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A DECADE IN MOTION. SOUTHERN CAUCASUS IN 2003-2013

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The decade between 2003 and 2013 was a crucial moment for the consolidation of the post-Soviet Republics of the Southern Caucasus. The security context proved to be a major issue in the region, with a full-fledge conflict between Georgia and Russia over South Ossetia (2008) and an ongoing simmering conflict between Azerbaijan and Armenia over Nagorno-Karabakh. Nonetheless, internal political stability improved in all three countries and their economies grew substantially.

Armenia, Azerbaijan and Georgia followed distinctive paths and reached different outcomes. Armenia development was hampered by relative isolation and Russian support remained vital. Instead, Azerbaijan experienced an economic boom driven by oil and gas exports. Eventually, Georgia embraced a pro-Western orientation, which attracted direct investments but also a tough Russian reaction.

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1. General overview

The second decade after the independence was a period of fulfilled promises and remarkable problems for the Southern Caucasus. All the countries in the region experienced economic growth, improving life standards and considerable international investments. Also domestic political stability improved: despite external shocks and occasional internal turmoil, the general trend has been towards a consolidation of the existing political systems.

In this sense, 2013 has been a crucial year, with national elections in all three countries. Armenian presidential elections took place in February, marking a considerable post-electoral stability when compared with previous post-Soviet experiences (see Chapter 2). Azerbaijan and Georgian presidential elections are due in October. In the case of Azerbaijan, the incumbent president is very likely to win an uncontested third term in office (see Chapter 3). Instead, in the case of Georgia the

incumbent president will expectedly leave the office, completing the smooth transition which began with the victory of the opposition in the parliamentary elections in 2012 (see Chapter 4).

Geographically, the Southern Caucasus has always been a major link between the East and the West. During the past decade, such a vocation mainly concerned energy. Politically and economically, the South Caucasus proved to be the best solution for exporting energy resources coming from the Caspian seabed. Therefore, two main pipelines were constructed and commissioned: Baku-Tbilisi-Ceyhan oil pipeline and Baku-Tbilisi-Erzurum natural gas pipeline (see Chapter 3).

Yet, for the Southern Caucasus the past decade has been far from a quiet period. Major security issues dominated regional politics, with a full-scale war between Georgia and Russia in August 2008 and a simmering conflict between Armenia and Azerbaijan over Nagorno-Karabakh. Both situations stemmed from the Soviet legacy, especially in the domain of ethnic policy and administrative subdivision according to a *divide et impera* rationale. Equally, both situations saw a certain degree of Russian involvement.

In the twilight of the Soviet Union, ethnically Armenian minority living in the region of Nagorno-Karabakh (legally part of Azerbaijan) started to demand accession to Armenia. They represented the majority of the population in the region and they were supported by Armenia, which became increasingly involved in the conflict. Furthermore, Yerevan received indirect but consistent Russian backing.

In 1988, while Azerbaijan and Armenia were still the parts of the Soviet Union, violence broke out, soon becoming a full-scale military confrontation after the collapse of the USSR. Conflict lasted until 1994 ceasefire, brokered by Russia. As a consequence, the conflict froze, leaving Nagorno-Karabakh region and seven adjacent districts – all legally part of Azerbaijan – under control of the Armenian minority, actively supported by Yerevan. At the same time, nearly 800.000 internally displaced persons and refugees spread across the rest of Azerbaijan, while nearly 300.000 ethnic Armenians had to left other regions of Azerbaijan and moved to Armenia and Russia.

In the following years, low intensity confrontation continued on the line of contact. During the past decade, the conflict continued to simmer, with ongoing lethal incidents near the borders, but without a large-scale escalation between Azerbaijan and Armenia.

The international community tried to contain the situation during the war, and in 1992 the CSCE (now OSCE) created the Minsk Group to mediate and find solutions to the conflict. Since 1997, the Group was

co-chaired by Russia, France and the US, which tried to produce a legitimate solution. The parties continued to work throughout the past decade without producing any major progress and the Group proved itself quite ineffective. Indeed, while the status quo was almost universally condemned, the countries involved in the mediation showed a substantial lack of political will to challenge the situation.

