armenians would not “maximalize” their position and so Baku wanted to save the involvement of the Karabakh Azeris as a trump card best deployed at some future point. The idea was that if the Karabakh Armenians claimed self-determination, Karabakh Azerbaijanis could make the same claims, especially in Shusha, which was a majority Azeri populated area of the former NK autonomous oblast.

For this reason, the Azerbaijani side believes that there are no irregularities or inconsistencies in the format of the peace negotiations, and Azerbaijan can not be accused of rejecting any contacts with Nagorno-Karabakh. Since 2009, when Azerbaijan accorded legal status to Nagorno-Karabakh Azerbaijanis, in the form of the “Public Union of the Azerbaijani Community of the Nagorno-Karabakh Region of the Azerbaijan Republic,” Azerbaijan has strongly supported inter-communal dialogue between the Azerbaijani and Armenian communities of Nagorno-Karabakh. This marks a new step towards peace by Azerbaijan, envisaging negotiations over the status of Nagorno-Karabakh between Azerbaijan and Armenia in recent years. This is part of a more broadly conceived strategy shift by official Baku. While the realization of these inter-communal negotiations would seem to characterize the final stage of the peace process, the whole strategy can not become a reality until Azerbaijan’s sovereign rights over the occupied territories are restored, and the safe and dignified return of the expelled Azerbaijani population is assured.

### *Question of the Final Status of Nagorno Karabakh and the Referendum Issue*

Negotiations surrounding the so-called “Updated Madrid Principles,” which should be a fairly basic document, have dominated the peace process for more than four years. The status of Nagorno-Karabakh remains a key issue of dispute between the parties. The status issue was also contested during the 1997-1998 OSCE Minsk Group’s peace proposals. In one of them, the so-called “step by step” solution proposed in Sep-

tember 1997, sought to find a quick solution whereby Nagorno-Karabakh would continue to exist in its present form until agreement on the final status was reached, but would gain internationally recognized "interim status."<sup>9</sup> Neither side wanted to make any concessions that could be interpreted as the other side's victory, and thus Azerbaijan defended the "interim status" as an act of progress,<sup>10</sup> while Armenia defended the "first status, then agreement" position. In the view of Azerbaijan, one option would be the withdrawal of Armenian forces from the territories adjacent to NK, except for the Lachin corridor; the return of refugees to those territories, and the provision of guarantees from a third party or parties. Then, an interim status for the borders of the former NKAO would be determined before the final accord is signed. This type of "step by step" resolution is indicated in the Madrid Principles, in its publicized text, and thus, this position is not held by Azerbaijan alone.

The defining of the legal status of Nagorno-Karabakh is no easy task, and it overshadows all of the other points which are comparatively easy to agree upon. The defining of the status from the Azerbaijani point of view is largely a matter of time; NK can survive under this interim status for another 5-10 years, and then both sides can agree upon its final status. However, Armenia fears that Azerbaijan could shape the determination of the final legal status of NK by populating NK with ethnic Azerbaijan in the future, and therefore, postponing any decision on the legal status is in the interests of Azerbaijan. Although the Madrid Principles do not mention the political boundaries of NK, the questions of how to incorporate the status of NK into the constitutional legal system of Azerbaijan and manage a timeline for the referendum remain important ones. To resolve this problem, the following must be addressed:

- Both sides must agree on the territorial boundaries of Nagorno-Karabakh. In this case, a possible compromise could be using

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<sup>9</sup> Volker Jacoby, 'The role of the OSCE: an assessment of international mediation efforts', *The Limits of Leadership: Elites and Societies in the Nagorny Karabakh peace process*, Accord, Issue 17, 2005,p.32

<sup>10</sup> 'Azerbaijan grants interim status to Karabakh as concession – official Baku', July 13, 2011, News.am, <http://news.am/eng/news/67766.html> [accessed 10 November 2012]

the borders of the former Soviet Nagorno-Karabakh Autonomy Oblast, plus the Lachin Corridor with an agreement giving the same status to Meghri strip (the southernmost part of Armenia's Zangezur province and Armenia's only link to Iran). In fact, the exchange of territories (giving NK to Armenia in exchange for Meghri, was part of the discussion in 1999); however, this is not a matter of exchange, but rather creating a "peaceful corridor" for each side. In 1999, a discussion between the Azerbaijani and Armenian presidents concluded that such an exchange was impossible, not only due to opposition by the Azerbaijani public, but also because Armenia would lose its border with Iran.

- Both sides must agree on the participants in a referendum, for which they can use 1989 Soviet statistics as the most recent demographic data and on the logistics of the voting process. At this point, it is also necessary to clarify the legality of the referendum in terms of the Azerbaijani constitution, which states that in any decision involving possible boundary changes, all Azerbaijanis must participate.
- A referendum may be facilitated by the OSCE, which would serve as a legally binding expression of will for the determination of the final legal status of Nagorno-Karabakh. Mutual agreement likely cannot be found if there is any mention of "independence" or "unification." What is needed is a model which can support the well being of Karabakh Armenians allowing them to fully exercise all of their fundamental rights in any kind of partnership with Armenia.
- Through representation in the negotiations and direct talks, Karabakh Azerbaijanis and Armenians can discuss the legal framework and status of NK status. They can help decide the power sharing dynamic, for example, the percentage of Azerbaijanis and Armenians working for the local authorities, police system and etc, as well as a quota for Armenians in the Azerbaijani parliament.



In this context, the alternative solution discussed among Azerbaijani scholars is that Azerbaijan, Armenia, and the Armenian and Azerbaijani communities of Nagorno-Karabakh agree to NK being an *anomaly within Azerbaijan*, whereby the status problem is resolved in an anomalous way. According to Niyazi Mehdi, Azerbaijan would accept Nagorno-Karabakh as the “Nagorno-Karabakh Republic” - although this could mean the recognition of NKR’s independence, which immediately comes into conflict with the fact that without a referendum in Azerbaijan, the NKR can not change its name to secede from Azerbaijani borders.<sup>11</sup>

In reality, the “anomaly” proposal is not especially popular, as both sides want to find a solution in accordance with international law. The implementation of any legal status for NK is will need to be compatible with Azerbaijan’s domestic law.

Further points of debate include the withdrawal of Armenian forces from the surrounding territories of NK, the composition of any international peacekeeping operation, and the return of IDPs.

#### *Withdrawal of Armenian forces, Return of IDPs & Composition of Peacekeeping Operation*

##### a) Withdrawal of Armenian forces

One of the key issues on the discussion table is the withdrawal of Armenian forces from the occupied regions, and a timeline for the return of IDPs. Five of the seven occupied Azerbaijani districts (Fuzuli, Jabrail, Gubadli, Zangelan, and Aghdam) are considered as bargaining chips by Armenia.<sup>12</sup> Armenia’s position has changed over time; in the first few years following the ceasefire agreement, the surrounding territories were referred to as buffer zones, or sometimes security zones.

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<sup>11</sup> Professor Niyazi Mehdi, ‘Anomalous autonomy as a solution to the Mountainous Karabakh conflict’, 18 June 2012, <http://peace.oneworld.am/blog/2012/06/anomalous-autonomy-in-mountainous-karabakh-conflict-resolution/>

<sup>12</sup> Gulshan Pashayeva and Nigar Goksel, The Interplay of the approaches of Turkey, Russia and United States to the conflict over Nagorno-Karabakh, SAM Review, No.3, February 2011, p.22

Recently, however, having kept these territories for more than two decades, the Karabakh Armenians have started calling them “liberated territories.” Any concession from this point of view is strongly linked to the concession of Azerbaijan on the status of Nagorno-Karabakh; the more maximalist view is that Azerbaijan must accept de-facto independence of the so-called Nagorno-Karabakh Republic.

Azerbaijan, fatigued of the status-quo situation, sees the starting point of reconciliation with Armenia as contingent on the withdrawal of Armenian forces from the occupied territories. In this context, official Baku’s position is supported by four UN Security Council Resolutions,<sup>13</sup> each of which reaffirm the territorial integrity of Azerbaijan. Many more resolutions condemning the Armenian occupation of Azerbaijani territory were issued by the EU, OSCE and other international organizations, for example. The UN resolutions regarding the withdrawal of Armenian forces from the occupied territories were acknowledged, but not implemented; nor punished by sanctions.<sup>14</sup> Further, the OSCE Minsk Group co-chairing states have called on Armenia to respect the territorial integrity of Azerbaijan and to withdraw the occupying forces from its territory.

In May 2010, the Azerbaijani side disclosed to the press a regime for the withdrawal of Armenian forces from the occupied regions, which was declared acceptable by official Baku. The first stage included the withdrawal of Armenian forces from five regions bordering Nagorno-Karabakh and 13 villages in the occupied Lachin district, the restoration of communications, a donors’ conference on postconflict rehabilitation, and the deployment of peacekeeping observers. The second stage entailed, according to the minister, the withdrawal of Armenian forces from the remaining Kalbajar and Lachin districts and the return

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<sup>13</sup> The UNSC adopted four resolutions (822, 853, 874 and 884) in 1993, which calls unconditionally for the withdrawal of occupied forces. The term “occupying forces” in the resolutions is used in reference to the occupying Armenian armed forces, and in fact, the documents do not identify whether the occupied forces represent the Armenian Republic or the self-defense forces of Karabakh Armenians.

<sup>14</sup> Azerbaijan tried repeatedly garner the recognition of Armenia as an aggressor party in a few international organizations, but did not succeed, except for the **Organization of Islamic** Cooperation (OIC).

of IDPs, and only then to be followed by the determination of the status of Nagorno-Karabakh, on the condition of the nonviolation of the territorial integrity of Azerbaijan.<sup>15</sup> It is worth remembering that in late 2009, when Turkey and Armenia signed protocols on the normalization of bilateral relations, the issue was deeply linked to Armenian constructiveness on the resolution of the NK conflict. Even Turkey expected the Armenian forces to withdraw from one or two regions as a way of increasing support within Turkey for the reopening of borders.

In this case, while disclosing the discussion points to the media, Azerbaijan declared that it preferred “detailed regime of withdrawal” rather than withdrawal from one or two regions. Azerbaijan is concerned that the former would allow Armenia to gain political capital with the international community for its “peaceful act,” and thereby, prolong the withdrawal process.

#### b) Return of IDPs and Property Rights

As a result of the Karabakh conflict, along with the collapse of the Soviet economy, Azerbaijan during the first years of the 1990s, faced an IDP problem. Close to one million people<sup>16</sup> who lived in Armenia and Karabakh itself were displaced, and fled to Azerbaijan, which created a humanitarian crisis. For Baku, following the withdrawal of Armenian forces, the return of IDPs to Karabakh is of crucial importance. However, the timeline and implementation of their return is unclear at a certain point. First of all, the return of IDPs to the surrounding regions of NK is feasible, but a second round—the return of Azerbaijanis to Shusha, which is within the administrative border of the former NKAO- is more difficult.

<sup>15</sup> Azerbaijani Foreign Minister Discloses Details of Madrid Principles, Caucasus Report, REF/RL, March 15, 2010. [http://www.rferl.org/content/Azerbaijani\\_Foreign\\_Minister\\_Discloses\\_Details\\_Of\\_Madrid\\_Principles/1984485.html](http://www.rferl.org/content/Azerbaijani_Foreign_Minister_Discloses_Details_Of_Madrid_Principles/1984485.html) [accessed 12 November 2012]

<sup>16</sup> There is no exact IDP number, while the International Crisis Group (2005) puts the number at 413,000 Armenians and 724,000 Azerbaijanis (1,137,000 total) as a result of own research; same text references UNHCR 2003 data with a total of 1,198,137. More: [http://www.crisisgroup.org/library/documents/europe/caucasus/166\\_nagorno\\_karabakh\\_viewing\\_the\\_conflict\\_from\\_the\\_ground.pdf](http://www.crisisgroup.org/library/documents/europe/caucasus/166_nagorno_karabakh_viewing_the_conflict_from_the_ground.pdf) [accessed 12 November 2012]

One aspect of this problem that has not been discussed is the link between property rights and IDP return; until now, both sides have not considered this issue of return in all its complexity. A good return policy must be based on a rights-based policy. This issue requires a comprehensive approach, but one that does not take into account the legal status of NK, because the IDP return is scheduled before that can be resolved. In fact, the solution of this problem could be solved by:

- (a) Putting IDP property rights into the additional agreement between Azerbaijan and Armenia, a "second" agreement (i.e. in addition to the peace agreement) that could be guaranteed by the UN's relevant commission, which could declare funding for reconstruction from an international organization. Part of these funds could be used to resolve the immediate housing problems of IDPs;
- (b) Both sides can agree that Armenia will not claim any right to property in the surrounding regions of NK; similarly Azerbaijanis will not ask for any property rights in former NKAO, with the exception of Shusha;
- (c) Regarding the property rights of Armenian IDPs in Azerbaijani cities, and vice-versa, a "Property Commission" could be established, with a mandate to deal with this issue within 3-5 years.

### *Deployment of Peacekeepers and the Nature of the Peacekeeping Operation*

This final point, which is strongly connected to the withdrawal of Armenian forces, and the return of IDPs, is about the nature and representation of forces (i.e. nationality). This is an especially sensitive issue for Azerbaijan, because Baku does not want to see Russian peacekeepers as the only ones in the possible deployment, for two reasons. First, until the ceasefire agreement in 1994, Russia's argument was that if Russian troops could monitor a cease-fire agreement, they would maintain Russian leverage in the region.<sup>17</sup> Later,

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<sup>17</sup> Thomas de Waal "The Black Garden: Armenia and Azerbaijan through peace and war," New York University Press, NY, 2004, p. 232

in the case of Abkhazia and South Ossetia, Azerbaijan acknowledged that Moscow's strategy was dangerous; nonetheless, Moscow continued to use its peacekeepers as a means to gain political leverage. Second, in the 1990's, Azerbaijan's general policy was to pursue the withdrawal of all Russian military bases from Azerbaijan, and on the basis of this "non-military zone" approach, it strongly opposed Moscow's intervention.

It must be noted that during the early stages of conflict, the military experts of the OSCE Minsk Group countries suggested an opportunity to establish an observer operation in the region; later, this idea gradually evolved into the concept of a multi-national peacekeeping operation. The Budapest OSCE Summit in December 1994 marked a turning point. The OSCE and Russia had overcome their disagreement, and a decision was made to send a multi-national peacekeeping contingent to the region made up of 3,000 troops – in the end, however, the peacekeeping mission failed to be deployed.<sup>18</sup>

However, in recent years, discussions on peacekeeping operation have seen Russia and Armenia come closer, with both sides supporting a "CSTO<sup>19</sup> Peacekeeping Operation." Azerbaijan is not a member of this Moscow-led military organization, and sees the "CSTO operation" as a camouflaged Russian peacekeeping operation. In addition, after September 2012, an agreement between the UN and the CSTO on the deployment of CSTO troops within the framework of UN peacekeeping operations in Syria, for Baku meant the end of any possibility for a "UN mandated mission" in NK.<sup>20</sup> As a further note, CSTO officials often make statements saying that the CSTO has carried out studies on the possible deployment of peacekeeping troops in Nagorno-Karabakh.

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<sup>18</sup> Margarita Tadevosyan, *Nagorno-Karabakh Conflict: War, Humanitarian Challenge and Peacekeeping*, Caucasus Edition, June 2010, <http://caucasusedition.net/analysis/nagorno-karabakh-conflict-war-humanitarian-challenge-and-peacekeeping/> [accessed 12 November 2012]

<sup>19</sup> Collective Security Treaty Organization (CSTO).

<sup>20</sup> 'CSTO allowed to deploy "blue chapkas" in Syria under UN mandate', 29 September 2012, <http://www.voltairenet.org/article176061.html> [accessed 12 November 2012]

Azerbaijan's principal position is that peacekeeping forces should not be from co-chairing (US, Russia and France) or regional countries (Iran, Turkey).<sup>21</sup> In this context, Azerbaijan prefers the option of peacekeeping operations under the umbrella of the OSCE. In the 1990's, when the OSCE failed to deploy multi-national forces; now it has greater experience while the OSCE managed a number of peacekeeping and peace-building missions in Europe.

Anyway, even though the deployment of a peacekeeping mission can contribute greatly to further stability and peace if both sides can come to a conclusion on resolution, but the concern is that it can achieve little when implemented alone, therefore, the OSCE should continue to push the parties to reach a political consensus on this matter.

### **Current & possible formats for conflict resolution**

*"We're hoping for more, and obviously we're working for more"<sup>22</sup>*

The mediating institution on the Nagorno-Karabakh conflict is balanced in geopolitical terms and provides a fair representation of global and regional power, with the US, Russia, and France. However, the NK conflict was first handled by the OSCE as an impartial third party mediator, in dispute resolution for an ethnic conflict that was taking place on the territory of the former Soviet Union.<sup>23</sup> But after the establishment of the OSCE's Minsk Group Co-Chairmanship, negotiations began in a larger format. The Minsk Group was comprised of eleven countries, but there soon emerged a troika: the US, Russia and France, with the latter as rotating Co-Chairman. However, since 1996, there has been no rotation; global issues have diminished the importance of the NK conflict for the

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<sup>21</sup> Agreement reached on peacekeeping forces in Nagorno-Karabakh, 7 June 2011, Trend Information Agency, <http://en.trend.az/news/karabakh/1887656.html> [accessed 12 November 2012]

<sup>22</sup> Quote by Ambassador Carey Cavanaugh, the top U.S. negotiator, he used these words during Key-West talks between Azerbaijan and Armenian presidents, April 2001. [http://www.azer.com/aiweb/categories/karabakh/karabakh\\_current/keywest\\_gutterman.html](http://www.azer.com/aiweb/categories/karabakh/karabakh_current/keywest_gutterman.html) [accessed 14 November 2012]

<sup>23</sup> Freire, M. R, Conflict and security in the former Soviet Union: The role of OSCE. Aldershot, Hants, England: Ashgate, 2003, p.131

“troika.” Thus, since 2008, Russia, in the name of the Minsk Group, has dominated the peace process, and in this sense, since 2008, the Minsk Group, seems to be dealing much more with “conflict management” – trying to reduce the tensions between parties via occasional visits to region, rather than with a “conflict resolution mechanism.” It is the latter, needless to say, that is the key to the solution of the conflict. Therefore, in November 2008, when Russia brokered a deal in the “Moscow Declaration” (Maidorf Declaration) between Azerbaijan and Armenia, both sides, especially Azerbaijan, approached Russia in a ‘Bismarckian way’- “The secret of politics? Make a good treaty with Russia.”

Thus, while Azerbaijan perceives the OSCE as an “international executor” that should help it regain its lost territory,<sup>24</sup> the effectiveness of the mechanism has been problematic. There are several key difficulties that should be noted:

First, the different interests among the Co-Chair countries in regard to the solution made the Minsk Group a “stabilizing factor” rather than a resolution mechanism. Azerbaijan sees the US-Russian Co-Chairmanship as an essential balancing factor, but is much more concerned over France’s position. On several occasions, Azerbaijan has openly discussed exchanging the French seat for a designated EU representative, with the goal of increasing the EU’s contribution, which some believe could prove essential. However, in recent years’ it has become clear that Azerbaijan was against France representation, acceding to the view of former National Security Adviser to Azerbaijan (1991-1999), Vafa Guluzade, who claims that France was fraudulently included in the Minsk Group, without Azerbaijan’s agreement.<sup>25</sup> However, EU high-level officials have repeatedly stated that France is there to inform the EU and that such a change is unnecessary. The other element of EU’s approach is that while France is the unofficial representative of the EU

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<sup>24</sup> Volker Jacoby, ‘The role of the OSCE :an assessment of international mediation efforts’, *The Limits of Leadership: Elites and Societies in the Nagorny Karabakh peace process*, Accord, Issue 17, 2005,pp.32-33

<sup>25</sup> ‘Negotiation Concerns: Removal of France from Minsk Group troubling to some’, March 2012, [http://www.armenianow.com/karabakh/36768/osce\\_minsk\\_group\\_france\\_mandate\\_eu](http://www.armenianow.com/karabakh/36768/osce_minsk_group_france_mandate_eu) [accessed 14 November 2012]

within the Minsk Group, the EU's Special Representative in the South Caucasus, since the first appointment back in 2003, has never worked together with France to establish a strong EU position on the resolution process. Moreover, the current EU's Special Representative in South Caucasus and on the Georgian Crisis is a French citizen, leading to further concerns about the balance of EU input.

Secondly, the Minsk Group has not succeeded in implementing the OSCE Lisbon Summit (1996) principles.<sup>26</sup> The 2008 Russian-brokered "Moscow Declaration" signed between the conflict parties repeats these principles; the core element is that Azerbaijan's "territorial integrity" and Armenia's "self-determination" are both accepted by Minsk Group, but they do not have a clear vision of how to manage these competing claims.

Third, the most problematic aspect is that the Minsk Group Co-Chairmanship represents the geopolitical realities of the 1990's. This approach ignores other regional countries' peaceful approach to the conflict resolution, and also lacks high level involvement, as in the 2001 Key West meeting supported by the US leadership. This can be compared with the process following the dissolution of the former Yugoslavia, where French President Jacques Chirac was personally involved in reaching the 2006 Rambouillet Accords, or for example, in reaching the Dayton Agreement in 1995, the US appointed special representative to the negotiation process. The Minsk Group needs mid-level diplomats of major powers with many different policy prerogatives to hammer out serious proposals, perhaps even in isolation from the political leadership of the conflict parties.<sup>27</sup>

In order to increase the functionality of Minsk Group, we do not nec-

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<sup>26</sup> Three principles accepted in 1996 by the 52 OSCE member states except Armenia, include first, the territorial integrity of the Republic of Armenia and the Azerbaijan Republic; second, the legal status of Nagorno-Karabakh defined in an agreement based on self-determination which confers on Nagorno-Karabakh the highest degree of self-rule within Azerbaijan; third, the guaranteed security for Nagorno-Karabakh and its whole population, including mutual obligations to ensure compliance by all the parties with the provisions of the settlement.

<sup>27</sup> Svante Cornell, *Azerbaijan Since Independence*, M.E.Sharper Armonk New York, US, 2011, p. 159



essarily need to find a new format, as opposed to re-working current options. To do so, the following steps could be effective:

First of all, France's position in the Minsk Group must be clarified, as Armenia strongly supports France's remaining in MG.

- **EU Oriented Coordination-** As above, one idea to improve the EU's presence in the conflict resolution process is to give France's seat to the EU. This idea is mainly supported by Azerbaijan, and in March 2012, the European Parliament's Committee on Foreign Affairs adopted a document on Armenia comprising of a proposal to replace the mandate of France in the OSCE Minsk Group with an EU mandate. Obviously, this was only a recommendation, but also a sign that inside the EU there is some political will for such a change. Due to Armenian opposition and some anxieties about political capital in Paris, the short term does not promise any sign of change. In the medium term, however, there could be some improvement. First, the EU's Special Representative (EUSR) and the French Co-Chair, with the participation of the head of the EU delegations in Azerbaijan and Armenia, could find a working framework to improve the EU's role in NK resolution. As well as the EUSR, there are also the Ambassadors for the individual EU countries. They could conduct a monthly consultation and then present the results to France. Secondly, the EUSR could informally attend, or attend with "observer status" the Minsk Group Co-Chairs' meetings. At the end, the format will change to 3+1. As described below, the final format could be 3 (US, Russia, France) +1 (EUSR) + 1 (OSCE Chairman Countries' Special Representative).
  