Also Georgian current situation has its root in the years of transition at the end of the Soviet era. Abkhazian and Ossetian minorities started to claim independence from Tbilisi, while central government tried to keep its authority in the region. Wars broke out at the beginning of the 1990s and breakaway regions gained a de facto independence with an indirect Moscow backing and an official post-conflict Russian presence on the ground under the form of CIS peacekeeping missions.

In August 2008 Russia and Georgia directly confronted over the control of South Ossetia (see Chapter 4), with a short war which menaced the very existence of Georgia. Russian forces restrained from conquering the whole country, but the war threatened the stability of the region and a complete defeat of Tbilisi could have triggered unpredictable consequences even beyond the Caucasus.

Despite a difficult security context, Southern Caucasus countries also experienced a decade of widespread economic growth. However, different endowments and economic policies led to remarkably different performances: while Azerbaijani economy enjoyed a strong, double digit growth, driven by its thriving energy sector, Georgian and Armenian economy experienced a lower – but still significant – expansion (see Fig. 1).

The 2009 international financial crisis also affected Southern Caucasus economies, even if unevenly. Indeed,

Georgia and Armenia underwent a recession (-4% and -14%, respectively), while Azerbaijan had a positive performance. From a global perspective, since the economic crisis the competitiveness of the Caucasian economies improved. According to the *Global Competitive Index* of the World Economic Forum, Azerbaijani ranking improved from 69th in 2008-2009 to 39th in 2013-2014, while Georgian ranking improved from 90th to 72nd and Armenian ranking improved from 97th to 79th.

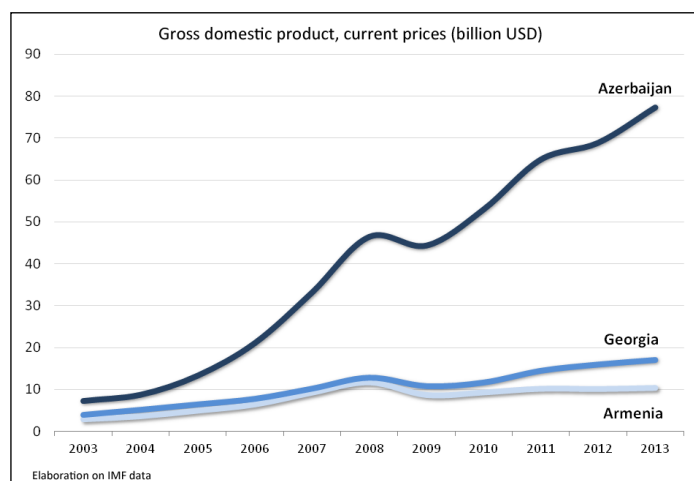


Figure 1

Beyond sheer numbers, Southern Caucasus economies continued with different patterns their post-Soviet reform process, attracting international investments, improving trade relationships, fostering private sectors and market economies. All in all, the past decade has been a decade of change. However, dynamics and outcomes widely varied from one country to another.

2. Armenia

Armenia experienced a decade of light and shadows. Economy grew and the political system was relatively stable. Nonetheless, 2009 economic crisis had a deep impact, while international situation and internal weaknesses prevented further achievements. The main constraint to Armenia's development was the relative isolation of the country, mainly due to its international stance on the Nagorno-Karabakh issue. Reliance on Russia for security and business opportunities represented a comfortable backup in a difficult regional context, but also a major restriction to the autonomy of the Armenian government. Indeed, military and business ties with Moscow intensified during the past decade, further limiting the scope for a more global and diversified strategy by Yerevan.

Security issues

Since the collapse of the Soviet Union, Armenia based its security strategy on its sound relationship with the Russian Federation. This relationship continued to grow during the past decade, with several bilateral agreement between the two countries, covering technical cooperation, collaboration and exchange of information, border protection, joint training. In addition, Russian industries were the main supplier of weapons for Armenia.

The two countries also cooperated on a strong multilateral basis, since both countries were full members of the Russia-led Collective Security Treaty Organisation (CSTO). Armenia was the only CSTO member in the Southern Caucasus, thus retaining a highly strategic valence. In particular, Armenian borders with Turkey and Iran represented an important foothold for the Russian presence in the region.