- **OSCE Chairman's Special Representative** - The appointment of an OSCE Chairman Country's special representative would improve the process. Currently there is the personal Representative of the OSCE Chairperson-in-Office, but here we are talking about the OSCE Chairman's Country - when he or

she takes the position (on a six month rotation), a special representative to the process should be appointed. For example, in six months, Ireland is chairing OSCE, and Ireland's Foreign Minister could serve as the chairman's special representative. In this way, the OSCE will be more clearly part of this process.

Thus, the format of the Minsk Group would evolve from the current "troika" to a 3+1+1 process. Arguably, this would be hard to push through within a short space of time, as the mandate would need to be amended. At any rate, it seems likely that increased EU involvement, alongside a clearer role for the OSCE, will improve the efficiency of the conflict resolution process.

### **The Role of External Actors & Incentives for Conflict Resolution**

*"Their willingness [Azerbaijan and Armenia] to compromise – is an extremely important element in this complicated process. That's why one shouldn't underestimate how constructive settlement of "frozen" conflicts depends on the US or Russia".<sup>28</sup>*

The Nagorno-Karabakh conflict has gradually been internationalized since 1992, with the involvement of neighboring countries which have also acted as regional brokers, namely Russia, Iran and Turkey; then the US, European countries, and followed by international organizations like the UN, CSCE/OSCE, OIC and others. These various players have all showed interest in taking part in the peace process at different levels, and each of these external actors has brought a different cocktail of interests.

The resolution of the Nagorno-Karabakh issue requires active mediation by neutral parties, who are not engaged in any self-serving effort to re-establish regional hegemony, or are seeking to pursue "privileged interests" of any kind. Among the public, there are some who believe that the Armenian and Azerbaijani governments would

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<sup>28</sup> Quote by Zbigniew Brzezinski, former US National Security Advisor, he used these words in 2010.

have reached an agreement long ago, had they been left to their own devices.<sup>29</sup> Some aspects of this are shared by scholars, namely that the mediation efforts in NK, turned out to be a complete fiasco and they themselves have prolonged the conflict resolution.<sup>30</sup>

Azerbaijan has mainly supported multi-party mediation. The established mechanism - the OSCE Minsk Group – has for the most part functioned exclusively, and other options for third party mediation have not been pursued. In general, Azerbaijan supported the Minsk Group, especially during the 1990's, but the question of whether it was an honest broker was always discussed. For instance, all three Co-Chairs (US, Russia, France) have strong Armenian lobbies. It was clear in the case of the US, during the 1990's, as the Armenian lobby managed to block US financial support to Azerbaijan, under the "Freedom Support Act" (FSA) program; in addition, the US ambassadorial nominee to Azerbaijan in 2010 was blocked by influential Senators from states with large Armenian populations. In this context, the prolongation of the conflict also affects Azerbaijan's bilateral relations.

As the Minsk Group Co-Chair efforts are continuing under the umbrella of the OSCE, below we will briefly assess the limits of the external actors, namely Russia, US, Turkey, Iran and the EU, with a view to future developments.

*Russia: not just a neutral mediator; privileged interests at stake*

It is commonly believed in both Azerbaijan and Armenia that Moscow's role is a key to the solution of the conflict. Less common is the view that the solution depends on the respective governments of Azerbaijan and Armenia alone. Perhaps, Moscow's role has changed substantially on three occasions:

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<sup>29</sup> Fariz Ismailzade, 'The Nagorno-Karabakh Conflict: Current Trends and Future Scenarios', Istituto Affari Internazionali Working Papers 11/ 29 – November 2011, p.6.

<sup>30</sup> See: Wendy Betts, "Third Party Mediation: An Obstacle to Peace in Nagorno-Karabakh", SAIS Review, Vol. 19, No. 2, 1999. Moorad Mooradian, "The OSCE: Neutral and Impartial in the Karabakh Conflict?", Helsinki Monitor, 1998, No. 2.

- a) During 1992-1993, due to the pan-Turkic view and anti-Russian stance of Azerbaijan's leadership, Moscow supported Armenia on the battlefields. At the same time, those pan-Turkic ideas were perceived by Iran as threat, leaving Azerbaijan self-isolated by this geopolitical sandwich.
  
- b) In 1993-1994, due to the change in government in Azerbaijan and Baku's official entrance into the Commonwealth of Independent States (CIS), a Moscow-led alliance, Russia put more effort into ending the military campaign, and as a result, brokered a ceasefire agreement. Since that period, Moscow has in some ways played the other hand, for example, helping to militarize Armenia. But at the same time, it has sought to improve relations with Azerbaijan, as part of a careful balancing act.
  
- c) Moscow's strong commitment to the resolution of the NK conflict can be dated to November 2008, and will probably "end" now that Vladimir Putin is back in office. From November 2008-January 2012, Russia hosted the Armenian and Azerbaijan presidents in direct talks. Meanwhile, Baku has played the "balance of power game" much more effectively than Tbilisi does, using its relations with three major powers (US, Russia, EU) to manage each other.<sup>31</sup> From Moscow's view, Azerbaijan has long decided not cross the two "red lines": seeking NATO membership and hosting US military bases.<sup>32</sup>

Now, the "trilateral meeting format" is drawing to a close. This push by Russia has its roots in two areas: firstly, the need to repair its damaged regional image after the 2008 August Russo-Georgian war, and secondly, Medvedev's personal efforts to find a diplomatic solution. Russia's current president, Vladimir Putin, has a different per-

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<sup>31</sup> Lauren Goodrich and Peter Zeihan, *A Crucible of Nations: The Geopolitics of Caucasus*, STRATFOR publication, 2011, p.71

<sup>32</sup> Dmitri Trenin, *Post-Imperium: A Eurasian Story*, Carnegie Endowment of Peace Publication, 2011, p.123

sonal relationship with the leaders of each of the conflicting parties - less progressive and less friendly than his predecessor. Putin likely sees the maintenance of the conflict's status quo as the best option in the near future; his interest in a peaceful resolution of the conflict would be as the broker of an agreement that bolsters Moscow's interests and reputation

*US & EU: More and More Approach in the Less and Less Realm*

The US has played an important role in strengthening the independence of the South Caucasus and Central Asian countries, as part of its foreign policy orientation. One part of this policy has been to overlook the resolution of frozen conflicts. The US role in the resolution process peaked in 2001, with the in April meeting at Key West, Florida between the Azerbaijani and Armenian presidents. This was a historical moment in the resolution process. After the failure of this meeting, the US took a backseat, but worked on other issues, energy projects and other economic related projects that can help the region's countries to reduce their dependence on Russia. There are interesting parallels between the July 2000 Camp David meeting between Israeli and Palestinian leaders and the 2001 Key West meeting of Azerbaijan and Armenian leaders. Both provided a momentum for peace, but failed because of the minimalistic stances of conflict parties.

The Key West meeting was 'litmus test'<sup>33</sup> for the US government, and after this meeting Washington's view changed, and the US preferred to continue under the Minsk Group format.

From Azerbaijan's perspective, while bilateral relations with the US improved during George W. Bush's presidency, there was no attempt by the US to develop the resolution process; after 2008, during Obama's first term, the US was more focused on the rapprochement

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<sup>33</sup> Author's meeting with former US ambassadors to Baku at the Atlantic Council in Washington, November 2012, former ambassadors acknowledge Key West as 'last great' attempt by US government. They agreed that after that US government became less interested.

between Armenia and Turkey, and did not see the NK issue as directly connected. This approach was criticized by official Baku, and even after the failure of Turkish-Armenian rapprochement, government officials believe that Washington is continuing to finance efforts at the track two level. Clearly, the role of the US is vital for conflict resolution. One of the things that the Azerbaijani political elites see or want to see from is the appointment of a Special Envoy on the Nagorno-Karabakh conflict resolution process by the US government.

In turn, the EU, as described above, is unofficially represented by France, a Minsk Group Co-chair. The EU's engagement in the region is based on technical assistance, and before 1999, it is hard to talk about the EU's role in the region, as opposed to that of its member states. In the words of Dov Lynch, "the EU retained a low overall profile, with little presence in the negotiating mechanisms, no direct involvement in mediation, and an undefined strategy to lead policy."<sup>34</sup> Since 2008, the general perception is that the EU's role in the region has increased. Prior to 2008, the statement of a high-level EU official, in relation to the EU's lack of engagement in conflict resolution is quite interesting<sup>35</sup>: "the EU wants to taking part in solution of regional problems in Caucasus, but not yet ready to play a regional actor role. However, undoubtedly it is an international actor." However, this "placebo" effect continued until the 2008 Russian-Georgian war. However, after 2009, efforts and more engaged policy has seen little follow-up action, despite the European Parliament resolution of May 20, 2010 "on the need for an EU strategy for the South Caucasus," which stressed that "frozen conflicts are an impediment to the economic and social development and hinder the improvement of the standard of living of the South Caucasus region, as well as the full development of the Eastern Partnership of the ENP [European Neighbourhood Policy]; whereas a peaceful resolution of the conflicts is essential for stability in the EU Neighbourhood." It should be noted that

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<sup>34</sup> Lynch, Dov (2006). Why Georgia Matters. Chaillot Paper 86. EU Institute for Security Studies, February 2006. [www.iss.europa.eu/uploads/media/cp086.pdf](http://www.iss.europa.eu/uploads/media/cp086.pdf) [accessed 14 November 2012]

<sup>35</sup> Author's meeting with high level EU officials in Baku, Azerbaijan, September-October 2011.

since 2009, the EU has had more tools that enable it to participate directly and indirectly in the conflict resolution:

- a) The EUSR is now clearly mandated to help with conflict resolution, and its mandate clearly defines active participation.
- b) Through Euronest, EU has an opportunity to increase bilateral contacts between Azerbaijanis and Armenians in the Parliamentary dimension. It is true, meetings at Euronest until now have only produced a battle of words, but even this is an importance element.
- c) The European Commission, though the Eastern Partnership and other mechanisms can increase its presence in terms of contact with conflict sides. It should be noted that signing Association Agreements with the EU could increase the EU's role, and increase the grounds for its presence.

Until now, unfortunately, EU's conflict resolution efforts can only be found on papers, and high-level EU statements. As stated above, EU could be more effective if Minsk Group format changes to a 3+1+1 format in the future, and if EU could effectively use the "Association Agreement" signings as a "stick" for the conflict parties. The EU's objective should be to create "safe spaces" for conflict parties to discuss and interact with each other, within a "wider strategy."

#### *Limited mediation: the Iranian and Turkish approaches*

Both Iran and Turkey have limited power as mediators in the resolution process of Nagorno-Karabakh conflict.

From Azerbaijan's point of view, Iran lost its credibility as a potential broker in the resolution of the Nagorno-Karabakh conflict. The general perception in Azerbaijan is that if Iran had not supported the aggressive policy of Armenia during the war (1992-1994), that would have been enough for Azerbaijan, which needed Iran's material and moral support during that period. However, it was noted by interna-

tional experts that Iran did support Armenia during the conflict over Nagorno-Karabakh and wished Azerbaijan to weaken.<sup>36</sup> Meanwhile, from Iran's point of view, a balance of power between Armenia and Azerbaijan is the goal of its mediation policy. Iran favours neither a powerful Christian Armenia nor a powerful Azerbaijan which might harbor territorial claims to northern Iran, which is home to many ethnic Azeris. Both countries have to be kept in balance by means of pressure on the stronger side.<sup>37</sup>

But even the neutrality of Tehran, which has been claiming that it is interested in mediation since the middle of 2010, raises suspicions. Iran's increasing cooperation with Armenia in various sectors and support for its economic development, coupled with strained relations with Azerbaijan since the end of 2010 raise serious concerns. Iran's efforts are unlikely to be taken seriously by either party. For Tehran, the most preferable position seems to be continued economic cooperation with Armenia, as a means of balancing Azerbaijan's efforts.

Turkey, a close strategic ally of Azerbaijan, has a strong interest in the resolution of NK conflict, despite the fact that Armenia has always opposed Turkish involvement in the conflict resolution process. Turkey's most recent efforts to serve as mediator came during the Turkish-Armenian rapprochement process, which angered Azerbaijan, due to the fact that no reference was made to the withdrawal of Armenian forces from NK and the surrounding regions. Azerbaijan's reactions were more muted this time round, and Turkey signed the Zurich protocols with Armenia in October 2009, though it was made clear inside the country that the government would not try to force the ratification of the protocols by the Turkish Parliament, where majority opposed such a move unless positive developments are seen towards the solu-

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<sup>36</sup> Iran's Security Policy in the Post-Revolutionary Era, Impact on Foreign Policy, RAND Report, 2001, [http://www.rand.org/pubs/monograph\\_reports/MR1320/MR1320.ch6.pdf](http://www.rand.org/pubs/monograph_reports/MR1320/MR1320.ch6.pdf) [accessed 14 November 2012]

<sup>37</sup> Abdollah Ramezanzadeh, Iran's Role as Mediator in the Nagorno-Karabakh Crisis, Contested Borders in the Caucasus, Chapter VII, 1996, <http://poli.vub.ac.be/publi/ContBorders/eng/ch0701.htm> [14 November 2012]



tion of the Nagorno-Karabakh dispute.<sup>38</sup> Most likely, the Turkish authorities were waiting for a 'one region return' as a good-faith gesture and a pre-condition to moving forward in the resolution process. But Azerbaijan's position in withdrawal of occupied territories based on the withdrawal regime. Turkey cannot act as a mediator because it prefers to maintain a pro-Azerbaijani policy due to its strategic links with Baku, and as such cannot be an honest broker.

Meanwhile, 2015 will mark the centenary of the 1915 events, a great Armenian tragedy, the definition of which remains much contested (i.e. genocide or not). In this context, officially, Ankara is much more interested in seeing progress away from the current stalemate, and in this way wants to open its borders with Armenia. Most probably in 2015, inside the Turkish government there will be strong political will to pressure the circles who oppose rapprochement with Armenia based on the Nagorno-Karabakh condition. In this context, Ankara may increase efforts in 2014.

### **Domestic Conflict discourse**

*"Time will tell who did what for Karabakh, and who, indeed, is selling it out."*<sup>39</sup>

The conflict's domestic discourse is the key element in bringing conflict parties to a peaceful deal. In the global experience, a classic example is found in the Arab-Israeli conflict, where after the 1993 Oslo accords, which did not bring peace and in fact, prolonged the violence. Another example is the Cyprus conflict; in 2004, the Annan Plan was a major attempt to resolve the dispute, but the Greek side's vote caused the failure of the peace accord, and later both sides

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<sup>38</sup> Mustafa Aydin, 'Geopolitical Dynamics of the Caucasus-Caspian Basin & The Turkish Foreign and Security Policies', The South Caucasus 2021: Oil, Democracy and Geopolitics, Jamestown Publication, 2012, p.184

<sup>39</sup> Levon Ter-Petrosian, former Armenian President in his resignation speech in Yerevan on February 5, 1998, referring to accusations from hard-liners and members of the opposition, including Robert Korcharian. [http://www.azer.com/aiweb/categories/top-ics/Quotes/quote\\_terpetrossian.html](http://www.azer.com/aiweb/categories/top-ics/Quotes/quote_terpetrossian.html) [accessed 12 November 2012]

gradually lost faith in the process. In the Nagorno-Karabakh conflict, there are also instances of such violence. In late 1999, rumors flew around that the both sides had agreed to sign peace agreements, and key figures in the Armenian parliament were assassinated. It's true that this case is not such a clear indicator as the others, but the point remains. If parties fail to prepare their societies for peace, public hatred for the enemy will increase conflict between societies, and ultimately slow down or obstruct any progress towards genuine peace.

In Azerbaijan, a nationalist agenda remains the highest priority of all generations of politicians and statesmen as a result of the failed negotiation process. Clearly, Nagorno-Karabakh is the only issue that is universally agreed upon by the political elites, but their methods are different. One example is the Turkish-Armenian rapprochement process; when Turkey opened the normalization process, the government was initially silent, but the opposition parties started criticizing the Turkish government. The ruling party used this 'pressure' as tool to show Turkish society that such feelings were widespread, not limited to the government. The whole society opposed this rapprochement, at least before there were positive developments in the negotiations.

In addition, opposition parties sometimes criticize the government for their bellicose statements on the Nagorno-Karabakh conflict. In the eyes of the opposition, the solution lies in making major changes to the package for the Karabakh Armenians needs major changes, including a concrete plan (which must consist of economic assistance, political self-governance, etc.) which are key to winning the minds and hearts of Karabakh Armenians. In addition, domestic democratic developments are urgently required. In this sense, the opposition parties support the idea that Azerbaijan would have been able to make more progress in the NK resolution progress if it had also worked on its overall democratic reforms and development, which are not currently happening. Those in the opposite camp view internal challenges to the current government as destabilizing and weakening Azerbaijan's position, distracting it from its main problem, i.e. the

conflict with Armenia.<sup>40</sup> The Azerbaijani political parties' views on the resolution process are summarized by London based LINKS, in their work with political parties across the spectrum. "Karabakh: A Big Debate" reveals similarities and differences:<sup>41</sup>

*"Azerbaijani political parties are fairly unanimous in seeking a solution to the Karabakh conflict based on the restoration of the territorial integrity of Azerbaijan, i.e. the return of Nagorno-Karabakh and the adjoining territories lost to Armenia in the conflict. There is widespread recognition of the need to give Nagorno-Karabakh extensive autonomy within Azerbaijan. Some parties have elaborated detailed plans of how this can be done. There is also recognition by some parties that the deployment of international peacekeeping forces of some sort will be needed. Some party spokespersons highlighted the need for Azerbaijani democracy to be strengthened in order to make the proposition of a return of the Armenian population of Nagorno-Karabakh back into the Azerbaijani fold more attractive."*

Another aspect of domestic discourse is the fact that civil society groups do not have enough leverage and power to resist the politically charged discourse, and the war continues on cyber space, in print media, radio, and TV, and the primary tool of this warfare is language. In such situations, nationalist rhetoric enables the government to bolster its own political force in order to justify the political status quo on the domestic level. One such example is the extradition of Ramil Safarov, an Azerbaijani officer who murdered an Armenian officer on a NATO course held in Hungary. After his extradition to Azerbaijan, he was pardoned and promoted to Major, and applauded by some parts of society. Many civil society activists, or members of young activist groups, strongly opposed this. These kind of events

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<sup>40</sup> Jale Sultanli, 'Azerbaijani Domestic Politics and the Diaspora: (Mis)use of the "Armenian Factor" and its Implications for Conflict Resolution', Caucasus Edition, May 2011, <http://caucasusedition.net/analysis/azerbaijani-domestic-politics-and-the-diaspora-misuse-of-the-%E2%80%9Carmenian-factor-and-its-implications-for-conflict-resolution/> [accessed 14 November 2012]

<sup>41</sup> Karabakh: The Big Debate: The views of Azerbaijani Political Parties on the Nagorno-Karabakh conflict and conflict resolution process, Links, London, December 2010, p.3

do great damage to many years' worth of patient efforts of peace activists, the expert community and others who are trying to rebuild contacts among Azerbaijanis and Armenians and to build mutual trust — without which any kind of peace settlement is a pipe-dream.

Another issue is the “generational” discourse of the conflict. The new generation has grown up surrounded by anti-Armenian feeling; they are the government ministers of the future. There is also the possibility that the IDP situation could erupt. The government understands that time is working against it: as the twentieth anniversary of the 1994 ceasefire approaches in 2014, nearly one million of Azerbaijanis are still IDPs, and approximately 20 percent of the country's territory remains occupied.

The most important issue in relation to these fragments of domestic discourse is society's exclusion from the negotiation process, and the lack of transparency. There is almost no process of consultation with groups in society outside of the government. It is also interesting to look at one such example in recent history: when there was a real proposal for resolution, the government opened the discussion to the public. For example, following the failure of the various Minsk Group proposals of 1997-98, President Heydar Aliyev made an unusual decision, ignoring his obligation to keep the negotiations strictly confidential, and publicized all of the proposals on the table and organized a parliamentary debate on the subject, to which members of the public and political parties were invited. Ultimately, however, the debate was not productive.<sup>42</sup>

There were also attempts by non-ruling parties to open alternative debates on the Karabakh issue involving the public - for example, in 2001, a group of competent and well-known politicians put forward the so-called “Karabakh Charter,” which criticized government policy and patriotic rhetoric as insufficient, and suggested the need for a consolidated position enjoying widespread popular support and un-

<sup>42</sup> Rasim Musabayov, *The Karabakh conflict and democratization in Azerbaijan, The Limits of Leadership: Elites and Societies in the Nagorno-Karabakh peace process, Accord, Issue 17, 2005, p. 62*

derstanding. The Charter was much discussed and gained the support of over 20 political parties, as well as hundreds of public bodies and figures.<sup>43</sup>

Finally, the general perception is that political parties mainly use Nagorno-Karabakh conflict as a means of gaining public support, and that their rhetoric on the conflict is geared toward the public's attitude.

### **Models of Resolution**

*"Nothing ages so quickly as yesterday's vision of the future"*<sup>44</sup>

Perhaps one of the key elements of the resolution of the Nagorno-Karabakh conflict is preparation of "models" for the status of Nagorno-Karabakh. Since the ceasefire agreement, Azerbaijan has officially offered the highest level of autonomy to Nagorno-Karabakh and demands the full withdrawal of Armenian military forces from the occupied regions. Indeed, the complexity of the Nagorno-Karabakh conflict means that all negotiations seem to be based on a similar formula as the Good Friday negotiations: "nothing is agreed until everything is agreed."

Interestingly enough, Azerbaijan's offer still in the early stage of development; what exactly "high level autonomy" consists of is mostly unknown to the public. Only the basic elements are clear: the withdrawal of Armenian forces from occupied regions, return of IDPs,, opening of communications, and economic rebuilding projects. Bizarre as it may seem, until now, neither Karabakh Armenians nor Armenian authorities have asked for details from Baku, and official Baku has declared that "any model in world practice is acceptable." Unfortunately, the Armenian side demands that the people of Nagorno-Karabakh are given the opportunity to exercise the right to self-determination – this would in reality mean independence, as they would almost certainly vote for

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<sup>43</sup> Ibid, p. 63

<sup>44</sup> Quote by Richard Corliss, a writer for Time magazine.

independent statehood. Baku, on the other hand, will contemplate a high-level of autonomy for Nagorno-Karabakh, but will not allow it to secede from Azerbaijan. Moreover, the right to self-determination of the Azerbaijani minority in NK must be protected.

If Azerbaijan's claims for territorial integrity are satisfied, the question of NK's autonomy will become a topic for discussion. Azerbaijan will feel obliged to engage in power-sharing if NK is "returned." The key issue here is the status of Karabakh, which has always been the most intractable issue. The most widely discussed suggestion initially was to grant Karabakh autonomy with the option of holding a referendum some time later.<sup>45</sup>

Of course, as it has been often said, "the devil is in the details." Currently, in the eyes of elites in Azerbaijan, there are three models in world practice that seem relevant:

*'Tatarstan Model':* In 1990, Russia declared state sovereignty and in doing this it provoked analogous declarations in the former autonomous republics. In August 1990 Tatarstan proclaimed the "declaration of state sovereignty of the republic of Tatarstan". This phenomenon was named the "parade of sovereignties" and was based upon the non-Russian population's resentment with their lack of legal recognition within the state. Shortly afterwards, Tatarstan was granted high-level autonomy inside the Federation, whereby it can appoint economic representatives abroad, and elect a President. But this 'high level autonomy' continued only until President Putin's first term, at which point the status of the autonomous republics inside the Russian Federation was gradually eroded; compare to the 1990's, Tatarstan has a lesser degree of autonomy today.

Actually, for years, the Tatarstan model was a political and managerial model for Russia's other regions. In the 1990's, the Azerbaijani

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<sup>45</sup> Rashad Shirinov, 'Karabakh 2014: A forecast on power-sharing and power transformation', Karabakh 2014: Six analysts on the future of the Nagorny Karabakh peace process, Conciliation Resources, 2009, p.44.

authorities have said in some official speeches that their highest autonomy model is similar in some ways to the Tatarstan model, for example in terms of economic independence and balanced relations with the patron state. Even as its autonomy decreased in the 2000's, Azerbaijan continued to use it as a point of comparison. For instance, the Azerbaijani Minister of Foreign Affairs, Elmar Mammadyarov, declared in 2008 that "Azerbaijan is ready to discuss the status of Nagorno-Karabakh using the example of Tatarstan."<sup>46</sup> In this sense, Azerbaijan's principal position was to offering models which will de-sovereignize the self proclaimed Nagorno-Karabakh while maintaining strong links with the parent state (Armenia) and will not seek secession. But there are two reasons that prevent Tatarstan being a good model. First, Tatarstan never declared independence from Russia, and there was no violence in the process of gaining high-level autonomy. More importantly, the developments of the 2000's showed that strong leadership or strong authority on the part of the patron state can reduce autonomy in models such as Tatarstan.

*'Åland Model of Autonomy':* One of the most discussed models for the resolution of the Karabakh conflict is the Åland model, which has long been proposed for the resolution of the Nagorno-Karabakh conflict, but never found universal acceptance. Finland's Åland Islands, an archipelago mainly populated by ethnic Swedes, enjoy extensive self-government that makes them effectively independent of Helsinki.<sup>47</sup> The main difference with the Karabakh conflict is that there is no history of violence in the Åland Islands, whereas in Karabakh, both ethnic groups have past and recent memories of interethnic violence and moreover the legacy of a full-fledged war. Despite this, some Western experts are prone to consider the Karabakh status as consistent with this model, but

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<sup>46</sup> Azerbaijani Foreign Minister Elmar Mammadyarov says the status Tatarstan and Bashkortostan enjoy in Russia could be a model for resolving the Karabakh dispute [ accessed 16 November 2012] [http://www.analitika.az/articles.php?item\\_id=20080415091116869&sec\\_id=8](http://www.analitika.az/articles.php?item_id=20080415091116869&sec_id=8)

<sup>47</sup> Armenia, Azerbaijan Mull the Åland Model. Could the Finnish-Swedish arrangement for the Åland Islands work for Nagorny Karabakh? CRS Issue 359, 28 Sep 2006 <http://iwpr.net/report-news/armenia-azerbaijan-mull-%C3%A5land-model> [accessed 16 November 2012]

the settlement of Karabakh on this model is not new one. However the Armenian expert community sometimes suggests that there are similarities with the OSCE Minsk Group Co-Mediators' 1998 proposal, which resulted in a resolution package called the "Common State Plan," which suggested that Azerbaijan and Nagorno-Karabakh form a common federative state. While Azerbaijani leaders rejected it, on the grounds that they were only ready to give the Karabakh Armenians a high degree of *conventional* utonomy. But the notion of the so-called "common state" and the Åland Islands model of autonomy are essentially very different. The "common state" in itself entails the exercise of state sovereignty of two or more states over one and same territory, whereas in Åland Islands, there was only one state involved – Finland, and only that country can exercise its sovereignty. It is more that the Åland Islands have very strong and broad autonomous rights and culturally very closely tied to Sweden. However, these two cases should not really be compared.

Thus, in recent years Azerbaijani scholars have been more engaged with these models, organizing government-supported conference, which means that Baku sees this model as basic model for conflict resolution. The most attractive part of this model in the case of Karabakh is that first of all, Karabakh Armenians will have hierarchical relations with official Baku, whereby they will have the right to reject proposals in the Azerbaijani parliament in regard to Karabakh authorities; they will have self-governance, rights to education and culture, public health, some branches of economy, police, postal services, etc. Also, as similar to the Åland model, Karabakh Armenians and Azerbaijanis who live under the system of autonomy will be exempt from military service. It will have the right to (economic) representation in foreign countries, and have the opportunity to participate in international organizations under guest status. Only foreign policy, judiciary and criminal law, the greater part of civil law, customs, and currency will be in Baku's hands. Nagorno-Karabakh autonomy will have "hierarchical" relations with central government. This model could be mutually acceptable; Nagorno-Karabakh Armenians enjoy self-government will have veto power and will forget their 'non-recognition complex' and focus on their own local regime.



*'South Tyrol Model of Autonomy'*: Since 2011, Azerbaijan, at the highest levels, has raised South Tyrol as another example of a possible conflict resolution model for Nagorno-Karabakh. It should be noted that Tyrol is the model for autonomy gained without a referendum. The referendum issue is one obstacle in the negotiation process between conflict parties. In the case of South Tyrol, the dispute was between Italy and Austria. In the decades following World War II, the parties were committed to a peaceful solution to the conflict. Further, South Tyrol's success is ending separatism by granting wide autonomy. Thus it is no surprise that many Azerbaijanis are very interested in this model. According to Farhad Mammadov, Director of Center for Strategic Studies of Azerbaijan Presidency, "Azerbaijan can create the necessary conditions provided that the Armenians give up their idea of becoming independent."<sup>48</sup>

While South Tyrol and the Aland Islands can offer much, a few of their key characteristics are absent in case of Karabakh. The difference between Karabakh and these two is mainly the presence of Armenian forces on Azerbaijani territory, in addition to the absence of any overarching international organization, or regional legal arbiter.

*'Nakhchivan Model of Autonomy'*: Looking to cases of autonomy, Azerbaijan has also drawn upon its own, namely the Nakhichevan Autonomous Republic, as a model for conflict resolution. Under the Constitution of the Azerbaijan Republic (1995), the public authority in the Nakhichevan Autonomous Republic (NAR) is based on separation of powers; legislative powers are regulated by the Supreme Majlis – Parliament of the Nakhchivan Autonomous Republic. Thus enjoying sufficiently wide authority in the spheres of policy and economy, Nakhchivan is free to select its own way of economic development. True, there are quite a few questions regarding Nakhchivan's present administrative methods of management; however, the scope of activity is to be complied by the two parties. The Nakhchivan example

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<sup>48</sup> Azerbaijan is going to turn Nagorno-Karabakh into South Tyrol, Arminfo, 21 June 2012, <http://www.arminfo.info/index.cfm?objectid=ABA62A60-BB7F-11E1-9873F6327207157C> [accessed 18 November 2012]

illustrates that within the framework of authority granted, Nagorno-Karabakh could contribute to the development of the region, formation of legislative and executive institutions, and problems that arose could be resolved within the framework of a dialogue between de-facto authorities of NK and Baku.<sup>49</sup>

In some cases, the NAR example is a less relevant one as a model for NK conflict resolution. First, NAR's experience is less relevant to today's reality, it is obvious that the NAR cannot act without "okay" from official Baku; second, the autocratic nature of the NAR's authorities; third, NAR's security is guaranteed by the 1921 Kars agreement between Azerbaijan and Turkey, and finally as stated above all of model examples due the history of conflict is not suit with NK conflict resolution.

All of the abovementioned models lack similarities in terms of methods and history. Therefore the key of solution is one that looks at both conflict parties and the need to develop its own model.

### **Conclusion & future scenarios: Beyond 2018**

In 2018, the three South Caucasus countries will mark the centenary of their state independence. Anticipating the situation in 2018 from today's perspective is not an easy task; it is more daunting than in the 1990's, when politicians and intellectuals probably imagined a safer and more prosperous region, with the short term resolution of all conflicts. Popular Front leader and the Azerbaijani Republic's second President, Abulfaz Elchibey, declared that "for the solution of our problems, the key is time." But time has not solved the problems, and on the contrary, inter-state conflicts have become more entrenched.

Meanwhile, the South Caucasus countries are living in different and even harder times. All three have established their foreign policy orientation, economic development and state systems, but on the other hand the lack of political progress creates an ever accelerating down-

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<sup>49</sup> Elkhan Shahinoglu, Applicability of European Autonomy models to Nagorno-Karabakh, 2011, <http://hca-anc.org/en/?p=1184> [accessed 16 November 2012]

ward spiral of violent conflict, disintegration of political entities, and stalling of economic development.

Therefore, the settlement of Nagorno-Karabakh is of great importance, and has the potential to totally change the geopolitical map of the region as a whole. In the years between now and 2018, both Azerbaijan and Armenia will see important developments, including two rounds of Presidential elections (2013 and 2018) will be held in both countries. Given that the multi dimensional nature of the region's future, we are limiting the scope of the discussion to the Nagorno-Karabakh conflict. In the conclusion we will discuss three scenarios, in addition to further conclusions and recommendations from the Azerbaijani perspective.

Understanding the potential pitfalls in the peace process in the coming years and examining different scenarios for the implementation of conflict resolution mechanisms is a useful process in order to try to discern a path to a durable peace between Armenians and Azerbaijanis. All of the scenarios examine the determinant factors, mainly domestic processes and the focus points of regional powers.

### **Scenario I: War - *Inadvertent, Local or Planned***

There is much talk of the potential for an accidental war between Azerbaijan and Armenia, where the main fear is that a minor local accident could provoke a full-scale war. But contrary to local experts, we believe that such a scenario is less likely along the line of contact, where local army commanders cannot act without permission of the high command, namely the leadership of the two countries. Indeed, war is seen as a last resort, a negative development for both sides. In the case of Azerbaijan, the country could lose the trust of energy consumers, which has been especially important since 2012 – Azerbaijan wants to be part of large-scale gas pipeline projects that link directly to the European market. Moreover, no one can guarantee that official Baku has the capacity to liberate the occupied territories. If they failed, Azerbaijan would lose not only the former NKAO, but also the surrounding territories.

There is domestic political dimension to war: the general public in Azerbaijan is not confident in the negotiations and peaceful solution, and the prevailing belief is that war is the only option in order to liberate the occupied territories surrounding the former NKAO. Such people are in support of a quick military solution, and there is pressure on the government. The thinking is that it is "better to die once rather than each and every time," and this camp is not satisfied with the current government expenditure on the military budget, especially on the modernization of military technologies.

Put differently, there is a possibility of war, but not the in the sense that local and international experts think, whereby a local incident on the LOC will turn into a full-scale war. It seems less likely given the chain of command, whereby presidents sit at the top.

Looking to the inadvertent war scenario, it is possible in the event of opening flights through the Khojali Airport near Khankendi (Stepanakert in Armenian) in breakaway Nagorno-Karabakh. The flights have yet to commence, but Azerbaijani officials have already blasted the possible move as a violation of the country's airspace. The airport has been ready since May 2011, but for more than a year, its opening has been delayed "for technical reasons." Obviously, Armenia understands that according to the international civil aviation code, Azerbaijan has the right to take any action to stop flights from this airport, and the situation could even lead to accidental war, as Azerbaijani officials have warned that they will "destroy" the airport's capacity to start flights from Karabakh area. But there was a misunderstanding by Armenia, and by international community, where they thought that Azerbaijan was threatening to taken down a civilian plane.

The scenario could unfold as follows: Armenia declares that the first flight will be from Yerevan to Karabakh. To reduce the threat the first passengers will probably include politicians, children and the people whose death could assemble for Azerbaijan in international media very bad image. In this case, the Azerbaijani side declares before the international media that they will not tolerate such action, and ask for

pressure on Armenia. The next move, contrary to Armenian expectations, Azerbaijan sends short-range missiles to the flying strip at the Karabakh airport, and at the end the plane will fly back to Yerevan. Armenian experts have agreed that a big danger for Armenian air defense may lie in sudden missile or artillery strikes,<sup>50</sup> as well as the fact that Khojali airport is just 40-50 km<sup>51</sup> from one of the big air defense systems located in Terter or Ganja in Azerbaijan. The other possibility is that the Azerbaijani missiles destroy the flying strip of the airport. If missiles cause human casualties, it is likely that Armenia will respond indirectly, by raising the issue in the international media. In the case that Armenia takes a more hard line position, they will again raise the question of de-jure recognition of the self-proclaimed Nagorno-Karabakh separatist entity as an independent republic. If this happens, the second stage will follow Azerbaijani military action, which will cause a local war; if not the airport issue will increase mistrust among conflicting parties.

The second war scenario is the '*local war*' scenario. As stated above, one option is as an answer to the Armenian recognition of the Nagorno-Karabakh separatist entity. Azerbaijan could launch military action with the aim of taking back occupied territories around Nagorno-Karabakh, using its air force in the first stage. The difficulty here is the reaction of the international mediators, and at what stage they would intervene. One option is that Russia will tolerate Azerbaijani action, and allow it to take back two or three adjunct territories, then declare that according to the ceasefire agreement and the November 2008 Moscow Declaration, Moscow is deploying CIS peacekeepers to Karabakh.<sup>52</sup> In this scenario, conflict resolution will be fully in Moscow's hands, and Russia will consolidate and build its presence in region.

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<sup>50</sup> Sergey Minasyan, 'Nagorno-Karabakh after two decades of conflict: Is the prolongation of the status quo inevitable?', Caucasus Institute Research Papers, No.2, Yerevan, August 2010, p. 47

<sup>51</sup> The distance taken while using Google map, 2 December 2012.

<sup>52</sup> Russia could use the 1994 ceasefire, which clearly states the 'deployment of peacekeepers', and the 2008 Moscow Declaration, in which both conflict parties agreed on the 'non use of force'.

The most probable war scenario is a 'planned war'. The most prominent local experts believe that Azerbaijan will refuse to continue negotiations, and will start military action to take back occupied territories. However, the 'planned war' is a part of the 'final resolution' of the Karabakh conflict. In one 'planned war' scenario, the Azerbaijani side starts a war mainly using air forces and special forces, liberating the Aghdam and Fuzuli territories (which are partly occupied) then at the intervention of international mediators, stops the war, and the parties immediately open talks for a peace deal. This scenario involves, crucially, defeating the secessionist political entity (so-called Karabakh authorities). A historical example is the case of Srpska Krajina in Croatia, when in 1995, Croatia's four-day blitzkrieg resulted in the restoration of Croatia's territorial integrity.

The other option for a 'planned war' stems from the scope of Azerbaijan's domestic reality. The ruling elite is worried about the results of the presidential election in 2013. In accordance with the 2009 constitutional amendments and referendum, "in the case of war, or extraordinary situation, an election (parliamentary or presidential) may not take place." Ultimately, a planned war will serve to rescue the ruling government, even the measure is antidemocratic. If even one or two territories are regained, this will be a double win from the government's point of view.

### **Scenario II: 2014: Anniversary Change**

According to this scenario, the current activity surrounding the Karabakh conflict resolution - based on the Madrid principles - could only begin gradually after the 2013 presidential elections in both Armenia and Azerbaijan. The Azerbaijani election is much more complicated, as local and internationally there are many more voices involved. Moreover, if President Aliyev wins a third term without a planned war, the conflict parties will feel increased pressure via the Agreement on Basic Principles by 2014. This has already happened in the Karabakh peace talks. In the 1998 and 2003 elections, both former President Heydar Aliyev and Ilham Aliyev started a new process in terms of peace talks. Additionally, 2014 is important from four perspectives.

First, in May 2014 both parties will mark the 20th anniversary of the 1994 ceasefire agreement, which will prompt greater pressure on the societal level. Secondly, 2014 is the year before the centenary of the tragic events of 1915, which will be marked by Armenians worldwide, and the Turkish government will feel internal and external pressures, making it more cautious about reopening borders with Armenia. Third, Russia will host the 2014 Olympic Games in Sochi, and thus in this period, the stability across the whole Caucasus is crucial from Moscow's point of view. At this point Moscow could develop its policy on Nagorno-Karabakh, pushing conflict parties to sign basic principles or even to agree on the withdrawal of Armenian forces from the occupied territories. In doing this, Moscow will have a chance to present itself as the real broker of peace, which will bolster its international image in advance of the Olympics. Fourth, also related to Russia, is the possible withdrawal of NATO/US forces from Afghanistan, and the increasing likelihood of increasing military strikes to stop the Iranian nuclear enrichment plan. Thus the US will seek more support from Georgia and Azerbaijan after 2014. Russia has long-running military base agreements with most Central Asian countries – where the US also has interests - and the US needs more support from the South Caucasus countries. There will be a dilemma: both the U.S and Russia could do more for the resolution of the Karabakh conflict, but both will have different aims and agendas. Russia could do it, stopping US involvement in Iran, as well as its involvement with and support for Azerbaijan and Armenia. On the other hand, the US will increase its efforts in both Afghanistan and Iran.

In the end, 2014 as a year for the resolution of the Karabakh conflict could evolve from the Russian and US perspectives. But from today's point of view, Moscow will have a better chance, and Turkey will focus opening borders with Armenia and decreasing pressure from the Armenian Diaspora and the US before 2015.

This year, Azerbaijan will feel pressure from Turkey due to the reopening of borders with Armenia, internal pressure for resolution, and international pressure, whereby the international community

will demand democratic elections for the 2015 Parliamentary elections. Some experts think that the 2013 election of Aliyev, which will be non-democratic according to Azerbaijani constitutional law, the compromise will be that the government will make the 2015 Parliamentary elections democratic. And in 2014, by solving completely or "half" (withdrawal by Armenian forces from only five regions), and Aliyev will gain real support from 'bottom to top'. In such a case, he could hope to continue to end his presidency in 2018 as success not an autocrat.

### **Scenario III: Best Scenario or Step-by-Step Solution**

This plan could be realistic, if the OSCE Minsk Group changes its format to the 3+1+1 structure as discussed above. This format would be productive, but Russia would lose its dominance in the negotiation process. Additionally, if the EU added further points to the Association Agreements with Azerbaijan and Armenia (more integration with Europe, lifting visa restrictions, etc. could work as 'carrots'). Meanwhile, this scenario envisions that Azerbaijan and Armenia agree on Basic Principles at the end of 2013 with the hard work of a more 'European' Minsk Group. Thus at the beginning of 2014, they agree on the implementation of a solution in two stages, first, withdrawal of Armenian forces from five occupied regions, and then on the following points:

- a) Demilitarization of regions from which Armenia withdraws and return of refugees;
- b) Deployment of international peacekeepers, most likely an OSCE-led peace operation; it could be conducted jointly with the EU.
- c) Armenians and Azerbaijanis of NK will live under an 'interim status'; they will decide the final status of the region after successful implementation of all confidence-building measures which will take a minimum of 3-5 years.
- d) At the same time, the return of Kelbajar and the future of Lachin corridor will be decided by the parties. The best option could be a mutual 'corridor change', while Azerbaijan will gain



the same status for the Meghri strip, which connects Nakhichevan with Azerbaijan along a highway.

- e) The most challenging point will be the final status of NK. It is obvious that Azerbaijan will oppose independence or unification of NK with Armenia, therefore while negotiating and in the period of possible signing, both parties could agree that the final status of NK depends on two parallel plebiscites held among the Armenians and Azerbaijanis of NK, similar to the parallel voting on the reunification of Cyprus held among the island's Greek and Turkish communities. If Armenians and Azerbaijanis vote in diametrically opposite ways, which is likely to be the case on the first attempt, the interim status would continue for a few more (e.g. five) years, until the population votes again.<sup>53</sup>

There are a number of possible formats for a peace agreement, and the most important thing is signing a peace agreement that ends the war and ensures the peaceful coexistence of the Azerbaijani and Armenian populations.

### **Towards a New Thinking: '*Engagement, Cooperation and Co-existence Strategy with Karabakh Armenians*'**

In conclusion, this paper will provide some recommendation on changing the Karabakh policy, from the Azerbaijani perspective. The key element is that both sides must change their 'all or nothing' thinking. Azerbaijan always argues that in Azerbaijan, more than 30,000 Armenians are living peacefully, and the country could help with the post-conflict rehabilitation of Nagorno-Karabakh and the surrounding territories. But such thinking has until now been limited to words, but 'thinking becomes reality when you make it into strategy' and Azerbaijan should consider building and implementing its engagement strategy with Karabakh Armenians. Within Azerbaijan, the "isolation

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<sup>53</sup> Tabib Huseynov, 'Karabakh 2014: The day after tomorrow – an agreement reached on the Basic Principles, what next?', Karabakh 2014: Six analysts on the future of the Nagorny Karabakh peace process, Consolation Resources, 2009,

camp”<sup>54</sup> has until now been stronger than the ‘engagement camp’ in regard to opening economic relations with Karabakh Armenians in advance of the withdrawal of Armenian forces. It is discouraging how difficult it is to identify the engagement camp, which has mainly consisted of a small group of intellectuals. The past 20 years of negotiations suggest that the solution is for the most part depends on the conflict parties, the level of mutual trust, and the potential for cooperation.

In this regard, Azerbaijan should develop an *‘Engagement, Cooperation and Coexistence Strategy with Karabakh Armenians’*. Karabakh Armenians are living under the patronage of de facto separatist authorities outside Azerbaijan, and also under an information blockade. As the new generation grows up in Karabakh, they will not understand the full spectrum of arguments unless they see some action. This strategy might also be beneficial for Azerbaijan because it does not question countries’ territorial integrity, nor does it force Azerbaijan now or in the future to recognize the self-proclaimed independence of Nagorno-Karabakh separatists.

The strategy should consist of the following aims:

- The Karabakh Armenians are citizens of Azerbaijan, among the Armenians currently living in Azerbaijan. Azerbaijan pledges not to threaten the physical security of its people, to provide all security guarantees to them, and to open up economic opportunities. Under this approach, Azerbaijani government officials must reduce threats to the physical security of Karabakh Armenians; the war or liberation of occupied territories should be an option in the event of failed negotiations.

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<sup>54</sup> The ‘Engagement camp’ consists of those who believe that there is a need for more people to people contact with Karabakh Armenians, and they support the possibility of early engagement with some economic help to Karabakh Armenians before their withdrawal from the occupied territories. The “isolation camp” consists of the majority, who believe that the “engagement camp” is naive and fail to see the emerging threat from the enemy, and that any level of engagement is impossible under current conditions of occupation.

- The Karabakh Armenians can benefit from coexistence with Azerbaijanis. The Azerbaijani government allocates money in the state governmental budget to Karabakh Armenians, which they can access from a “third country,” for example Azerbaijan’s Tbilisi embassy. It should be noted that, the budget cannot be used for any activity by the de-facto authorities. In this regard, separatists cannot ask the EU or the US for direct financial assistance. Instead, the Azerbaijani government will ask the EU and the US for help in coordinating this. For example, the Azerbaijani government is repaying Soviet era bank deposits to Azerbaijanis. Karabakh Armenians can also access their deposits; all they need to do is show the record of the deposit and their ID; this could be a simple way of beginning the engagement process via a neutral financial process.
- One of the key goals of *‘Engagement, Cooperation and Coexistence Strategy with Karabakh Armenians’* is to strengthen the EU and US bargaining power in the Karabakh conflict. This has been seen in the case of Georgia, where the EU tried to build stronger ties with Abkhazia, which, in turn, could be used to increase Abkhazia’s contacts with Georgia, or to nudge Sukhumi towards creative legal formulae on the question of status in future negotiations. Before the 2008 August War, Georgia had not an “engagement without recognition” strategy. But before declaring “engagement without recognition” policy in 2010, Georgia’s fear was that EU or US support for NGO activities could legitimize the breakaway entities. Azerbaijan has a better chance than Georgia, because due the August 2008 war the people of Abkhazia and South Ossetia have lost trust to the Georgian government. However, Azerbaijan, can coordinate NGO activities, along with the EU and US. In this way, Azerbaijan could have ask the US and EU to refrain from implementing projects that could strengthen the Karabakh authorities, and instead to focus on initiatives that will increase the trust of Karabakh Armenians in Azerbaijan.

- After the initial implementation of soft economic engagement and NGO based projects with Karabakh Armenians in the first stage, further steps could develop and the government could declare later the full points of engagement policy, and add security guarantees if the conflict is resolved.

It is possible that the majority of “patriotic” groups in Azerbaijan, Armenia, and Karabakh the solid conviction is that on the first hand, Azerbaijani authorities with the help of EU and US is trying to implement some sort of “soft strategy” aimed at the restoration of Azerbaijan’s territorial integrity. This argument and the exploitation of patriotic themes can serve as a strong political instrument to legitimize curtailing further engagement in Karabakh. But it is possible that this type of thinking also makes it impossible to justify any engagement projects and/or moves toward confidence-building. The majority will be blamed for having “sold out national interest for the sake of Azerbaijani funds.” But, at this stage, it is important to continue the engagement policy.

Moreover, these are the initial points for such types of thinking. Looking to other intrastate or inter-state conflicts, the problem was always was the timing and political will of conflicting sides. Finally, it is hard to imagine the quick resolution of the Nagorno-Karabakh conflict before 2018, but it could be possible by changing attitudes and moving on from the ‘all or nothing’ thinking. In the long term, there is no alternative to a peaceful dialogue, and it is necessary to render concrete assistance to conflict resolution in the South Caucasus.

# **THE RECIPROCAL IMPACT OF UNRESOLVED CONFLICTS ON THE PROCESS OF DEMOCRACY BUILDING - GEORGIA IN THE REGIONAL CONTEXT**

**George Khutsishvili**

*This article was started and finalized after the October 1, 2012 parliamentary elections in Georgia that have marked the transition from one conceptual framework and one political ideology, which had developed and shaped during eight years since the so-called 'rose revolution', to another, which is only vaguely outlined at the moment, and has yet to be defined and implemented. It reflects the deep disappointment Georgian people had with what I call the policies of purposeful deadlock that entailed the quest for opportunities with new people in power. That is also why different scenarios of short-, medium- and long-term development have to be reconsidered but do not become easier to formulate.*

## **Ethno-Territorial Disputes in the South Caucasus and their Impact on Democratic State-Building**

The political situation in the South Caucasus is marked by unresolved conflicts, an underdeveloped state of democracy, and, as a result, a lack of stability and security in the region. In Georgia's case, unresolved conflicts, complicated relations with Russia and the seceded territories represent a major counter-indication for a more pronounced and efficient European integration process. Deficiency of democratic institutions and of respect for human rights represents an even more serious obstacle. The foremost among major factors creating a combined insecurity effect on a regional scale is the continuing Azerbaijani-Armenian confrontation over the Nagorno Karabakh issue.

Unresolved conflicts in the Caucasus, as well as the state of democracy in the region have been studied in numerous works. However, the interrelation of these two topics and especially the impact of the for-

mer on the latter have been understudied. The paper aims to make a step towards filling this gap by undertaking a study of the versatile impact of unresolved conflicts in the South Caucasus (mostly focusing on Abkhazia and South Ossetia cases, and on Georgia-Russia relations) on the process and the prospect of democracy-building both in the regional states and the unrecognized republics, and the region as a whole. The regional security issues, reasonable neighborhood policies and the prospect of Euro- and Euro-Atlantic integration of the South Caucasus states, as well as their sustainable development in general largely depend on realistic assessment of interrelationship between and interdependence of democracy and conflict. Apart from commonly known patterns of mutual alienation, stereotypization of perceptions, enemy image making etc., the case of the Caucasus reveals the patterns that repeat or resemble those of various other regions. However, the Caucasus also creates a pattern of its own.

There are two distinct parts of the Caucasus region on a geopolitical map. The entities constituting North-Caucasus area of Russian Federation have been developing in a common and interconnected post-Soviet environment, while three South Caucasus countries - Georgia, Azerbaijan and Armenia - while maintaining different levels of attachment to the rest of post-Soviet space, developed as independent sovereign states experiencing the effects of globalization and operating in an open system of international relations. On the other hand, Georgia and Azerbaijan have regions that have seceded and therefore did not participate in their mainstream development and have had much closer interdependence and interconnection with other neighboring post-Soviet countries: in Georgian cases Abkhazia and South Ossetia have had close affiliation to Russia, and especially the Russian North-Caucasus area, and in Azerbaijani case Nagorno Karabakh affiliated with Armenia, and to a certain extent to Russia. Formally positioning themselves as independent states, Abkhazia and South Ossetia plainly identify with the Russian North-Caucasus area, considering themselves part of it not only culturally and ethnically, but also geopolitically, and Nagorno Karabakh identifies with Armenia. Prolonged periods of isolation and dis-attachment caused by the conflict resulted in alienation of Nagorno

Karabakh, as well as Abkhazia and South Ossetia, from respectively, Azerbaijan and Georgia. That has shaped a peculiar perception of the external world, in which Abkhazians, South Ossetians and Nagorno Karabakhis feel ethno-culturally much closer to the post-Soviet area than Azerbaijanis, Georgians or Armenians who have effectively transcended post-Soviet identity and seek to further develop as national states that aspire to establish their distinct place and role in a world of modernity if not yet post-modernity.

Unresolved conflicts have deeply influenced mentality and mass consciousness of Georgians. The wide-spread syndrome of a defeated nation formed traumatically in the beginning of 1990s, slowly subsided since and was revitalized again in August of 2008. A Kosovo precedent and Saakashvili's surprise attack on South Osset capital Tskhinvali on August 7, 2008 encouraged Russia to finalize its preferred configuration in the region at the expense of cutting off the already fragile ties with Georgia and further deepening the embittered feelings of its people. The situation was ideally locked again by Putin's resolution not to talk to Saakashvili and Saakashvili's respective formula "First de-occupation, then the dialogue." Almost the whole world supported Georgia in non-recognition of the seceded autonomies, but no dynamics followed, and the security situation did not improve.

This has shaped a pattern of relationships between citizen and citizen, citizen and state, state and neighbor states, a world of kin and a wider world, "us" and "them", demanding to restore the country's territorial integrity and placing hard responsibility on the governments in that respect. When conflicts remain 'frozen' for almost two decades, long-term consequences become clearer, objectively giving the opportunity to the rulers to become more authoritarian and explain it as a necessary response to a social demand. The 'rationale' of the rulers sounds as follows. No time for liberalism and pluralism when the war is not yet finished, parts of the country are alienated and there is the risk to lose even more. Confidence-building looks as a logical answer, when no official diplomacy has so far been successful. But what sense does it make to speak with the seceded communities or their de facto

rulers if they are totally dependent on their patrons in Russia? They are thus not really parties to conflict, but derivatives from the only real "other side" – Russia. Okay, a question may rise: then you need to develop dialogue with Russia, don't you? The answer is: Wait a minute, but does it make sense to speak with Russia? What kind of dialogue can be between a huge empire and its former small colony that it seeks to return to its sphere of influence?

In Georgia's case, the really existing external threat from Russia has been raised to the level of irrational, picturing an opponent as incommunicable, non-negotiable and insatiable in its effort to totally destroy and absorb Georgia's independent statehood at all costs. Be that so, no bilateral diplomacy can work by definition and the only possible pattern of behavior is to seek protection within a strong military alliance of civilized nations, such as NATO. As this scenario is also not materializing, the deadlock becomes complete. Seeing this, the world appeals to the sides to start the dialogue without preconditions as soon as possible. Okay, the rulers say, we are ready for such a dialogue, but it is the other side who is blocking it. Looking at this vicious circle, average Georgian's mindset can only perceive the issue of restoration of the country's territorial integrity at a remote and abstract plane, while actors involved and movements done are perceived in a Kafka style where people seek unrealistic goals, the government shouts at a remote and overwhelming opponent who does not seem to hear but occasionally makes disastrous moves, the international community makes impotent statements and appeals for the impossible, and the resulting theater of absurd becomes a kind of *modus vivendi* for everyone involved. In a changed reality since October 2012, developments are expected in Georgian policies towards Russia and the seceded regions that should also make the international community redress its attitudes towards the Georgian issues to support initiatives and proactive steps to overcome the post-August status quo.

What kind of effect does the prolonged status quo and absence of communication do to an unresolved issue? Will there more or less opportunities appear, as the time passes? On the one hand, there is an



objective need for de-isolation of the secessionist regions, and the government at a declarative level adhered to approaches that substantiated this need. On the other, we have seen the actual policies that deepened isolation and increased security risks. Russia has achieved as a result of the August 2008 war its major geopolitical goals in the regions; its military presence has been reestablished after withdrawal of the bases according to the bilateral agreement signed in Moscow in May 2005. The longer the stalemate lasts, the more it means vanishing chances for Georgia to reverse the situation any time in future.

There are definite features that make the South Caucasus conflict-related situations, conflict-affected areas and the respective communities similar, comparable though different from each other. There are also similarities and differences in the policies chosen, declared or practiced by the regional powers. For instance, since *the State Strategy towards the Occupied Territories* was adopted in January 2010 by the Georgian government, “engagement without recognition” had been the declared state policy supported by the international community. However, failure or unwillingness to ‘engage’ in the dialogue with the secessionist communities and regimes hindered the processes initiated by the civil society groups and known as track-two diplomacy.

Without sustaining the declared policy of *non-recognition* with *engagement*, Georgia is risking to encourage and ensure the final recognition, at least, in case of Abkhazia. The only viable alternative would require abandoning of the antagonistic rhetoric towards Russia, followed by the start of Georgia-Russia dialogue on a wide spectrum of issues, followed by real engagement and de-isolation policies of the Georgian state towards the seceded regions, and the subsequent confidence atmosphere achieved between the sides. Such a vision of ‘engagement without recognition’ is shared by practically all external stakeholders, but the problem is that they do not see a motivation for themselves to invest an increased effort towards its realization.

The post-war status quo imposed by the overwhelming third party (as in the case of Russia-Georgia five-day war in August 2008) or

prolonged standoff between comparable parties (such as Armenia and Azerbaijan over Nagorno Karabakh) feed strong-hand regimes and justify maintenance of underdeveloped state of democracies. Manipulation of the image of external threat and maintenance of status quo reveal themselves as 'smart power' tools (the cases of Azerbaijani-Armenian and Georgia-Russia confrontation) in the hands of power holders. Real and virtual roles of third parties in conflict development may be distinguished: e.g. virtual Russia in Georgian government-controlled mass media propaganda and public perception, and virtual Georgia in Russian mass media and public perception.

Unresolved conflicts prompt the regimes to grow authoritarian, they impose uncompromising stance on the governments toward the issues that cannot be resolved without a compromise. Most Georgians accept that communication with Abkhaz and Ossets needs to be kept alive, or otherwise the alienation will be complete. The issue in Georgian discourse is not legitimacy of the dialogue, but its feasibility, while in Azerbaijan legitimacy of a bilateral dialogue with Karabakhis is under a big question mark. Apart from what arguments are usually brought to explain this, the *pragma* behind it is that Abkhazia may go astray – it has a common border with Russia and access to sea – while Karabakh cannot go anywhere, and Azerbaijanis just need to be patient until historical conditions appear to facilitate the restoration of the country's jurisdiction over its seceded part. So Georgians feel like talking with Abkhaz is needed but very difficult to materialize, while Azerbaijanis feel they may not bother to talk to Karabakhis. A risky strategy, but inevitably gaining a foothold while the leaders consolidate their power via frozen conflict. In the Georgian case, the opportunity of freezing the conflict within a post-August status quo framework had been utilized to a full swing by the Saakashvili government, and the Russian policy was quite in concert with this. Not that Russia, unlike Georgia, risked any stake in that process.<sup>1</sup>

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<sup>1</sup> Khutsishvili, George. "Contemporary Russia-Georgia Relations: The Orwellian Power Phenomenon in 21st Century," in George Khutsishvili and Tina Gogueliani, eds. *Russia and Georgia: the Ways out of the Crisis*. Tbilisi: ICCN-GPPAC, 2010.

It is noteworthy that whenever an election period approached, or political struggle in the country reached a high point, the NATO issue was activated in the Georgian internal political discourse, presumably, to strengthen hopes that the current government was able to speed up the Euro-Atlantic integration process or just to steer the public opinion from current affairs to a brighter future ahead. NATO membership was considered to be a defense mechanism against Russia, an eternal and unmanageable threat to Georgia's existence, according to the government propaganda. Although hardly anyone believes that the NATO membership is achievable in near future, and even if such a decision was made due to extraordinary geopolitical circumstances, a decision in NATO to protect Georgia against an external aggression would have to be made upon a consensus of 28 member states, which renders it almost impossible.

For an authoritarian ruler, an overwhelming external threat is not something that you try to mitigate or prevent or manage, but rather something that you seek to maintain, caress and foster to be able to use it as a stick in your struggle against domestic political opponents, and to manipulate the external environment to your interest. Even at the risk of increasing risks and propagating the threats for your country and beyond. The U.S., NATO, the West have been objects of external manipulation and tools for internal intimidation for the Russian leadership, as it has been for all autocracies in Asia, Africa or Latin America, as well as Belarus. What the West is portrayed to be for Russia, the same Russia appears to be for Georgia (and further on, Georgia for Abkhazia and South Ossetia). In that sense, there is nothing different in how the picture of confrontation is substantiated or used: if Russia did not exist, it should have been invented.

To summarize this section, we may conclude that **unresolved conflicts cause**

- growth of authoritarian tendencies in regional powers (governments are prompted to show a tough and uncompromising stance, rather than demonstrate an open and inclusive

approach; temptation grows to legitimize bureaucratic trends and limitation of human rights by necessity of strong state and prevention of destabilization; unitary state is seen as a goal and federalism is a swear word);

- strengthening of nationalist attitudes in a divided society and anti-Western sentiment at the level of disappointment or frustration (while European integration is the declared goal of the conflict-affected South Caucasus countries, there is frustration caused by the long-term effects of international involvement with its declarative approach and appeals to both sides to collaborate);
- excessive focus on development of power structures and military capacities allegedly needed to confront possible external aggression but also used as demonstration of force in internal politics;
- fragmented views on democratic development and nihilism towards democracy as a feasible goal; growing disbelief in the system of values that the West considers to be fundamental for modern civil nation-building and the establishment of democracy;
- hampered democratic institution-building in regional states (excess power concentrated in a head of state; impaired or ineffective balance between executive, legislative and juridical power branches; lack of checks-and-balances mechanisms and accountability of government before the society);
- fragile state of national and regional security (absence of peace and non-use of force agreements between sides, foreign military bases and troops stationed in conflict zones and adjacent territories, human security issues and incidents happening along ABL enhance security anxiety and predictions of renewal of hostilities);
- hampered or frozen confidence-building between the parties to conflict (non-willingness to develop direct communication with de facto authorities of secessionist regions; in Georgia's

- case, announcement of Russia as a sole adversary in the conflict and neglect of Abkhazia and South Ossetia as parties to conflict; neglect of Nagorno Karabakh in Azerbaijan's case);
- transference of responsibility on third parties (Russia was always seen as a main perpetrator of the conflicts in the Caucasus, and since August 2008 is officially seen as the only party to conflict with Georgia; the role of national liberation movement leaders in late 1980s and early 1990s, and subsequent mistakes and wrong approaches are generally mitigated and blurred);
  - hampered process of integration of the regional states into a larger community of developed states and the international collective security structures (delayed international agreements on regime facilitation in different directions, such as visa-free regime and free trade; in Georgia's case this is also a delay in getting a membership action plan (MAP) considered to be a green light before a country is officially announced as a candidate to NATO membership).

Democracy is often measured by the degree of civil society development, human rights protection, freedom of mass media, pluralistic political environment, etc. Symptomatic for all South Caucasus ruling elites is inadequate assessment of the civil society in their countries, underestimation and rejection of opportunities to cooperate with the independent NGO sector in tackling the issues of critical importance (comparison may be made with some African states, e.g. Kenya and Ghana, where state-sponsored *peace commissions* have been created to deal with post-conflict challenges with participation of both governmental and civil society leaders). Necessity to develop *infrastructures for peace* (I4P) in the Caucasus region is obvious, but the regional state actors in our region are reluctant to do so in their countries. Here again, lack of democracy creates obstacles for conflict transformation/resolution.

### **Lack of democracy, in its turn, causes**

- inability of the titular nations of regional states to come to consensus about the causes of conflict and acknowledge their own share in development of conflict;
- inability to develop a vision of how to prevent or overcome crises in society (in an extreme case, generation of purposeful deadlocks and crises as tools in internal political struggle);
- inability to develop and pursue strategies towards confidence-building and bridging of the gaps in communication between the sides;
- exaggerated influence of radical positions in societies about solvability of conflicts and the necessary concessions the titular nations need to make.

### **Factors preventing the South Caucasus nations from rapidly covering the distance to an established democracy:**

- growingly authoritarian model of rule, incompatible with pluralism, accountability and the division of powers;
- recent totalitarian past with limited freedom of speech and expression, one-party rule, fictitious elections and dependent judiciary prompt people – especially middle and older generation – to skepticism towards feasibility of democratic institutions and value-based state system;
- more recent experience of repeated and unaccounted election fraud deepen disbelief in change of power through elections;
- lack of experience of living under the conditions of open society, market economy and free media is not helpful for developing self-organization and collective civil forms of protest; it also prevents civil society organizations from proliferating their values and ideas in wider circles of population;
- fragmentation of society caused by recent war and conflict

traumas strengthens ethnic phobias and xenophobic prejudices, which, along with social hardships and inefficient social management produces a particularly painful outcome in a traditionally multi-ethnic and diverse community of people;

- selective justice and unequal opportunities for representatives and supporters of the ruling party, on the one hand, and the rest of society, on the other, in doing and developing business, finding qualified jobs in a public sphere, defending and restoring their rights vs. the state, escaping responsibility and punishment in cases of perpetration of law create a depressive effect in the country;
- revival of a nomenclature-style government and one-party rule breeds nihilism, discourages young people from seeking to build their future in their home country, deprives them of hope to find implementation for their potential in Georgia;
- skillful manipulation by the governmental propaganda of stereotypes, nihilist attitudes, virtual and actual fears in a fragmented society breed conspiratorial mindsets, mystify the existing external threats, denigrate the political opposition as bearers of alien values and promoters of Russian imperial interest in Georgia;
- wide-spread present poverty, unemployment and failed social programming, combined with hailing of the Georgian reforms by the West spread disbelief in Western liberal values and sincerity of the West's declared support for the country's development.

**Factors preventing the West from objectively assessing and adequately reacting to the situation in South Caucasus states:**

- low place of Georgia and Armenia in the scale of strategic interests of superpowers, dependence of Armenia on Russia;
- rich natural resources of Azerbaijan;
- pro-Western reputation of the team in power since the 'Rose Revolution' in Georgia.

## The Phenomenon of Georgia-Russia Confrontation

An interstate problem often starts as what is or seems to be an incident, then turns into a conflict, and finally may turn into a pillar of a nation's self-concept, usually affecting mentality of a smaller and more vulnerable nation. This can hardly happen between Armenia and Azerbaijan, or generally between comparable actors, but has already happened between Turkey and Armenia. For many Armenians the concept of genocide of 1915 and perception of Turks as perpetrators of genocide prevents normalization of relations, as this would mean turning upside down their self-concept that upholds the national identity idea. (For the sake of comparison, for Jews the problem of the holocaust was not so centered on Germans after the Second World War, but was perceived as a latest stage of a history-long persecution and oppression experienced from different bigger actors.) Now the same pattern is discoverable in the Georgia-Russia case, only this time it is a constructed one.

The current Russia-Georgia relations contain so many singularities, contradictions and such an enormous degree of subjectivity that they are undoubtedly phenomenal. Yet they may also be called phenomenal in the sense that goes back to a Kantian tradition, according to which *phenomenon* is the thing how it appears to us, as opposed to *noumenon* which is the thing as it is in itself (Ding-an-sich). There are distinct and significantly different pictures of Russia-Georgia relations in Georgia, in Russia, and in that part of the external world that has some knowledge and interest towards what is happening between the two countries. It can also be seen that phenomenality of Russia-Georgia relations shows itself in a most salient way where the incompatibilities are concerned. To the extent that the suspicion rises whether the entire confrontation is more of a carefully constructed hoax than a geopolitical reality.

It is well known that Russia played a key role in developments related to the conflicts in Georgia. The main stages may be picked out: 1992-2004; 2004-2008; 2008- present. The Caucasus conflicts were linked



with dissolution of the Soviet Union by the end of 1980s, the rise of ethno-nationalism, and Moscow's attempt to maintain power and influence over the provinces that were moving away. When ethnic wars broke out and the world had to appoint custodians of peace, it was clear from the start that Russia was a disputable broker, as it had a too much visible interest invested in the conflict. Yet nobody seemed to notice that, as Russia seemed to be the only viable actor in that part of the world at that time, and dealing directly with rogue states and uncontrolled territories made no one happy.

Saakashvili's government created the much disputed conception of non-transformability of Georgia-Russia relations. Saakashvili and his team were trying to persuade everyone that Russia is not swallowing Georgia only because they have created a defense wall against it. They had been positioning themselves as the only and uniquely bright, far-sighted and patriotic team who constantly had to fight not only against external threats and challenges, but also against internal agents of influence and fifth columns operating under the disguise of political opposition and their supporters. Therefore one-party rule and marginalization of the opponents should have found legitimization. It is amazing how the external world would buy this story without raising serious questions, yet it is a fact that it did.

Things had developed so that the Russia-Georgia standoff looked irresolvable, generating in the population of Georgia both fears of future and disbelief that the conflict issues would have found a rational solution any time in future. There has been a lot of effort applied to make it look like that. The changed situation in Georgian parliament and government opens new opportunities. Georgia has an issue in changing the post-August status quo. Russia theoretically has the key to the settlement, but practically has little incentive to use it. Russia has achieved its basic goals by securing its southern borders with buffer zones and restoring its military presence in Georgia as a result of a five-day war in August 2008. What is the price Georgia will be offered to pay to advance towards realization of its national project?

## **The Possible Impact of the Outcomes of the 2012 Parliamentary Elections on the Developments in Georgia and in the Region**

Through competitive elections with a high voter turnout Georgia for the first time in its post-Soviet history of independent statehood has a parliament representing two major existing political forces – the *Georgian Dream* coalition led by the businessman and philanthropist Bidzina Ivanishvili (54 percent of votes) and Saakashvili's *United National Movement* (41 percent) – dividing the 150 total seats in the highest legislative body of the country into, respectively, 83 and 67 seats on either side. The myth of inevitably weak opposition vis-à-vis Saakashvili's team that had been nurtured through the eight post-“rose-revolution” years is finally destroyed.

Strong opposition cannot just appear out of the blue. It needs to build and mature and develop in years, and the government needs to support this growth and development. This process has taken a longer time-frame in Georgia, and the question frequently asked was if this was inevitable or a result of a purposeful policy. Even appearance of a particularly wealthy person as an opposition leader cannot change the scene overnight. When the government prevents and blocks through many years any private contributions or donations that might support growth of opposition and finally – 29 December 2011 – passes a law that places unbearable burden on any financial activity of opposition in front of the elections and intimidates anyone who might wish to express support to it, it is difficult to expect miraculous results. Yet the result that followed the elections had an astounding effect on the society long-accustomed to a nihilist attitude towards elections as such.

There are practically two more possible outcomes of the October 2012 parliamentary elections in Georgia. The first and objectively positive one would mark the end to the one-party domination stage in Georgian politics and the start of a more pluralistic one by establishing a strong parliamentary majority able to compete with the strong opposition and elaborate the viable decision-making process. The other and objectively negative would entail dissolution of the winning

coalition into smaller competing groups, thus enabling Saakashvili's group to reverse the situation, although unlikely to ever regain the constitutional majority (now raised to three-fourths from two-thirds of 150 seats) in the hands of UNM, thus giving a stimulus to further authoritarian trend in power and throwing the country back in its development and aspirations.

Does the prospect of Russia-Georgia relations depend dramatically on the outcome of the October 2012 parliamentary elections in Georgia? Pro-Russian turn and deviation from the current pro-Western course was vehemently predicted by the ruling UNM party and its leader President Saakashvili in case the opposition would win or even get a strong representation in the Parliament. This in fact an overstatement unsupported by objective data has been nevertheless replicated in much of the world media sources. Of course, there would be changes in external policies, mainly in regard to Russia and the unresolved conflicts, but not for pro-Western and Euro-Atlantic orientation the consensus on a vital importance of which is country-wide. There is no evidence at the same time that Ivanishvili would use his position in power to submit the country's interest to Russian or any other external interest that would challenge the national interest or status of Georgia as an independent state.

### **What kind of consequences may the Georgian election results have on the regional situation?**

If we consider the regional context for Georgia as including Russia, Turkey, Armenia, Azerbaijan, and Iran, i.e. wider than the Caucasus proper, we see that political developments in Georgia may significantly impact situation in the regional neighborhood and even generate new transnational projects. Progress in Georgia-Russia relations, mitigation of the existing standoff and especially a breakthrough in economic aspect will cause positive dynamics in Georgian-Abkhaz and Georgian-Osset directions, giving rise to the ideas of new transport corridors across the Caucasus, linking Russia to Turkey via Georgia, which would inevitably include the territory of Abkhazia and this would

require a certain progress achieved in Georgian-Abkhazian relations to be materialized. A serious obstacle to development and materialization of these plans would be Moscow's insistence on Georgia's acknowledging independence of Abkhazia and South Ossetia as a precondition, which would mean bringing things back to stalemate again.

The victory of Obama in the presidential election in the US in November 2012 may give an impetus to revitalizing the Turkish-Armenian rapprochement dialogue at some point, yet development of economic relations and subsequent visa facilitation between Turkey and Armenia have much more prospect than a breakthrough via direct negotiations involving such sensitive issues as recognition of genocide or territorial disputes.

Another dimension of developments touches upon the Iranian issue, although history shows that development in and around Iran have less impact on developments in the post-Soviet area of the Caucasus.

Getting back to the South Caucasus political processes, the already established Georgian example of peaceful transition of power to opposition through elections breaks the previously unified picture of the Caucasus that was exemplified by crackdowns on opposition during the elections of October 2003 in Azerbaijan, November 2007 in Georgia and March 2008 in Armenia with subsequent consolidation of power within authoritarian systems. If confirmed by post-election democratic processes, the Georgian counter-example may impact seriously the developments in other South Caucasus states.

### **Short-term sketches (2-3 years):**

- Development of dialogue between Georgia and Russia may start, causing economic relations to develop, resulting in confidence-building programs with Abkhaz and Osset societies to develop and signing of non-use of force agreements with de facto authorities to take place, but the status quo will remain;
- Russia will not succeed in raising international support for the independent status of Abkhazia and South Ossetia, and

may subsequently submit to the necessity of taking a neutral stance towards Georgian-Abkhaz and Georgian-Osset dialogue;

- Turkey will grow in its role as a regional power. Turkey will develop partnership with Russia but not liaise with Russia; there rather will be a division of the spheres of influence;
- Armenian-Azerbaijani relations in the meanwhile may further deteriorate, periodically raising fears of the renewal of hostilities, which would however keep at low-intensity level, not flinging into a full-scale armed confrontation.

### **Medium-term sketches (5-10 years):**

- Most difficult to predict! Most plausibly this may be a prolongation of the short-term developments.

### **Long-term sketches (15-25 years):**

- Under the pressure of new economic and geopolitical realities an active conflict transformation process may start in Georgia and later in Azerbaijan, causing the unrecognized republics to participate in advantageous transnational projects that require cooperation with the recognized states, leading to finally shaping of a common legal space;
- Regional power configurations may develop; one scenario that cannot be totally dismissed is the South Caucasus confederation (3+3 model) that could start to take shape under international aegis.

Being currently close to one extreme - disintegrated Caucasus with insecure borders, occupied territories, seceded regions and undeveloped democratic institutions - we could also think of the other, a desirable "extreme," a peaceful, integrated, developed and prosperous Caucasus, something like a mini-EU to shape in the long-run.



# CHAPTER V

## DYNAMIC ENGAGEMENT: THE EUROPEAN FUTURE OF THE SOUTH CAUCASUS





# **ARMENIA-EUROPE: MINIMIZING OPPORTUNITY COSTS**

**Alexander Iskandaryan**

## **Introduction**

The very term “European integration” has its own special meaning in Armenia (and apparently in many other former Soviet countries), which is quite a bit wider than – or different from – the integration of Armenia with various European countries and institutions. Whereas, Armenian society at large is still relatively little informed about the actual process of interaction and cooperation with European bodies which is unfolding on the ground, the expression “European integration” or “integration with Europe” is mentioned very frequently by politicians and the media, most of the time with a positive connotation. In fact, it has already become one of the important keywords of the Armenian domestic discourses. One can say that the move, or drive towards integration with Europe is currently one of the least questioned policy issues, especially in the parlance of politicized intellectuals and political leaders. Meanwhile, in the way it is presented by the media and perceived by the public, “European integration” does not necessarily relate to Armenia’s ongoing efforts to cooperate with the European Union in the legal, economic or political realms.

Analyzed in closer detail, Armenian discourse about integration with Europe reveals a set of dualities, very often placed in a ‘good-bad’ paradigm. In this paper, I will try to identify these dualities and see what they mean for the prospects of Armenia’s integration with Europe.

First, for people living in Armenia, as in most other post-Soviet countries, “integration with Europe” is synonymous with the transition from one cultural realm to another. This transition is about de-Sovietization, but also about modernization. In this context, becoming part of Europe

implies replacing archaic Soviet values and practices with modern European ones. Attraction to European values, European political culture and nation-building paradigms exists throughout the post-communist world, especially in spheres such as democratization, elimination of corruption, establishment of rule of law, protection of human rights and the creation of efficient modern institutions and mechanisms. None of this is in fact about foreign politics; this is a predominantly domestic trend, in Armenia and elsewhere. Europe is seen as a role model rather than a geographical area or political entity, and integration in this context is not about mechanisms or bodies, but about “becoming like Europe”: not integration but rather, Europeanization.

When mentioned in the Armenian domestic discourse, “European integration” is mostly used in this sense. Meanwhile, the two are in fact quite different things: a country can have a pro-European political orientation but no desire or intention to adopt European-values, and vice versa. This fact is well illustrated by Armenia’s relationships with other countries and cultural realms: although Armenia maintains very positive relations with the United States, Iran and Russia, it would be very unusual for an Armenian citizen to wish to become an American, Persian or Russian while also remaining an Armenian citizen living in Armenia. In contrast, an average Armenian often aspires to become “a European” and does not see this option as incompatible with staying Armenian and continuing to live in Armenia. In fact, such a cultural transformation is not only perceived as possible but also as a desirable and prestigious one.

This said, one can only wonder to what extent this is about culture; the fact that European countries are rich and welfare-oriented play a huge part in forming Europe’s attraction as a role model. In Armenia’s public discourse, the European model is viewed as the best method for achieving the material well-being of society through the means of a cultural mechanism (as opposed, for example, to natural resources). Arguably, this is what makes the mechanism so attractive to poor countries like Armenia. Indeed, by many in the Armenian society, European values are not appreciated per se but rather, based on the perception that they can be instrumental to achieving economic well-being and

social welfare. This leads us to one of the dualities: that between the perception of Europe as a role model for becoming rich and the cultural drive towards European values for their own sake. Either way, the aspiration for the whole Armenian nation to become “European” is there, creating a powerful incentive for integration on the ground.

Second, whatever its motives may be, support for European values – and more importantly, the introduction of European practices – in Armenia is strongly enhanced by practical steps on the road to integration, such as membership in European bodies, e.g. the OSCE and the Council of Europe, if only because the membership comes with commitments in the political, legal, economic and social spheres. The commitments specifically require the Armenian government to change domestic rules and practices, not just its relations with Europe. Once institutionalized in the form of membership, a pro-European political orientation comes with a domestic agenda, prescribing the establishment and reform of a wide variety of institutions. This, in itself, contains another duality – one between accession to European bodies and organizations, on the one hand, and the domestic institutionalization of European models and practices, on the other.

Third, naturally, orientations towards and relationships with other, non-European, countries and cultural realms also affect the prospects of a country’s integration with Europe. In the case of Armenia, the choice (or rather, lack of choice) of political orientations creates yet another important duality: that between Europe and Russia. This duality, universally perceived as a dichotomy, has become a key dimension of domestic and foreign politics throughout the post-Soviet world. The special case of Armenia is that it refuses to acknowledge the exclusive status of either relationship.

### **The Russian Factor**

The official foreign policy doctrine known as “complementarism” implies that in its policies, Armenia, in contrast to, for example, Georgia, is trying to avoid the dichotomy between Russia and the

West. Complementarism is based on the assumption that being pro-European or pro-Western does not automatically imply being anti-Russian, and vice versa, that one can be pro-Russian but not necessarily anti-European or anti-Western. In a nutshell, complementarism is a strategy of balancing between external players; some experts have called it "sitting on the fence." It has become the trademark style of Armenian politics. Although the result is that Armenia is perceived in the West as being pro-Russian, and in Russia, as being pro-Western, although neither player actually considers Armenia a hostile actor. Europe does not treat Armenia on a par with Belarus, nor does Russia treat Armenia on a par with Georgia.

Armenia's conscious decision to "sit on the fence" has in many ways been the consequence of its geographic situation. Although neighboring four countries, Armenia only relates to two of them. It is in a state of cold war with Azerbaijan as a result of the unresolved territorial conflict over Nagorno-Karabakh, whereas Turkey sealed its border with Armenia back in 1993 in a gesture of solidarity with Azerbaijan's cause. Internationally-mediated efforts to re-establish diplomatic ties between Armenia and Turkey have failed so far, as have all formats for resolving the Karabakh conflict. In functional terms, Armenia only has two neighbors: Iran and Georgia. Given the tense relations between the United States and Iran on the one hand, and between Russia and Georgia, on the other, an orientation towards any one particular external player could cost Armenia significantly. The opportunity cost of a decisive political orientation would be damaging to its relations not just with one of the key external players in the region, but also with one of its two functional neighbors. This is a cost Armenia can not afford. Not surprisingly, it is trying to sustain a constructive interaction with all stakeholders, regardless of the tension existing between them.

It is hard to assess Armenia's complementarism in quantitative terms, or to calculate the weight of each external and regional player in Armenian politics. Influence is distributed in different ways in different spheres, and here, too, geography is important. The EU is Armenia's largest trade partner, and in terms of values, Armenia also gravitates towards Europe.

Two-thirds of Armenia's communications run via Georgia and about one third via Iran. Meanwhile, there are two spheres in which Russia's weight is so far crucial: security and investment, chiefly in energy production. Since those two spheres are of prime importance, it would be very hard for Armenia to sacrifice relations with Russia.

The balancing game began the moment Armenia gained its independence in 1991. Its first government positioned itself as openly liberal, pro-Western and anti-communist. Ironically, it was also one of the most, if not the most, pro-Russian government in the former USSR, despite the fact that in the years preceding Armenia's independence, Moscow had been strongly opposed to Armenia's emerging anti-communist powers and had done its best to crush them. Central Soviet authorities even went as far as to arrest and imprison in a Moscow prison almost the entire leadership of the Armenian independence movement, including Armenia's future first president Levon Ter-Petrosyan. The Soviet army was at the time supporting Azerbaijan in the conflict over Nagorno-Karabakh.

However, once the USSR disintegrated, Armenia's complementarity immediately took effect. Boris Yeltsin rose to power in Russia and Levon Ter-Petrosyan, in Armenia, and the relationship between the two countries became almost idyllic. This was not just about personalities, although the two presidents were certainly on very good terms. There were objective reasons in play. By 1992, Armenia was fighting a full-scale war with Azerbaijan, and the Russian army was its only potential source of armaments. The newly independent post-Soviet states had nowhere else to go for weapons, ammunition, technical assistance or fuel; the NATO alliance, or any other bodies and countries, were not options, and consequently, all post-Soviet wars were fought with Russian weapons. A friendly relationship with Russia did not just give Armenia a source of weapons but also provided a security umbrella: the former Soviet army base located on Armenia's territory ensured the non-involvement of Turkey in the conflict over Nagorno-Karabakh, despite Turkey's solidarity with Azerbaijan. There was no alternative to being on good terms with Russia, and the

Armenian leadership was working very hard to use the newly found friendship to its best advantage.

After the war ended with a ceasefire in 1994, Armenia, just like its neighbors, began to engage the EU and NATO. However, it made sure to stick with Russia too. While having the same extent of institutional engagement with the NATO as the other South Caucasus states (in the form of the NATO Partnership for Peace, and the involvement of Armenian officers in peacekeeping operations in Kosovo, and later, in Iraq and Afghanistan), Armenia remained a member of the Russia-led Collective Security Treaty Organization (CSTO) and allowed the Russian army base to remain on its territory. As a result, Armenia is the only country in the South Caucasus which fully controls its territory; complementarity is allowing it to balance between regional and international players, whereas, the conflict over Nagorno-Karabakh, though still unresolved, does not flare up again.

Investment is the other priority in Armenia-Russia relations. For a developing post-totalitarian country like Armenia, foreign investment is obviously crucial for economic growth. Meanwhile, given the fact that Armenia is landlocked, poor and has meager natural resources, Western business has little incentive to invest in it. Its domestic market is tiny, and transportation costs are out of proportion because routes to Europe are cut off by the sealed Armenia-Turkey border, so that shipments have to take a large and expensive detour, crossing many borders. As a result, the Armenian market is chiefly attractive for companies targeting domestic consumers, such as the Coca Cola factory or telecommunications operators.<sup>1</sup> Where Armenia's export-oriented industries are concerned, they only attract Western capital if there is something special about the product, as was the case with the Armenian brandy factory that was bought by a French company for the sake of the traditional brand, relatively well-known and popular in some parts of the world. Obviously, investment on this scale is insufficient to boost Armenia's overall development.

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<sup>1</sup> Chatschatrjan, Arutjun. 2004. "Wirtschaft und Politik in Armenien." *Diaspora, Öl und Rosen. Zur innerpolitischen Entwicklung in Armenien, Aserbaidschan und Georgien.* Berlin: Heinrich Böll Stiftung, pp. 161-178.

Under these conditions, Armenia is strongly challenged to attract foreign capital to industries that require large investments and that do not promise rapid profit. Investments from Russia are an obvious solution for many reasons, including the economic ties and networks surviving from Soviet times, and the fact that Russia faces all sorts of challenges when trying to invest outside the post-Soviet realm. As a result, Russian companies have invested in several key sectors of Armenian economy, primarily in energy production. Since Armenia is the region's only exporter of electricity, which it sells to Georgia and Iran, the prospects of increasing electricity production using Russian capital can lay the basis for developing other industries, as well as boosting the export potential of a country which has no hydrocarbons of its own.

So far, no other country has had the incentive to commit to Armenian markets on a comparable scale. In the logic of complementarism, the fact that Russian investment may well be politically motivated is not a very big challenge. Political incentives lead to investments on a scale that a country with Armenia's constraints can never hope to receive for purely economic reasons. The political costs to Armenia are not high: despite popular apprehension, close cooperation with Russia does not strongly affect Armenia's domestic politics. Russia need not – and does not – particularly care what sort of domestic policies are in place in Armenia as long as Armenia stays under Russia's military wing and does not choose an openly pro-Western orientation. Armenia, meanwhile, can not afford to adopt an orientation of any kind due to geographic constraints, nor can it opt out of its partnership with Russia in the military and energy realms as long as the conflict over Nagorno-Karabakh remains unresolved and the borders with Azerbaijan and Turkey remain sealed. In contrast, European bodies place very specific demands on the domestic policies of partner countries, making integration and cooperation contingent on the implementation of reforms and commitments to democratic standards. In this aspect, Armenia is under much stronger pressure from Europe than from Russia.

As a matter of fact, military security and energy production and transportation are the two spheres in which Russia extends most – if

not all – of its influence over the former Soviet world. It is in these spheres that Russia is heavily present throughout the former Soviet space, or Commonwealth of Independent States (CIS). For some post-Soviet countries, this presence has become a heavy burden, with Russia manipulating them using energy as leverage (as it happened with Ukraine) or even subjecting them to military pressure (as was the case with Georgia).

Meanwhile, other post-Soviet countries are successfully using this presence to their advantage by manipulating Russia's geopolitical ambitions. The reasons why some countries fall into the first group and some into the second, also often lie in the realm of geography; "geography in this context is no longer an end in itself but a means to an end."<sup>2</sup> In the case of Armenia, a key factor is that, unlike Georgia, it does not directly border on Russia. By virtue of this purely geographical fact, Armenia is not susceptible to the apprehension and inhibition that inevitably arise from directly neighboring a huge country, especially a former empire to which its newly independent neighbors were subjugated for centuries. Armenia can, therefore, try to use Russia's policies to its own advantage, especially in a situation where Russia's perceived interests (or atavistic motives) sometimes coincide with Armenia's aspirations.

By playing this rather intricate game, Armenia is evolving a culture of balancing between the concerns of various political entities. In Armenia's case, a consensus culture and the ability to coordinate the interests of many players and to play on many fields are not dictated by an ideological paradigm but by a geographical one, enhanced by the country's small size and lack of natural resources. However, doing the right things for the wrong reasons very often works in politics; in fact, consensus-making and multi-dimensionality fit European political culture very well. A tradition of avoiding external conflict and surviving in a multi-cultural and multi-player setting can bring Armenia closer to Europe even though many of the players in question are not at all European. The constant need to connect and coordinate policies

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<sup>2</sup> Braudel, Fernand. 1995. *The Mediterranean and the Mediterranean World in the Age of Philip II*. Volume 1. Berkeley and Los Angeles: University of California Press, p.23.



so as to avoid clashes between domestic and external players is making Armenia rather good at achieving a modus vivendi. In the context of European integration, this means taking consistent steps towards institutional cooperation with Europe while carefully avoiding any radicalized rhetoric or decorative moves that could irritate Russia.

### **The Practical Aspect**

In institutional terms, Armenia's integration with Europe dates back to the Partnership and Cooperation Agreement (PCA) between the EU and Armenia, which laid the legal basis for their relationship, regulating their economic, social and other ties.<sup>3</sup> The PCA came into force in 1999, simultaneously with the European Union's PCAs with Azerbaijan and Georgia, and two years later than the one signed with Russia. In January 2001, Armenia and Azerbaijan achieved membership in the Council of Europe. Since 2004, Armenia has been one of the 16 countries neighboring the EU (former Soviet republics, Balkan and Northern African states) included in the European Neighborhood Policy (ENP). In 2005, a cooperation Action Plan was adopted by the EU, with a special focus on democratization, eliminating corruption and empowering civil society.

In 2008, the EU tabled the Eastern Partnership project involving just six post-Soviet countries: Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine. Launched in 2009 in Prague, the project envisions Europe's cooperation with its neighbors on a regional scale; it forms part of a new approach to the EU neighborhood that also includes the Northern Partnership, the Mediterranean Union and Stabilization and Association Agreements implemented with various Balkan countries. Since May 2011, the Euronest Parliamentary Assembly has been operating as part of the Eastern Partnership project; Euronest consists of sixty members of the European Parliament and sixty members of the parliaments of Eastern Partnership member states, ten from each country.

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<sup>3</sup> Partnership and Cooperation Agreement between the European Communities and their Member States, of the one part, and the Republic of Armenia, of the other part. [http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:21999A0909\(01\):EN:HTML](http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:21999A0909(01):EN:HTML)

The gradual unfolding of cooperation with the EU agrees very well with the overall trend of Armenia's foreign policy of "sitting on the fence." Armenia's president until 2008, Robert Kocharyan, prioritized the country's relationship with Russia and the CSTO over that with the EU and the NATO. The incumbent president, Serzh Sargsyan, adheres to a more balanced policy: according to him, Armenia does not aspire to membership in the EU or the NATO but wishes to deepen its cooperation with both. While being diplomatic with respect to Russia, this stance is also quite pragmatic and logical, given the fact that membership in the EU or the NATO is now very far from being a realistic prospect for Armenia.

As to the trends in public perceptions, they are much steeper. The general view of integration with Europe lacks the diplomatic caution of political positions while also ignoring the complexity and long-term nature of the integration process. According to a poll done in late 2004 by the Armenian Center for National and International Studies (ACNIS), 64 percent of Armenians supported the idea of EU accession for Armenia, and just under 12 percent were against it. A poll done by Vox Populi in the same year in Armenia's capital city, Yerevan, yielded an even larger number of proponents of European integration, 72 percent.<sup>4</sup> The level of Armenian support for EU membership reached a peak of 80 percent in 2007,<sup>5</sup> and has declined ever since, albeit not abruptly. According to the Caucasus Barometer produced by the Caucasus Research Resource Center (CRRC) at the end of 2011, 62 percent of respondents were in favor of Armenia's integration with the EU, and 8 percent opposed it. Trust in the EU went down to 37 percent in 2011; as many as 18 percent told CRRC they did not trust the EU.<sup>6</sup> Apart from discrepancies between methodologies used by different think tanks, the decline can be attributed to the global financial crisis, which in public perception is strongly associated with the West, and therefore, with Europe – for

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<sup>4</sup> "Poll Finds Strong Support For Armenian Entry Into EU." Radio Free Europe/Radio Liberty. Caucasus Report, January 7, 2005. <http://www.rferl.org/content/article/1341705.html>

<sup>5</sup> "Armenia Says Not Aiming For NATO, EU Membership." Radio Free Europe/Radio Liberty, July 16, 2007. <http://www.rferl.org/content/article/1077640.html>

<sup>6</sup> Caucasus Barometer 2011. Caucasus Research Resource Centers – Armenia. [http://www.crrc.am/store/di11/CB\\_2011\\_onepager-English.pdf](http://www.crrc.am/store/di11/CB_2011_onepager-English.pdf)

most people in Armenia, the two are synonymous. Should this explanation be correct, it can also serve as factual proof of the hypothesis formulated above: that for the general public in Armenia, European integration is not so much about values as about material well-being, of which Europe is the key symbol in Armenia.

In the meantime, cooperation projects with Europe have been unfolding at a stable and consistent rate. About half of Armenian exports go to EU countries, more than exports to CIS states, even though exports to the CIS increased slightly in 2011 with the re-opening of the Russia-Georgia border. Armenian imports from the CIS are slightly larger than those from the EU, and are growing; as per the types of goods, the two are quite different, with Armenia chiefly importing consumer goods and industrial products from the EU and energy resources from the CIS. People-to-people ties have also been expanding. For example, according to official data, citizens of EU countries accounted for 39.4 percent of all tourists who entered Armenia from January-September 2012. Most European tourists to Armenia came from Germany, the UK, France and Italy.

As a current development of the Eastern Partnership project, starting in June 2010, Armenia has been engaged in negotiations over an Association Agreement with the EU, of which a key element will be the establishment of a Deep and Comprehensive Free Trade Area (DCFTA) with the European Union. According to the to-do lists of the Eastern Partnership countries, Armenia is second only to Moldova in its progress on the way to the DCFTA, followed by Georgia, and with Ukraine significantly lagging behind. Azerbaijan still has a long way to go, and Belarus does not even have a negotiations agenda.

By the calculations of the European Friends of Armenia, exports from the EU to Armenia can grow by 30 percent once the Deep and Comprehensive Free Trade Area (DCFTA) is established.<sup>7</sup> These pros-

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<sup>7</sup> "EU and Armenia seek conclusion of Deep and Comprehensive Free Trade agreement in 1 year." Public Radio of Armenia, November 30, 2012. <http://www.armradio.am/en/2012/11/30/eu-and-armenia-seek-conclusion-of-deep-and-comprehensive-free-trade-agreement-in-1-year/>

pects create additional incentives for the Armenian elite; the Road Map for the DCFTA adopted in May 2012, with an action plan running through November 2013, includes reforms and improved regulations in the sphere of trade but that also has a section on democratic reform, human rights (improvement of the justice system and support for independent media) and efforts towards the peaceful resolution of the conflict over Nagorno-Karabakh. Given Armenia's steady progress towards its implementation, it is planned to finalize negotiations by autumn 2013.

## **Conclusion**

The dualities contained in the public perception of European integration in Armenia are not necessarily mutually exclusive; provided that the steady progress of technical cooperation programs continues and expands, these dualities may, paradoxically, pave the way to a more profound, even if very gradual integration.

The first duality concerns the perception of Europe as a value system as opposed to its perception as a rich society. The two paradigms are mutually connected, if not in obvious ways; political scientists usually point out that mature democracies are usually better off than non-democratic nations. The Armenians' urge to overcome poverty can become an incentive for accepting the European value system, and vice versa, the wider dissemination of European norms can be conducive to improved social welfare and the raising of living standards.

The second duality is between the integration with European bodies and the institutionalization of European norms in Armenian politics. The two do not necessarily develop at the same speed but are mutually stimulating. Should Armenia improve its record of human rights and freedoms, efficient institution- and state-building, and market reforms, this will stimulate European bodies to increase the scope of cooperation with Armenia. Meanwhile, integration with European institutions involves support for domestic reform and creates a general framework for their implementation.

The third and most widely discussed duality is that between security and development, which in the case of Armenia is manifested in the form of the perceived need to choose between Europe and Russia. Seen from a distance, the two options appear mutually exclusive. However, history has known cases when states, even in the midst of cold war, found paradigms for cooperating with various global power centers. For example, for decades from the end of World War II and until the disintegration of the USSR, Finland remained part of the Western world but made allowances for the Soviet Union, taking its strategic interests into account while preserving its own sovereignty, and even found ways to benefit from this situation.

The challenges remain immense. It is extremely difficult to adopt a set of values which was formed in a totally different cultural context, and to start using it as your own. The main hope for Armenia lies in the fact that the multi-dimensional and multi-layer quality of its movement towards European integration will stimulate it to evolve the kind of political culture which is characteristic for Europe: consensus-making, balancing the needs and concerns of various actors, and elaborating ground rules for the complex interaction between players with contrasting agendas.



# THE SOUTH CAUCASUS: THE EUROPEAN FUTURE

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## **Three phase in the evolution of the EU approaches**

Since the dissolution of the Soviet Union, the EU has gradually formulated its interests in south Caucasus and sedately continued deployment of instruments to realise them. Three major phases could be observed in consolidation of the EU's common interests towards the Eastern Europe (including South Caucasus):

- Introduction of Partnership and Cooperation Agreements (PCA) as of an institutional tool in former Soviet Union in 1991.<sup>1</sup>
- Inclusion of South Caucasus in the European Neighbourhood Policy in 2004 (June 14 EU Council Decision).<sup>2</sup>
- Initiation of the Eastern Partnership at the 2009 Prague EU Summit.<sup>3</sup>

None of these phases granted the South Caucasus anything qualitatively different from that proposed by EU to so-called Western NIS4, however, informally, until the appearance of the EaP, the South Caucasus states were somehow considered as following so-called astern NIS in their rapprochement to the EU:

- <sup>1</sup> Esra Hatipoglu, EU and Russia: Partnership and Cooperation, Marmara Journal of European Studies, Vol: 5, No1, 1999, p.1  
<http://avrupa.marmara.edu.tr/dosya/MJES/Vol:5%20No:1-2/EU%20-%20Russia.pdf>
- <sup>2</sup> [http://www.consilium.europa.eu/ueDocs/cms\\_Data/docs/pressData/en/gena/80951.pdf](http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/gena/80951.pdf)
- <sup>3</sup> [http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/er/107589.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/er/107589.pdf)
- <sup>4</sup> Belorussia, Moldova, Ukraine. The term was first used in March 11, 2003, EC Communication "Wider Europe..."

- a. PCAs with Armenia, Azerbaijan and Georgia were signed in 1996, almost two years latter than with Moldova, Ukraine and Byelorussia. In the same time trade provisions of the agreement with above mentioned countries had contained possibility of consultations on the future FTA, that is considered as the recognition of their integrative ambitions and that is not a case in PCAs signed with South Caucasian states.
- b. European Neighbourhood Policy initially (in 2003) did not consider inclusion of South Caucasus. Council endorsed decision on Armenia, Azerbaijan, and Georgia more than one year latter and after strong protests from side of South Caucasian governments. Rose Revolution of 2003 in Georgia was probably a catalyst for such a decision as well. Subsequently negotiations of action plans with Armenia, Azerbaijan and Georgia started latter than for Ukraine and Moldova. They were set for five years against the tree year plans for Ukraine and Moldova. EU excluded Byelorussia from the active treatment because of the political context in the country. This approach could mention only one thing – EU was cautious with rapid rapprochement and inspiring any hopes regarding the integration perspectives to South Caucasus. What was the exact reason for such a differentiation between two regional groupings of the former Soviet Union? Evidently, geography, geopolitics, and foreign policy priorities of the member states were decisive factor.
- c. Eastern Partnership marked a completely new approach, non discriminatory and egalitarian in terms of opportunities, with actual differentiation in treating partners according to their progress. Noteworthy to mention that again, starting points for the partner countries (still only with the bilateral track) were already unequal, as Ukraine had being negotiating Association Agreement (AA) for already two years (2007), but all other partners, save Belarus, started negotiating the AA very soon (2010) after the Prague Summit (2009).

In between of mentioned three phases we can easily find different interim steps and attempts to design and establish a long term policy towards the region. This is well observed in the Council decisions



on “ENP +” (2006) or Black Sea Synergy (2007), etc. However, as it was mentioned above in this paper the differences between the individual interests of EU member states (MS) negatively affected rapid determination of the general part of the Union towards the East. Bifurcation of the ENP (still virtual, but well articulated) in two policies L’Union pour la Méditerranée and EaP, eventually accelerated the acceptance of the South Caucasus by EU MS as of integral part of the Eastern Europe and as an essential element of the EU’s policy towards the East.

The last twenty years of independence of South Caucasus, EU’s external policy experienced evolution. The politicians in EU member states and Institutions gradually started believing in the success of their own policies towards the wider region of the Black Sea and the Caspian.

Going back to the content of all three mentioned frameworks of cooperation designed by EU for former soviet realm, we can observe the growing of the EU’s ambition, trust, believe and consequently the interest. The exposure of the EU’s aims and engagement objectives, as well as the limits to such actions are well traceable in basic documents establishing the cooperation:

- a. PCAs with South Caucasian states aimed at relatively modest results - accelerating democratic and market transition in Armenia, Azerbaijan, and Georgia, converting them into international partners able to engage in active cooperation with the Union.
- b. ENP and following several less well known frameworks and initiatives have established higher degree of cooperative objective – to provide ground for the deep political cooperation and economic integration.
- c. The Eastern Partnership has clearly defined the goal of “Association” of states concerned (South Caucasus among them) and practically opened way for full-fledge integration in the future through huge possibilities of deepening the integration offered by AA’s and the process itself.

Along the last 20 years the evolution of the EU's approaches towards the EE and South Caucasus can not be qualified as planned or anticipated in any manner. In the same time, there is certain feeling that such a conversion of attitudes was inevitable and followed the objective historical path. Obviously, at present we can observe visible expansion of the EU's engagement towards the Eastern Europe and in the region of South Caucasus, in particular.

But, what are the drivers of the process? Is it subjected to the interests of certain member states, or interests to all member states, or EU's common interest, driven mainly by EU institutions?

It is most probable that the EU's common interest, as of a new quality actor not always coincides with that of the member states separately. This thesis may sound strange, as one could argue that any decision taken by EU institutions comes out of the expressed consent of member states. This is true, but the mentioned decisions are taken with consideration of the common EU interests sometimes, rather than of individual interests of a member state. EU has reached such level of consolidation, when (that) supranational policy priorities can influence intergovernmental decisions.

### **EU's common interest**

The best sources to detect common EU interests directly, articulated and formulated in a comprehensive manner are European Parliament Resolutions and reports. All other documents, even having much stronger impact on the policy decision-making process – like Presidency Declarations, Council Decisions, or European Council Conclusions, etc. are not always relevant to proper EU's real interests. The practical and viable EU foreign policy decisions always derive from a long process of compromises and clashes between different views and counter interests of other international actors. Therefore, they cannot directly respond and fully match with the particular interest of those who made the decisions. That is why we think that the resolutions of the European Parliament, being far from their immediate implementation, are very

useful to understand EU's common interests in South Caucasus. EP resolutions since 1992 were insisting on the importance of the region of South Caucasus for European security, diversification of the energy supply roots, access to the resource rich region of Central Asia, expansion of EU values, etc. The resolutions, and other EP documents, especially on the latter stage, explicitly demonstrate the EU's "willing to play an increased role in the South Caucasus, especially in the area of conflict resolution, political and economic reform, and intraregional cooperation...necessity to encourage development of values and strengthening of efforts in democratic state building".<sup>5</sup> The EP has asserted "...the South Caucasus bridges Europe with Central Asia and will in the future be neighbouring region of the enlarged EU". Nevertheless, another catalyst for EU's growing interest was (and still stays) the fact that "the countries of this region (Armenia, Azerbaijan, Georgia) are favourably disposed to mutually beneficial partnership with the EU."<sup>6</sup>

2007 report adopted by the European Parliament Foreign Relations Committee stated: "Whereas the significance of the region for the positive involvement of the EU is not only linked to its geographical position as a transit area for energy supplies from Central Asia to Europe but is also based on the mutual interest, shared by all concerned, in the development of the region with a view to enhancing democracy, prosperity and the rule of law and thus creating a viable framework for regional and inter-regional development and cooperation in the South Caucasus area."<sup>7</sup>

Analysis of the EU's agreements with the South Caucasian countries signed in 1990th clearly shows that the Union was preoccupied with stability and development of the region in general. Main interest was

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<sup>5</sup> PROPOSAL FOR A RECOMMENDATION TO THE COUNCIL pursuant to Rule 49(1) of the Rules of Procedure by Per Gahrton on behalf of the Verts/ALE Group on EU policy towards the South Caucasus, B5-0429/2003

<sup>6</sup> IBID

<sup>7</sup> European Parliament report on a more effective EU policy for the South Caucasus: from promises to actions, 2007/2076(INI), <http://www.europarl.europa.eu/sides/getDoc.do?type=REPORT&reference=A6-2007-0516&language=EN>

to promote democratic changes and transition to the market economy in the neighbouring region. Promotion of the peace and regulation of internal conflicts in Georgia and between Armenia and Azerbaijan with emphasis of the independence and respect of sovereignty of these countries was always seen as the high priority in EU's foreign agenda. EU considered as an important task engagement of South Caucasian states in international cooperation. EU was also strongly promoting the idea the respect of international and European conventions constitute the essential part of the state building process. EU supported and backed the full-fledge membership of South Caucasian states in leading international organisations – the UN, IMF, World Bank, OSCE at the early stage and WTO and the Council of Europe latter. EU and member states encouraged participation of the South Caucasian countries in important international arrangements related to the limitation of conventional forces in Europe, non-proliferation of nuclear weapons and materials, prohibition of land mines, etc... It aimed to increase international control over the risks related to the undesirable developments in the region with weak and still not democratic societies. The EU also tried to defend from the possibility of spillover of conflicts or other negative processes to Europe. The general EU interest was to transform this part of the post soviet space into a well-established, stable, and predictable flank. By that, EU tried to avoid any undesirable developments and complications for herself because of the possible failure of newly established states in proximity of borders of the Union. The adherence to the respect of human rights and fundamental freedoms the EU considered essential for the South Caucasian partners.

### **Structuring the interests**

Among particular interests, that EU has shown in the region since early days of its independence was promotion of the energy cooperation with the view of creating so called energy corridor for safe transportation of the hydro-carbonates from Caspian region (including Central Asia) to Europe. Initiation of big technical assistance projects such as INOGATE and accession of Georgia and Azerbaijan to the European Energy Charter treaty (with its “transit protocol”) in the mid 1990s was

a practical step for realisation of the mentioned interest. Cooperation in the field of transport, in particular with promotion of the Europe-Asia transport corridor using the respective supportive project TRACECA in the same time aimed to enhance additional opportunities for access to the resource rich region of the Central Asia. Involvement of the south Caucasian states in the pan-European transport network by securing the transport links around the Black Sea was one of the components of those far-reaching economic interests of the EU.

At the latest stages – after the development of the European Neighbourhood Policy (2003-2004) and initiation of the Eastern Partnership EU's approach towards the region of Caucasus has become in the same time more generalised and more structured and detailed at the same time. First of all the South Caucasus has become a part of a larger EU's policy aimed at converting its neighbourhood into the area of "Stability, Prosperity, and Justice." This (these) are not just a slogans, but formulation of real goals that shall secure compatibility of the neighbouring states with the EU in terms of the political values and development, economic and social welfare and cultural proximity. Only under such approach, the EU can secure the stability near its borders and good soil for the enlarged cooperation with neighbouring states. New terms the EU institutions started using to describe goals of there policy towards the East Europe and South Caucasus like "closer economic integration" and "deeper political cooperation"<sup>8</sup>, latter in EaP related documents – "political association"<sup>9</sup> marked qualitatively new position and perspectives for the whole region. Differentiation, as a principle introduced in both above mentioned policies in reality introduced a quasi-individual approach with the neighbouring states where the countries are not escaped from the regional context, but kept with the promise to have additional benefits in case of conducting the reform process better

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<sup>8</sup> European Neighborhood Policy STRATEGY PAPER Brussels, COMMUNICATION FROM THE COMMISSION, 12.5.2004 COM(2004) 373 final, p. 2

<sup>9</sup> COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL Eastern Partnership Brussels, 3.12.2008 COM(2008) 823 final {SEC(2008) 2974}

than others. South Caucasus is a very vivid example of such a conduct from side of the EU. As an appreciation of the eventual progress in certain fields EU started consultations on Association Agreement with Georgia earlier of Armenia and Azerbaijan, but finally all three countries were invited to the negotiations almost in one time, and would Azerbaijan be member of WTO, it would not be left isolated in DCFTA related issue neither.

Despite of the fact that the Eastern Partnership has established an apparent equality of opportunity for all EaP Partner countries on integration with the EU, still the geographic proximity of the Western NIS plays the role. Ukraine, Belarus, and Moldova certainly have more chances to become closer to the EU if we judge according to the political will in the EU. This is just matter of the face and inadequacy of the actual government in Ukraine that the progress on this way is stuck. Byelorussia is another, even more interesting case, when the country is so welcome to establish close ties with the EU, but the regime that reigns in that country leaves no chance itself for such development. Moldova that proved its independence from Russian influence just recently, overpasses very soon all other EaP countries and is frequently articulated as a country with EU membership perspective. At least some big EU member states do not exclude such a possibility for Moldova.<sup>10</sup> This is also true that these differences are noticeable rather among the EU member states than within the EU common policies. Evidently, Georgia in the South Caucasus has more direct "lobbyist" states in EU that its immediate neighbours. Among such "friend-countries" may be mentioned all three Baltic states as well as some other Central and Eastern European countries, or Sweden from the North Europe.

To soften the geographic factor and obtain really equal opportunities for South Caucasian states they need to show even more progress in democratic development and stability than Western NIS. This is difficult due to the cultural and historical specificities in the region. There

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<sup>10</sup> see: [http://www.setimes.com/cocoon/setimes/xhtml/en\\_GB/features/setimes/features/2012/09/03/feature-03](http://www.setimes.com/cocoon/setimes/xhtml/en_GB/features/setimes/features/2012/09/03/feature-03)

is indeed another field – economic development and growing engagement of the EU’s economic interests that could compensate the projected delay in democracy building. This is affordable task for all three countries, but if the third important factor provided – security. Major goal is reaching lasting solution for protracted conflicts. Minimum requirement could be the transformation of the conflicts to a qualitatively new stage, when they do not provoke alarming security concerns.

To understand the EU’s general interest towards to the south Caucasus is enough carefully learn the context of multilateral dimension of the EaP and to determine the specific interests towards the each country of the region the analysis of the EU action within bilateral dimension is highly useful.

Concluding this part of analysis we can state that there is a pool of topics that constitutes EU’s interests in South Caucasus:

- development of democratic institutions, provision of human rights and rule of law, good governance and stability, security and resolution of conflicts;
- economic development through comprehensive government policy in supporting SMEs, Innovation and Industrial and agricultural development, trade and regulatory convergence with EU policies;
- enhanced sectoral development and cooperation in such spheres as Energy, Transport and Environmental protection; people-to-people contacts stimulated trough youth and students exchange and cooperation, scientific cooperation and culture, etc..

EU attempts (as is highly interested) to bring region connected and stimulates interregional cooperation between EaP partner countries, in particular among South Caucasus. This interest comes from understanding that EU has gradually became responsible for this area – stability, security, economic development, social justice, etc. is only viable if the countries will start cooperating and helping each other in all relevant endeavours.

Apart from these, the EU is interested to establish deep bilateral frameworks for cooperation and for openness with South Caucasian countries through Association Agreements, including deep and comprehensive FTAs. The latest will provide ground for preferential presence of the EUs investments and commodities in the regional market. Introduction of a well established migration policy and full control by SC countries the legality of the population in and outflow process represents the high EU priority as well. That is why in exchange EU is planning to provide visa free regime (consultations with Georgia have already started). Bilateral agenda with Georgia is also quite intensive in the field of defence and security. EU is gradually opening to the partner countries like Georgia (who's intentions to join NATO are higher than elsewhere in the region) and provide ground for possibilities to engage in joint security operations under EU hospices.

All these matters constitute EU's interests and it is difficult to detach one from another and range priority interests. EU's internal development and its serious engagement in the region dictates itself the fields where the EU action is mostly required and necessary.

## **EU and Russia**

In the period before the EU's eastern enlargement, the Union has never been demonstrating the ambition of conducting individual policy and was always referring to the necessity of all international actors to engage and be active in supporting the mentioned countries. The EU was always cautious towards Russian interests in the region. There was no attempt to intervene in sensitive political issues without consulting big neighbour. EU officials were always requesting especially Georgia to normalize the relations with Russia and deepen economic and political cooperation with that country. Neither there was any move to jeopardise the creation of the security/military alliance between Russia and CIS countries, including the South Caucasus. The EU accepted the leading mediatory role of Russia in the conflicts in Georgia and Nagorno Karabakh and was herself predominantly focused on the humanitarian and financial aspects related to conflicts.



These two superpowers have crossed each others interests and the contradicting visions are dominating their agendas. A short history of EU-Russia relations after the break-up of the Soviet Union comprises two basic stages - "pre-Putin" and "Putin era." The last decade of the 20th century Russia was cooperating and taking advice from the EU in her state building process. It was also a supposed EU ally in providing the stability in the post soviet realm. The EU was granting Russia with technical support was seriously expecting to convert it into a reliable partner, ready to integrate economically. Such expectations were at place despite of the Chechen war, Russia's brutal involvement in internal affairs in Georgia, Moldova, etc. The EU still was optimistic about Russian "conversion."

The expectations been lowered in 2003 when Russia denied participating in the EU's ENP and became necessary to develop a separate agenda for EU-Russia relations.<sup>11</sup> Since then, Moscow refused EU's technical assistance, expressed its own vision of state building and affirmed its ambition of presence in all former soviet states. Latter Moscow even started using the term "privileged interests,"<sup>12</sup> while talking about the South Caucasus. Russia is frank and open in formulating her foreign policy aims in the South Caucasus. Still there is much to understand the real intension behind her rhetoric. Firstly, Russia is a past oriented country that cannot avoid thinking on her strategic interests, in particular military control over the South Caucasus. Russian geopolitical thinkers like Alexander Dugin have strongly influenced Putin's vision of the country's role in this region. "Deterrence of the Western expansion" and protection of the "Russian Southern flanks" became essential foundations of the policy towards the South Caucasus. Secondly, Russia considers South Caucasus as a key to her dominance over Central Asia. "Holding" the South Caucasus, means for Russia having a comparative advantage over Europe by controlling the access to the Caspian region. After this, the energy that became the main factor of Russia's power and well-

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<sup>11</sup> Creation of so called "Common Spaces" adopted at the St. Petersburg Summit in May 2003 [http://eeas.europa.eu/delegations/russia/eu\\_russia/political\\_relations/political\\_framework/index\\_en.htm](http://eeas.europa.eu/delegations/russia/eu_russia/political_relations/political_framework/index_en.htm)Sankt-Petersburg

<sup>12</sup> see Medvedev's speech at the Council on Foreign Relations, Washington, DC. <http://www.vesti.ru/doc.html?id=224151>

being constitutes another behavioural imperative in south Caucasus. Putin's government is doing its utmost to limit the energy transit from the Caspian region to Europe through the South Caucasus. This aims to conserve Russia's exclusive position of the energy provider for Germany, France, Central, and East European EU member states.

Derivatives from those basic Russian interests also appear in such spheres as business relationship, ownership of strategically important infrastructure systems in the South Caucasus (well succeeded in Armenia and partially in Georgia), enlarging cultural ties and attempting to establish their security structures. Most dangerous derivative is Russia's interest to conserve and freeze the conflicts in the South Caucasus, keeping them without perspectives for the lasting solution. By other words, she attempts to downsize the attractiveness of the region for international projects, especially in the energy field, allegedly stop the west from "pushing" such countries as Georgia to the NATO, and prevent serious long-term perspectives for integration of the whole South Caucasus in the EU.

As we can see, EU interests coincide with the interests of the SC countries and contain positive elements, subjected to the goals of overall strengthening and development of the states of South Caucasus, while Russia mainly preoccupies with its own unilateral interest, in major cases, in contradiction of essential needs of her southern neighbours. In exchange for "friendship", Russia demands from these states to pay with their sovereignty and independence in foreign policy decisions. Georgia, as a key country (due to her geographic location) for the success of the Russia's policy has been directly attacked by military means in August 2008. This intervention was followed after numerous attempts to "subject" the will of the country through economic pressure (gas cuts, embargos on the agricultural products and processed food, introduction and tightening of visa regime, etc).

Eventually comparing the two approaches (the EU and Russia) with the aims to influence the countries of South Caucasus we can easily see that the EU creates positive gravitation and invites into her

orbit the region without any blackmailing or threat to castigate. The strongest “punishment” the EU may use to stimulate the country towards the reform is delay in granting new opportunities, in increased financial assistance or downgrading preservatives for a preferential treatment in trade or visa issues. It is also easy to deduct that for Russia, it will become more difficult to deter the westward path of the South Caucasian countries, which naturally look into the direction that offers and promises better opportunities for the country and for their people.

At the current stage, the EU’s policy in the South Caucasus is becoming more independent from Russia’s influence. The EU, especially after introducing EaP, has practically crossed the Rubicon and declared to Russia, that there will be no limitations for engaging East European partner countries, including South Caucasus into the Europeanization process. The mentioned will lead to the deep integration of these states into the European economic and political cooperation. Russia responded by intension to create alternative so-called Euro-Asian Customs Union. Rilka Dragneva and Kataryna Wolczuk argued (2012) that “this initiative, which offers a forward-looking, advanced form of economic integration, has serious implications for EU–Russian relations in general and the EU’s strategy in the post-Soviet ‘shared neighbourhood’ in particular.”<sup>13</sup> Practically, Russia “forces” certain East European countries to participate in it. This attitude resembles a panic reaction to the appearance of EU’s eastern agenda. The attempt to establish so called “Euro-Asian Union,”<sup>14</sup> as a new replica of the Soviet Union it is “condemned” to stay just within the mythology of 21st century. Main miscalculation under the mentioned decisions is the lack of the collective will behind. Just because of the Russia’s interest or, rather caprice of her leader, nobody will contribute to the creation of a union, especially when there is nothing serious at stake to offer to the neighbours.

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<sup>13</sup> Rilka Dragneva and Kataryna Wolczuk, *Russia, the Eurasian Customs Union and the EU: Cooperation, Stagnation or Rivalry?*, Russia and Eurasia Programme | August 2012 | REP BP 2012/01, p.1  
[http://www.chathamhouse.org/sites/default/files/public/Research/Russia%20and%20Eurasia/0812bp\\_dragnevawolczuk.pdf](http://www.chathamhouse.org/sites/default/files/public/Research/Russia%20and%20Eurasia/0812bp_dragnevawolczuk.pdf)

<sup>14</sup> [http://axisoflogic.com/artman/publish/Article\\_63844.shtml](http://axisoflogic.com/artman/publish/Article_63844.shtml)

Certainly, the tensions between the EU and Russia may rise in coming years. They probably last before the end of this decade, when Russia's new political leadership will acknowledge the necessity to change the attitudes, revise policy towards the EU, and towards her Europeanised neighbours.

### **Is there need for special mechanisms for integration?**

When the ENP started functioning, European politicians were frequently obliged delicately, deny the possibility of using the framework for preparation of the participant countries for accession into the EU. The statement like "the European Neighbourhood Policy (ENP) is not about membership of the EU" was so common that even was included in the FAQ section of the European Policy Webpage of the EC.<sup>15</sup> Same declarations, but with less confident tonality accompany the explanations of the substance of EU's Eastern Partnership initiative. Certainly, the accession of countries into the EU require very well determined procedure, like consideration of the application of the country by the EU Council based on the opinion of the Commission and consent of the European Parliament (as provided by Art. 49 of the Treaty on the European Union),<sup>16</sup> and consequent granting of a candidate state status. Following procedures as a rule envisage agreement on the accession strategy, starting the accession negotiations and long process of monitoring of the country's progress in fulfilling the overall criteria and very detailed program. Only after member states' unanimous recognition of the country's readiness for the membership the agreement will be signed and goes under long constitutional procedures in each member state and EU institution.

All this is about the procedure, but the main issue is not the procedural arrangement. It is the preparedness of the country, compatibility with the EU in sense of functional institutions, values, societal and cultural achievements, the attractiveness for the member states, coinciding economic interests and political rational behind the country's

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<sup>15</sup> see: [http://ec.europa.eu/world/enp/faq\\_en.htm#1.11](http://ec.europa.eu/world/enp/faq_en.htm#1.11)

<sup>16</sup> see: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:083:0013:0046:EN:PDF>

membership. Both existing formats of cooperation with the Eastern Europe and South Caucasus – ENP and EaP practically serve the purpose of the preparation of the partner country to the EU membership. Effective implementation of the provisions agreed under the mentioned cooperation frameworks undoubtedly lead the country to the state of development sufficient to be accepted as an EU membership candidate. The determination and the interest shown by the partner country may create indispensable conditions for the acceptance of the country's EU membership. The sufficient requisites may still include the EU's absorption capacity and international context, than may impede immediate accession of a country due to certain risks related to it. In reality, there is no special need for a separate mechanism or program dedicated to the preparation of such countries as Georgia, Armenia, or Azerbaijan. Existing frameworks, in case of a serious motivation from side of those countries could serve same goal.

Why the governments of the mentioned countries insist so much to have in the preamble of future Association Agreements a provision standing on (from side of EU) the "recognition of their European perspective"? Such statement would encourage the governments for the future reforms, would give more legal rights to remind time to time EU about the declared consent on their future membership and get more political and economic support. It would also strengthen international respect and image of a country, in some cases help to avoid demonstration of enmity from side of certain international actors.

### **Beyond the Eastern Partnership**

The logic of the previous paragraph leads to the conclusion that EaP may stay as a main multifaceted cooperation framework among the EU and South Caucasian countries. This may be true and their will not be a need to invent something new. The multilateral cooperation possibilities of Eastern Partnership open wide perspectives for joint projects and initiatives almost in any field important for the functional integration of the region with the EU. This dimension leads also towards the closer intraregional integration. The multilateral platforms, flagship initiatives,

thematic panels, and especially annual ministerials and biannual summits establish strong base for closest partnerships. However, the opportunities for eventual integration with the European Union undoubtedly lay in the cooperation infrastructure built up by the bilateral dimension of EaP. Association Agreement in particular, with immense possibilities of deep cooperation in big number of fields, institutional deepening, and further development of the agreed provisions. It will serve as a strong tool for advancing individual rapprochement of a country with the Union. With the higher rate of approximation of partner countries with the EU the differences made in the progress of those countries will appear more evident. Consequently, the differentiation can become more apparent. We argue based on the experience of Western Balkan countries, which without yet existing firm guarantees of membership have shown different progress and received different from each other treatment from side of the EU. Eventually just two from six Western Balkan states got up to now the status of EU candidate country. We can also state that until this ultimate phase (that may start in the South Caucasus in 5-6 years) countries in the Western Balkan were treated equally.<sup>17</sup>

European Integration is an open process and cannot be artificially stopped or delayed. This process has its own logic and rules. European states, which perform their activities in conformity of the mentioned rules, have high chances to join the EU in the future. The South Caucasus states may become candidates for the membership (separately or all three together) until 2020. This is not an easy task and requires presence of following conditions, which to my opinion we can divide on two groups – country conditions and cooperation conditions. The first embarks the political and socio-economic context in the country and the other - ties and closeness with the EU.

## **I. Country conditions**

- Democratic institutions in place. Rule of law and protection HR at a qualitatively new level;

<sup>17</sup> safe Slovenia, that has become EU member state in 2004 for her strong cultural and political affiliation with the Central Europe and due to her extraordinary reform leap in 1990th).

- Government structures and institutions working in accordance with the practice and code accepted in OECD countries;
- Internal stability of the country based on the compromises between political parties;
- Consensus-based society and high political culture respecting the constitutional norms, minority rights, solidarity, and equal opportunities for everybody;
- Sufficient level of convergence of the regulatory framework and legal-institutional basis with that of the EU. This especially concerns to the approximation with the EU acquis;
- Sustainable economic and social stability expressed in good macroeconomic indicators, well functioning social protection policy, proper level of infrastructure development, efficiency and competitiveness of industries and companies, diversification of trade;
- Poverty downsized to the tolerable level and unemployment does not exceed one digit figure.
- Stability in foreign relations and well-provided security of external borders of the states could also be essential. Resolution of conflicts. Internal and intraregional peace arrangements.

## **II. EU cooperation conditions**

- Free trade arrangement with the EU functions in benefit of both parties; Trade figures between EU and South Caucasian state reaches new levels – 60-70% of total trade for partner country and more than 1-2 percent for EU18. Growing rate of European investments in the country.
- Special EU interests in energy, transport, and other important areas are satisfied with effective functioning of big international projects. The country (ies) joins European energy community,

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<sup>18</sup> In case of Azerbaijan, the last condition is satisfied but just because of the energy exports to EU.

- Citizens enjoy visa free regimes, which do not create problems for EU member states. It brings benefits not only to a partner country, but the EU member states as well;
- Intensive cooperation in science and education, stronger people-to-people contacts and ties developed leading to better understanding of cultural similarities and tolerating differences;
- The EU and a SC state reaches full consensus in issues of external security and regional cooperation. A SC state joins all EU CFSP declarations and takes part in EU's security operations.

The presented list may not be exhaustive. It can be amplified and detailed, but cannot include topics impossible to reach for any of South Caucasian states.

Each of the South Caucasian states has there limiting factors able to delay their advancement on the European Integration, downgrade their motivation. For Armenia, it is Nagorno Karabakh and resulted political dependence from Russia. For Azerbaijan - democratic choice that is not fully guaranteed at this moment. For Georgia - occupied territories. Georgia and Armenia have smaller economies and fewer growth opportunities, while Azerbaijan is quickly expanding economy with a huge potential. This may create certain attractiveness for the EU to keep Azerbaijan on the European Integration track. Georgia is geographically better connected to the EU and shows higher motivation for integration. Analysing all possible "pro" and "counter" factors and recent trends in rhetoric of the EU and MS officials we can observe that Georgia is viewed as a leader in Europeanization. The leaders of the EU member states more frequently mention two Eastern partner countries – Moldova and Georgia. This makes us to think that they will treat these two countries differently and there prospects to become candidate states in the foreseeable future are higher than of others. This does not mean that the others have no same chances. The situation, as well as attitudes, may change depending from the effort shown by the county itself.



## **Conclusion**

Despite the complexity and difficulties related to the realisation of EU aspirations, the perspective for Georgia, Armenia, and Azerbaijan is open and realistic. The countries have chance to become candidate states until the end of this decade. There is no need to ask or expect a new special decision or an instrument to prepare the countries for such a stage. The cooperation and institutional instruments included in two existing frameworks – ENP and EaP are sufficient to this end. The countries need to formulate their goals in a more detailed and transparent way, merge the state building agenda with the objectives and tasks presented in the mentioned two frameworks is essential. No external actor is more able to impede the EU integration of SC countries as the EU has already engaged sufficiently in the region and demonstrates sufficient independence in its decisions. The differentiation between the states of South Caucasus may take place more intensively in coming years and most probably, Georgia, as a Black sea littoral state will become the candidate country earlier than other neighbours. However, Armenia and Azerbaijan may have equal chances with Georgia if they make successful efforts toward solving conflict in Nagorno Karabakh and step forward towards the democratic change.



# CHAPTER VI

## THE WAY AHEAD: RECOMMENDATIONS



# RECOMMENDATIONS

## ARMENIA

As a region that has been more defined as an arena for competition than cooperation, the South Caucasus is approaching an important landmark in 2018, marking the centennial of an earlier period of true regional integration and interdependence. That early period of 1918 provides an important historical precedent and serves as a model for a new approach aimed at surmounting divisions and differences, in order to remake the region. In this way, there are several specific elements for such a new approach to regional reintegration, based on the replication of the 1918 model, but applying it to the regional reality of 2018.

Moreover, in the roughly two decades since the collapse of the Soviet Union, the three small countries in the region, Armenia, Azerbaijan and Georgia, each continues to face a daunting combination of historical legacy and current conflict, posing fundamental threats to the future development of these three states. But the lack of a common shared vision, exacerbated by the conflicts and divisions between the three states, combined with the weak sense of regional identity, pose a fundamental challenge to longer term development.

### **Political Development**

In political terms, Armenia needs to overcome its own deficiencies and must seize the opportunity to fulfill its potential as a stable and democratizing state. Although through much of the 1990s, war and closed borders tended to thwart early attempts at building democratic institutions and bolstering political reform, and only strengthened nationalism. Against this backdrop, the cumulative effect was one of only weaker independence, marked by more missed opportunities than achievements.

On a broader level, Armenia must correct three specific problems: overcoming and addressing discontent amid a deeper crisis of confidence; forge more durable and truly assertive democratic institutions that can serve as a system of checks and balances and a separation of power; and force open the closed nature of the political system itself, especially as there is no mechanism for expressing political discontent, a situation that only exacerbates underlying tension.

Most crucially, these structural flaws demonstrate that the current political system is incapable of sustaining itself in the face of mounting pressure and suggests that the only viable avenue toward democratic development in Armenia is through reforming and forcing open the inherently closed nature of the country's political system. Thus, in order to attain lasting gains in the political and economic transformation of Armenia, the current imperative is to focus on overcoming the internal threats to statehood, ranging from the need for leaders who govern and do not simply rule and the imperative to defeat the "cancer of corruption." In this way, legitimacy is the key to stability, while most crucially, institutions matter more than individuals for real democratization.

But the Armenian government must recognize and meet higher popular expectations for real change, and it must demonstrate a new sense of political will and commitment to reform. More specifically, the Armenian government has moved to resolve the lingering political crisis, sought to ease the polarized deadlock between the authorities and the opposition and exhibited a degree of statesmanship previously lacking in Armenian politics. But public discontent remains, driven by years of widening disparities in wealth and income, a deeper trend of increasing poverty and a pronounced lack of economic opportunity.

### **Economic Development**

Throughout the 1990s, the economic situation in Armenia was grave, exacerbated by constraints of demography and geography, as a small, landlocked country with few natural resources. For Armenia,

this early phase of independence was marred by war, blockade and economic collapse, culminating in severe shortages of food, electricity and fuel. These conditions also predetermined the development of the economic system, and seriously distorted reform. Within this closed economic system and facing little state oversight or regulation, several commodity-based cartels emerged, bolstered by a powerful combination of criminal links and political influence. Their power also stems from opportunities and profit from being able to exploit the conflict economics through the acquisition of monopoly positions controlling scarce commodities, such as gasoline and heating oil, and basic staple goods, ranging from flour to sugar, for some of the more notable examples.

Despite the fairly successful weathering of the impact of the 2008 crisis, the Armenian government has yet to fully address and overcome a number of deep-seated challenges, ranging from a still politically polarized population to a pronounced degree of general distrust and unpopularity among much of the population. Moreover, the government remains beset by challenges from serious economic problems and structural deficiencies, including limited foreign investment, entrenched corruption, and most notably, the burden of powerful commodity-based cartels that dominate the export and import of core commodities. This later issue has not only fostered a closed market by serving as a barrier to entry and an obstacle to competition, but has become so powerful that it now undermines the credibility and efficacy of the state itself, by failing to pay its share of taxes and through its monopolistic dominance over market share in several sectors of the Armenian economy.

Armenia's economic transformation has been equally hindered by widening disparities in wealth and equality, driven by an economy that has become distorted by entrenched corruption and the influence of powerfully entrenched commodity-based cartels or semi-monopolies. More crucially, the onset of the recent global financial and economic crisis has only exposed the deeper structural flaws impeding reform in Armenia. Given this economic reality, the imperative for

Armenia is to demonstrate the appropriate political will required to open the economy and take back control by reducing the power of the oligarchs. There are two attractive instruments for the government to leverage, however.

First, the Armenian government needs to leverage the notable progress in reform to date, and to exploit the fact that Armenia has performed well in specific policy areas, in terms of fighting inflation, maintaining monetary stability. More specifically, it should also leverage the success in its negotiations with the European Union over a new Association Agreement and for a Deep and Comprehensive Free Trade Agreement (DCFTA), set to be concluded in November 2013. In this area, the coming challenge centers on the government's commitment to carrying forward the next generation of reform, which entails tackling powerful vested interests endowed with economic power and political influence, and necessitates tackling the threat from the close relationship between business and politics in Armenia.

A second opportunity for Armenia stems from efforts to reach a ground-breaking agreement on normalizing relations with Turkey, including a possible reopening of the long-closed Turkish-Armenian border and the establishment of diplomatic relations, the course of Turkish-Armenian diplomacy has become both delicate and difficult, as the process has broken down since the historic visit to Armenia of Turkish president Abdullah Gul in September 2008. But the real challenge, and the real burden, now rests with the Turkish side. It was Turkey that closed its border with Armenia in 1993 and withheld diplomatic relations in support of Azerbaijan over its war for control of Nagorno Karabagh. And, most crucially, it is Turkey that remains challenged by the need to face the historic legacy of the Armenian genocide.

At the same time, the normalization of Turkish-Armenian relations also represents a strategic opportunity that Turkey may be in danger of missing, especially given a recent flurry of diplomatic threats and political posturing aimed at reassuring the nationalist camps both



within Turkey and in Azerbaijan. But this issue of normalizing must also be seen in the proper perspective, as any move by Turkey to reopen the border and extend diplomatic relations with Armenia represents only the bare minimum of expectations of normal neighboring countries. In this way, even with a Turkish adoption and implementation of this normalization agreement, Turkey should not be overly praised or rewarded, as such a decision would only be a first step in addressing more fundamental challenges facing Turkey, including the Kurdish and Cyprus issues and the imperative for significantly deeper reforms. Thus, for Turkey, the issue of normalizing relations with Armenia also stands a key test of Turkey's strategic future and as an indicator in the course of the Turkish bid for EU ascension.

But at the same time, the normalization process between Turkey and Armenia offers several strategic opportunities. First, it enhances regional stability by seeking to resolve disputes by diplomacy rather than force, in contrast to the deadly lesson from the Georgian war. A second opportunity stems from the possibility of leveraging Turkish-Armenian diplomacy to renew focus on the unresolved Nagorno-Karabagh conflict, which now stands as the last remaining "frozen" conflict in the South Caucasus.

And a third opportunity centers on the broader impact of normalizing relations with Turkey as an important mechanism to deepen democracy and bolster reform in each country, while also offering a new path toward region reintegration and broader development once borders are opened and trade restored. And finally, in a larger sense, Turkey's diplomatic engagement of Armenia may also help to advance Turkey's quest for eventual EU membership, especially in light of Turkey's recent launch of a new "Kurdish initiative."

Despite the poor record of past initiatives at normalization, the potential benefits from even the most basic and rudimentary form of engagement are clearly mutual for each country. For Turkey, opening its closed border with Armenia would constitute a new strategic opportunity for galvanizing economic activity in the impoverished east-

ern regions of the country, which could play a key role in the economic stabilization of the already restive Kurdish-populated eastern regions and thus meet a significant national security imperative of countering the root causes of Kurdish terrorism and separatism with economic opportunity.

Likewise, an open border with Turkey would offer Armenia not only a way to overcome its regional isolation and marginalization, but also a bridge to larger markets crucial for economic growth and development. In addition, the commercial and economic activity resulting from opening the Armenian-Turkish border would foster subsequent trade ties between the two countries that, in turn, would lead to more formal cooperation in the key areas of customs and border security. And with such a deepening of bilateral trade ties and cross-border cooperation, the establishment of diplomatic relations would undoubtedly follow.

Thus, the opening of the closed Armenian-Turkish border could not only bring about a crucial breakthrough in fostering trade links and economic relations, but may also serve as an impetus to bolster broader stability and security throughout the conflict-prone South Caucasus.

## **European Engagement**

There is also an obvious need for greater engagement by the European Union (EU), in the region as a whole, but also in terms of the Nagorno Karabakh conflict. A greater role for the EU would help to expand the number of stakeholders and would offer a much needed new sense of external concern. More specifically, bringing in the EU directly, not as a replacement or rival for the OSCE, but to strengthen and support both the mediation effort and the ceasefire monitoring mission. Such a greater EU role is not only feasible; it is also desirable as a means to expand the power of stakeholders in preventing and preempting any outbreak of war, especially as Karabakh is the only conflict within wider Europe where the EU has no role whatsoever. And EU engagement would also bolster the “back to basics”

diplomatic approach of the Minsk Group and help in addressing the underlying lack of trust among the parties to the Karabakh conflict by introducing a greater degree of transparency in the peace process.

Any new engagement by the EU in the region would also help to address a three-fold challenge: (1) the relative complacency, and general lack of urgency, of the international community over the deteriorating security situation in the region; (2) the degree of Azerbaijan's frustration over the lack of demonstrable progress from the OSCE peace process; and (3) the lack of tangible linkage between the deepening of Armenian and Azerbaijani integration with EU institutions and the Euro-Atlantic security community.

Equally important, there is an obvious and very relevant lesson of the danger of ignoring trends of insecurity in the South Caucasus. Obviously, that lesson comes from the complacency of the summer of 2008, when the international community was startled by the outbreak of war between Georgia and Russia. Yet even in the wake of that war, there is a similar complacency that ignores the warning signs of a possible renewed war in the South Caucasus, with equally powerful repercussions for many actors in the region and with an added potential to impact energy supplies, impede the recent US-Russian "reset" of relations and impel the engagement of a wider range of players, including Turkey, Iran and the EU.

In order to sustain the success of greater engagement in the region, however, the EU needs to overcome the seemingly contradictory nature of EU strategy, as several leading EU member states have each tended to follow their own competing and, at times, diverging national policies. Such divergence is most clearly evident in relations with Russia and over energy policy. Yet the EU holds an inherent advantage from both its EU Action Plans and from its Eastern Partnership, which have each contributed to a steady accumulation of political capital in the region.

Nevertheless, the future of EU engagement in the region largely depends on the EU itself, which has already reached a crossroads, with

a choice between the comfort of competing national policies and the challenge of forging a common policy for strategic engagement. And there is still a sense of optimism that the EU will live up to its expectations for deeper engagement in the region, as it is no longer possible to ignore or downplay the imperative for the EU to assume a lead role in fostering greater security and stability in the South Caucasus, which remains very much a “region at risk.”

Consequently, looking back at the “lessons” from 2012, it is clear that the leaders of each of the states of the region, and including Nagorno Karabagh, themselves now hold the key to their future. And while there is a need to prevent regional isolation, with engagement an obvious imperative, real stability and security depends on legitimacy, and on local economics and politics, and much less on grand geopolitics.

### **Conflict Transformation**

Although the lingering “frozen” conflicts of the South Caucasus have fostered greater international attention and external mediation, the real prerequisites for regional security and stability are rooted more in internal issues. More specifically, for the South Caucasus, the internal imperatives of legitimacy, leadership and statesmanship are the most essential ingredients for durable security and stability. A second interesting paradox in the region is the fact that, while the strategic perception of the South Caucasus has been largely defined by grand geopolitics, the regional reality is defined more by local politics and economics. From this perspective, it is democratization that must come first, prior to any hopes for an effective or lasting resolution to the “frozen” conflicts in the region. And it is clear that the institutions of democracy matter much more than any individual democrats for real democratization. Consequently, it is the leaders themselves who hold the key to their future. But over the long-term, there is an obvious need for more attention on regional reintegration.

But as the unresolved Nagorno Karabakh conflict has emerged as the central impediment to regional development and cooperation, looking

to 2018, there must be a new focus on ways to overcome and surmount the parameters of the conflict. In this way, there are several specific measures to consider. First, considering the lack of significant progress in the peace process, compounded by ineffective mediation efforts and a fragile military situation, the imperative is to address the underlying lack of trust among the parties to the Nagorno Karabagh conflict. One of the more effective measures may be to seek to create a new environment conducive to fostering a more active, but more limited round of negotiations among all parties to the conflict, including Nagorno Karabagh itself, as a direct party to the conflict. Such a measure would be buttressed by policies to build confidence and trust, on a basis of “bridging divides” and “spanning generational divisions.”

Second, such an initiative would offer a new approach of forging a forward-looking strategic analysis of the Nagorno Karabagh conflict. By offering a long-term analysis focusing on the next five to ten years, this initiative may provide key decision makers and influential elites in each country with a new opportunity for “thinking strategically” about Nagorno Karabagh. What makes this effort especially attractive is that this approach has been largely absent from the debate and dialogue in Armenia, Azerbaijan and Nagorno Karabagh. And from this context, there is a need to look beyond vested interest groups.

This would be one of the most important aspects of engaging the political and economic elites in each country, by looking beyond the current group of officials and leaders and focus on three specific subgroups. First, it would be useful to engage the emerging political elite, including military and security officers on both sides, many of whom have completed Western training programs. Second, it is necessary to involve commercial and business leaders, especially those engaged and interested in regional or global business opportunities beyond their home base. And the third essential target for creative engagement are student groups, university faculties and societies, and internet-based media sources, also to empower a new generation of Armenians, Azerbaijanis and Georgians. Only then can the people of the region once again recapture the spirit of a region with a shared future.

# RECOMMENDATIONS

## AZERBAIJAN

In 2018, the South Caucasus region will celebrate its 100th anniversary of state independence, prior to the Sovietization of the region. Looking to 2018, it is tricky at this stage to predict a safer, more integrated region. This paper seeks to illuminate the factors and trends that are most likely to influence the current stalemate. The following are the conclusions reached by Azerbaijani analysts.

### **European Engagement**

Since regaining independence, European integration has been an important policy focus, especially during the first decade of independence. The term “pro-European” was used as a synonym for “anti-Russian”; there was a strong belief among the public and ruling elite that Moscow’s primary aim ran counter to the independent official policy of Baku.

European integration did not just mean EU membership aspirations; the focus was gaining the support of the major EU powers, especially France, Germany and the UK, coupled with significant support from the US. But after the oil revenue came into the country and Azerbaijan started to pursue its own strategies, aided by its valuable energy card, since then relations have changed dramatically. Since 2005, Baku’s desire for integration into Europe has been less apparent. From many perspectives, there has been a clash of values that has distanced Azerbaijan from Europe and various associated initiatives including the EU, Council of Europe, OSCE, and NATO, OSCE, Azerbaijan has signed numerous European and multilateral conventions, joined programs and signed bilateral agreements with EU and European organizations, but the ruling elites have had neither the

political will nor the capacity to fully implement reforms and properly honor those commitments and obligations.

Perhaps at this point it is still hard to say whether the ruling elite in Azerbaijan is against joining the EU or fulfilling its obligations. None of the representatives of the ruling party or government have sent clear messages on this issue. The negotiations over an Association Agreement have been very slow with the EU; while Deep and Comprehensive Free Trade Agreement (DCFTA) negotiations can not be opened because Azerbaijan has not joined the World Trade Organization (WTO), which is a prerequisite for the DCFTA.

In the short-term, it seems that the basis of the problem is the conflicts that have arisen following Azerbaijan's unfulfilled human rights obligations – which are core values of European integration. Individual member states see the EU's "more and more" approach as running parallel to democratic development.

Here are our recommendations for the European integration process beyond 2018:

- Azerbaijan should increase its work to seek to joining the World Trade Organization (WTO), which is a prerequisite for signing a Deep and Comprehensive Free Trade Agreement (DCFTA) with the EU.
- In order to speed up integration with Europe, Azerbaijan should implement its obligations in the field of democratic development; at the same time the EU, CoE, and OSCE must coordinate in requiring frequent updates and reports from the Azerbaijani government on its progress in democratic development issues.
- The European Union must deepen its involvement in the resolution of the Nagorno-Karabakh conflict, which the government uses as an excuse for the delay in implementing its obligations and commitments in democratic development.

## **Economic Development**

An appraisal of Azerbaijan's economic development over the past two decades shows that overall, it is the hydrocarbon resources and its gradually increasing income that have played the central and fundamental role in helping Azerbaijan to achieve economic stability. However, oil and gas resources are not infinite, and the annual drop in revenues from these resources puts the future of Azerbaijan's economy at risk. Related to this is the one-sided development of the country's economy, which is heavily dependent on the oil industry. A close look at official data from the State Statistics Committee reveals that the oil sector accounts for up to 94 percent of total exports, more than 60 percent of local industry, and 60 percent of state budget revenue. Therefore, the future development of the economy of Azerbaijan, given the declining growth in the oil sector, will depend on the speed of reforms. These reforms include WTO membership, the fight against monopolies and corruption, the faster diversification of the economy, the development of small and medium enterprises, and the elimination of existing barriers to foreign trade.

Here are some recommendations for sustainable growth:

- Corruption places severe constraints on a country's capacity to undertake economic reforms. The main beneficiaries of corruption are the powerful elite. Therefore, economic reforms depend largely on political reforms, as what is required is greater transparency, accountability, free and fair competition, deregulation, and reliance on market forces and private initiative, as well as the limiting of discretionary powers, special privileges, and price distortions. The fight against corruption and bribery should be accelerated and carried out systematically with special attention devoted to the formation of anti-corruption institutions.
- The oil industry's influence on the economy of the country is so prominent that significant effort and power is required to reduce overdependence. If the government had taken certain



steps, it would have been able to free the economy gradually from its substantial dependence on oil. In this regard, free economic zones for non-oil commerce as used by other oil-rich countries could be used as lessons. Also, in this regard, the volume of funds transferred from the State Oil Fund to the state budget should be reduced to an optimal level, and certain limits should be applied to the level of those transfers.

- In the country, and especially in the regions, business incubators, centers providing free legal and economic advice to entrepreneurs to improve business management skills should be created, drawing on international expertise.
- The number of illegal inspections of businesses by the tax authorities must be reduced. A monitoring mechanism of these inspections should be created, and the range and quality of electronic services provided by the Ministry of Taxation should be increased.
- There is an urgent need for reform of the education system. A poor education system is one of the determinant elements of corruption. The quality of education must be increased by training teachers at foreign universities. Subsequently, the capacity of secondary schools and universities should be strengthened, including the expanded use of the internet and integrated teaching methodologies.

## **Non-Oil Sector**

One of the challenges for Azerbaijan's economic stability is how to invest in and develop the non-oil sector, and how to design an effective strategy that will take into account short- and medium-term demands. In the past, the government has benefited from unexpected increases in the price of oil, which has boosted budget revenues. But in the next 12 years, much will depend on world market prices. For instance, the drop in oil prices has immediately affected the government's policy - they received less than they expected. If the price of oil remains at \$80 per barrel, for example, the Azerbaijan economy

will receive \$12.1 billion in oil revenues and \$1.1 billion in gas revenues over the next 12 years. The problem is that there are large budget transfers out of the State Oil Fund, which was established to protect oil and gas revenues for future generations and to support economic growth. The money has been poured into various projects without proper preparation or analysis, and if over-spending and financial mismanagement are not corrected, there is a strong danger of the onset of “Dutch Disease” by around 2018.

- The government should seriously focus on mitigating this likely loss from the oil sector through developing other sectors of the economy; otherwise, rescuing economic growth in 2016 will be impossible. To maintain the current level of state expenditures, the government will go into debt, which may turn into a serious problem both for the national economy and future generations.
- There is need to formulate a non-oil sector strategy. For some time, the World Bank and IMF have demanded that the government focus on the implementation of a growth strategy for the non-oil sector. For this to be possible, the government would have to reduce other expenditures, which could result in unrest (even political) in the country.
- The best way out of the situation is to shift some of the investment from the budget to companies by creating a favorable business environment and implementing the necessary infrastructure projects – but once companies are ready and willing to invest in production. Simply investing in infrastructure without proper cost-benefit analysis will only reduce resources and diminish efficiency.

### **Resolution of the Nagorno-Karabakh conflict**

The Armenia-Azerbaijan, Nagorno-Karabakh conflict has been ongoing since independence and is the number one problem in terms of both domestic and foreign policy. During the last decade, there

were “golden moments” where both parties came close to conflict resolution, but overall, despite the involvement of the US, Russia and France in conflict resolution via the OSCE Minsk Group, international involvement has deteriorated and became more of a conflict management mechanism rather than a resolution strategy. In the short- and mid-term, Azerbaijan’s domestic policy and foreign policy is highly dependent on the resolution of the conflict. Here are some recommendations for the period leading up to 2018:

- In advance of 2014, which marks the 20th anniversary of the ceasefire agreement between Armenia and Azerbaijan, international actors must accelerate their efforts toward the resolution of the conflict, because otherwise, the risk of accidental war will increase. In addition, the Azerbaijani government will feel greater pressure from society due the ongoing stalemate.
- The negotiation process needs more European engagement, a more European “Minsk Group.” There are possibilities to increase European engagement. First, the European Union Special Representative (EUSR) for the South Caucasus and the French co-chair, with the participation of the head of the EU delegations in Azerbaijan and Armenia, could find a working framework to improve the EU’s role in the resolution of the Nagorno-Karabakh conflict. As well as the EUSR, there are also the ambassadors from the individual EU countries. They could conduct a monthly consultation and then present the results to France. Second, the EUSR could informally attend the Minsk Group co-chairs’ meetings, or be elevated with an “observer status.” Further changes in the Minsk Group are also required. One possibility could be the appointment of an OSCE chairman country’s special representative. Currently, there is the personal representative of the OSCE chairperson-in-office, but here we are talking about the OSCE chairman’s country -- when he or she takes the position (on a six-month rotation), a special representative to the process should be appointed. Thus, the format of the Minsk Group would evolve from the current “troika” to 3+1+1. The final format could be

3 (US, Russia, France) +1 (EUSR) + 1 (OSCE chairman countries' special representative).

- Azerbaijani government officials must reduce threats to the physical security of Karabakh Armenians; or more correctly they should make it clear that the target of the threat is not the civilian population, but the Armenian leadership, which is blocking a peaceful resolution of the conflict. Otherwise, any statements containing threats will be used in a PR campaign against Azerbaijan.

Political Transformation Developments in Azerbaijan over the next five years will be decisive for the country's future - whether it will choose to be part of a system of Western democratic values or not. The October 2013 presidential election is close and the incumbent president, Ilham Aliyev, is the main candidate for the next 5 years. This was made possible by the adoption of constitutional amendments in a referendum held on 18 March 2009, when the provision about limiting the presidential term was abolished. Besides, there is no serious opponent to President Aliyev, although in the last few years, young people have been advocating greater democratic development by the government. But the problem they face is that over the last twenty years none of the significant opposition party leaders has actually changed, and they can not meet the requirements of the contemporary political struggle. The impact of new political movements and parties, among them the center-right "Real" movement, for example, are worthy of mention but still can not constitute a genuine challenge. These movements and groups have not yet formed their social base within Azerbaijani society and there is a serious shortage of qualified staff. In general, these groups make extensive use of virtual possibilities of social networks to spread their ideas. Social networks have become a springboard of political struggle not only for groups but also for individuals, and for young activists who seek to express their own ideas and beliefs. Despite the fact that such activity has had more impact in society than the work of the opposition party leaders, these various protest movements have no clear leadership or formal political agenda. At this stage, it is difficult

to expect that they can be converted into serious political structures, to demonstrate a serious alternative to the current administration.

Here are some recommendations:

- In the past few years, Azerbaijan's image has been damaged by international human rights organizations who have called the government to account over various human rights issues, demanding the implementation of the basic standards of a democratic society. The government must ensure that for the sake of the country's stability, reforms are urgently implemented. For the public, the politics of personality are less important rather than what governments will do to improve the situation – including giving people a free voice, not repressing people, hearing the problems of society, etc.
- From today's perspective, it may be true that the current administration is much more powerful and there is no base for any opposition movement. If the President wants to guarantee a strong and successful political legacy by 2018, one hundred years after the creation of the first Azerbaijan Republic, he must make some radical changes, including revitalizing government structures and perform an urgently needed cabinet shuffle. The real challenge will be the 2015 parliamentary election, where the government must ensure fair and free elections. If the government can guarantee a fair political process, by 2018, the country will have a system of checks and balances, which is a requirement for a democratic government.

## **RECOMMENDATIONS GEORGIA**

Georgian politics have entered a turbulent period after the 2012 October parliamentary elections. As that election was a remarkable upset for the ruling party of President Saakashvili, the competitive nature of the election produced an outcome that represents an important milestone on Georgia's democratic development path. According to the Organization for Security and Cooperation in Europe (OSCE), the process marked an important step forward in consolidating the conduct of democratic elections. International observers assessed all stages of the election process positively, stating that it demonstrated a "healthy respect for fundamental freedoms." Equally importantly, the election results were accepted as legitimate by the Georgian public, thus enhancing the credibility and effectiveness of state institutions.

The peaceful transfer of power between the government and opposition was an unprecedented event in the post-Soviet world and could serve as a model for other aspiring or evolving democracies. However, the next few months will be quintessential to understand what type of co-habitation will be devised between President Saakashvili, who under the constitution has to remain in his post until the presidential election set for October 2013 and Prime Minister Ivanishvili, who just acquired the prime ministerial post and is now seeking rapprochement with Russia. Further complicating matters, over the following 12 months, Georgia's political system will transform from a presidential to parliamentary system, with the effect of stripping the office of president of most powers, while transferring them to the prime minister. The parliament is thus slated to play a more vigorous role than it had in the past. So far it seems that the prospects for an easy stabilization of political life in Georgia are limited, as both sides show a reluctance to cooperate with each other.

As the results of this election can shape Georgia's trajectory for many years to come, Georgian political elites may need to overcome their zero-sum approach to politics and must learn to govern through consensus. As a difficult co-habitation process has just started, it also remains to be seen whether the recent political shuffle will propel Georgia toward a Western-style liberal democracy or whether it will plunge into violent political turmoil. According to recent developments and current challenges, it is advisable that the Georgian government improve the above listed priority areas, summarized below:

### **Political Development**

- Functionally, Georgia has not moved forward with democratization since the mid-2000s, the new government needs to support democratization and the development of a more stable political system to move forward without undermining the previous government's achievements.
- To boost its successful transformation, Georgia needs to bring the state closer to a balanced political system with more power residing with the parliament. It also requires a competitive political environment with viable alternatives to existing policies. It also needs to strike a constructive balance between two or more competing political players and to build a more pluralistic political party system.
- The process of combating corruption and ensuring government transparency must be continued by the new government, and especially the commitment to the principle of equality before the law; the incumbent government needs to engage in a good-faith dialogue with multiple political forces, civil society representatives and business leaders while designing and implementing key reforms.
- To establish the rule of law, the new government needs to establish the system of checks and balances, install a full-fledged system of transparent and accountable governance, reform the justice system, and improve the media and busi-

ness environment, so as to alleviate the symptoms of “super-executivism.”

- In order to avoid a decline in the quality of governance and the rollback of some key reforms, structural advances are needed in the realm of local government to ensure political freedom and active participation for the Georgian population.

## **Economic Development**

The Ivanishvili Administration will be expected to deliver on its election campaign promises, especially in the economic arena by generating growth and creating employment. According to the European Bank for Reconstruction and Development (EBRD), Georgia’s major economic challenge is to make a permanent transition from investment financed by international financial institutions to sustainable private sector investment. Consequently the new government should:

- Further improve the business environment;
- Scale up the economy – further integration;
- Increase competition, achieve competitive input prices;
- Strengthen public institutions, improve public finance management, and improve the rule of law and judiciary;
- Keep the size of the government at a sustainable level and ensure the fiscal and macro stability of the country.

## **European Engagement**

Despite the complexity and difficulties related to the realization of Georgia’s EU aspirations, the perspective for Georgia European integration is open and realistic. The country still has a chance to become a candidate state until the end of this decade. None of the political parties in Georgia can monopolize these strategic goals for the country because it is based on the Georgian people’s will, and not on a single party policy.



- The new government's open policy lines with Russia shall by no means jeopardize the Georgian implementation of the European integration agenda.
- Tbilisi should start negotiations on trade by next year and as soon as an agreement will be signed, which is expected in 2014, the DCFTA will be enforced.
- Neither the EU nor Georgia is fully ready at this point, so we need to do our best collectively to build Europe in Georgia, while implementing all the necessary reforms and transformations.

### **Conflict Transformation**

Changing the post-August 2008 regional status quo is objectively in the interests of Georgia, while Russia adheres to the decisions made in late August 2008 of its recognition of Abkhazia and South Ossetia as independent states. As the policies chosen by the Saakashvili government towards the occupied Georgian territories did not lead to an expected "engagement," the new government of Georgia needs to embark on a model relationship that will (a) bring a more predictable, secure and guaranteed situation across the conflict divides, (b) create economic, infrastructural and human incentives for the population of the conflict zones to engage in dialogue and confidence-building process, and (c) help transform the Geneva process into a viable negotiation area. The started bilateral Georgia-Russia dialogue that currently concentrates on economic, cultural and humanitarian issues should enable in the long run the opening of windows of opportunities that will positively affect the conflict-related political process.

There are certain risks in changes in external policies, mainly in regard to Russia and the unresolved conflicts, but not for the country's pro-Western and Euro-Atlantic orientation, where the consensus on a vital importance of which is country-wide. There is no evidence at the same time that Ivanishvili would use his position in power to submit the country's interest to Russian or any other external interest that

would challenge the national interest or status of Georgia as an independent state.

### **Security issues**

The new Georgian government has underscored its commitment to Euro-Atlantic integration. However, a newly emerging foreign policy stance increases policy of uncertainty. Ivanishvili's choice of a foreign policy team suggests he plans to tone down the heated rhetoric that has marked bilateral relations with Russia. It seems that the new administration will try to adopt more pragmatic, less ideologically driven and a more balanced line with Moscow and improve economic and cultural ties with northern neighbor. While such prospects could help alleviating Georgia's security predicament, they also contain risks to the country's long term strategic interests. Accordingly, the new government should avoid the following risks:

- There are some signs that Moscow, emboldened by the regime change in Tbilisi, is seeking to lure Georgia's new leadership and bring it closer to the Russian political and security realm and has made it clear that it is expecting specific steps from Tbilisi. One related risk is that Russia may attach its embrace of the new Georgian government to demands that Georgia takes steps to integrate with the Russia-dominated Eurasian Union in exchange for other concessions.
- There are indications that Moscow wants to change the Geneva format and replace it with bilateral negotiations. The Kremlin also wants to display to the international community that it can settle relations with Tbilisi without any western engagement. As Georgia would find it easier to influence Russia by means of international levers under the Geneva format, from the Kremlin's point of view, any external involvement (specifically by EU member states and the U.S.) in Russia's sphere of influence are not welcome and may hamper bilateral relations between Russia and Georgia.

- As any new negotiation format may decrease the risk of direct Russian aggression towards Georgia, any issue in relation to Moscow should be solved within a comprehensive framework aimed at the de-occupation of the two Georgian regions and the restoration of Georgia's full sovereignty. As Tbilisi pushes toward more engagement with Moscow, it should not inadvertently invite the Kremlin and give it a chance to regain the leverage over Georgian domestic affairs that it effectively lost after the war.
- As for the political course, both in domestic and foreign terms, it will not be clarified before the presidential election, It is already clear that Russia is ready to develop relations with Georgia – albeit selectively, conditionally, and with clear political consequences. There is a certain risk that unless checked under heavy pressure from Moscow, Georgia may take a pause on its path towards Euro-Atlantic integration, which could in turn slow institutional reform aimed at bringing Georgia closer to EU standards.

Although it remains to be seen whether Georgia will be able to bargain the best deal for itself in this delicate situation, one thing is certain- Georgia's place in the region, and its relations with both Russia and the West, are entering a crucial new phase. Simply put, it is "make or break it" time for Georgia.

## CONTRIBUTORS BIOGRAPHIES

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### **Dr. Sci, Professor Teimuraz Gochitashvili**

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### **Dr. Gubad Ibadoglu**

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### **Assoc. Prof. Dr. Rovshan Ibrahimov**

received bachelor degree on International Relations at Ankara University in 1998. Defended own master degree at the same University in 2001 (Thesis topic: the EU TACIS Program and Azerbaijan). In 2008 received Phd on political sciences from Ankara University (Thesis topic: The relations between the EU and the Southern Caucasus Republics). Dr. Ibrahimov has worked at Qafqaz University since 1999. He has taken positions of Director for Center of Energy Studies, Head of Region Studies Department, and Vice-Rector on External Affairs. Since 2003 till today take a position of Head of International Relations, founder of this department. Since 2011 Dr. Ibrahimov has taken position of Head of Foreign Policy Analysis at Center for Strategic Studies under the President of Azerbaijan Republic. Dr. Ibrahimov is the expert in the number of strategic centers in Turkey, Russia, and Great Britain. Author on more than hundred articles and comments.

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### **Dr. George Khutsishvili**

combines the profiles of a scholar and practitioner in conflict resolution, and is also known as political analyst. He holds PH.D. Degrees from Ukraine Academy of Sciences (1991) and Tbilisi State University (1977), taught conflict theories and international conflict at Tbilisi State University and the University of Georgia. Dr. Khutsishvili is author and editor of numerous books and articles. With support from the John D. and Catherine T. MacArthur Foundation he founded in 1994 and currently directs the International Center on Conflict and Negotiation in Tbilisi, Georgia. In mid-1990s Dr. Khutsishvili initiated and coordinated from the Georgian side the first Georgian-Abkhaz dialogue program and immediately after the August war of 2008 initiated and developed the Russian-Georgian expert dialogue process known as the Istanbul Process. Since 2003 Dr. George Khutsishvili is



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