The most concrete sign of the military cooperation was the Gyumri military base, a Soviet time facility currently staffed with several thousand Russian soldiers. Located near the Turkish border, Gyumri forces were also equipped with aircrafts and anti-missile systems, providing a fundamental contribution to the defence of the Armenian

airspace. In 2010, the lease on the base was extended up to 2044, providing a long term perspective to the cooperation.

All in all, security cooperation between Armenia and Russia reached a very high level, entailing two main consequences for Armenian decision makers. The first outcome was a comfortable level of security: Russian backup represented a mighty balance against every bordering country. In particular, Russia presence was an assurance against any unilateral resolution of the Nagorno-Karabakh issue by the Azerbaijani side.

The importance of Russian backup is particularly evident when comparing the size of the military spending of Armenia and its neighbours. Armenian cumulated expenditure for the last decade was 3,3 billion dollars, while Georgian expenditure was 5,7 billion dollars and Azerbaijani expenditure was above 15,8 billion dollars. Considering also the fact that Armenian population is approximately 3 million while Azerbaijani one is above 9 million, the paramount importance of the Russian presence for the Armenian strategy is even clearer.

Nonetheless, Russian military presence had also a second, less positive outcome for Yerevan. Since Armenian security relied on Russia, the autonomy of the Armenian decision makers was limited, especially in the foreign policy domain. Indeed, Armenian government needed to coordinate with Moscow any major security and foreign policy decision, highlighting the unbalanced nature of the relationship between the two countries.

Political situation

Armenia experienced a dynamic and chaotic political scene during the past decade. In 2003, incumbent President Robert Kocharyan was re-elected for a second term after defeating Stepan Demirchyan at the second turn. The opposition disputed the results and mass demonstrations followed. Nonetheless, the Constitutional Court upheld the results and Kocharyan could serve for another five-year term, without major accidents nor prolonged political instability.

The results of 2008 presidential elections had instead more destabilising consequences. Having hold the office for two terms, Kocharyan could not be re-elected. Therefore, he openly supported Serzh Sargsyan, his prime minister, who ran against former President Levon Ter-Petrosyan. Ter-Petrosyan had previously served as Armenia's first president (1991-1998), but he resigned due to his backing to the proposed peace plans for Nagorno-Karabakh. Conversely, Sargsyan – a Karabakh native – had a more hawkish stance about the conflict with Azerbaijan. Sargsyan won the election at the first turn, sparking a strong reaction

from the opposition, which disputed the results. Ter-Petrosyan's supporters gathered in Yerevan's Freedom Square for several days, before police and the army violently dispersed them, killing ten people. After the breakthrough, a state of emergency was proclaimed for Yerevan and many opponents were arrested, cooling the protest movement down. During the following months, the situation almost normalized and the claims of election fraud slowly faded away, without other major incidents.

In February 2013, Sargsyan stood for a second term and easily won against the outsider Raffi Hovannisyan, while major opposition parties decided not to nominate any candidate. The campaign was relatively peaceful, but one candidate was shot one month before the elections. After the polls, the defeated parties contested the results and organised several protests after the elections, but no clashes or violence took place, showing signs of improving stability of the political system.

Apart from the turmoil after each presidential election, during the past decade the Armenian political system experienced a high degree of continuity, also in the foreign policy domain. Based on strategic and security considerations, Yerevan's foreign policy was consistently aligned with Russia. In a difficult regional context, Russia provided political leverage and economic support to the Caucasian republic, which otherwise was relatively isolated at regional level.

Apart from the simmering conflict with Azerbaijan on the Nagorno-Karabakh issue, Armenia also experienced a strained relationship with its Western neighbour, Turkey. Armenian-Turkish difficult relations had deep historical roots, with a tragic apex during the Ottoman era, in 1915. For those events, Armenia and several international partners claim the definition of "genocide", while Turkey denies such an interpretation. Soviet era projected bipolar confrontation at regional level, in fact crystallizing the situation.

The land border between Armenia and Turkey had been opened in 1991, but it remained closed since 1993 Armenia-Azerbaijan war, as a reaction to the occupation of Nagorno-Karabakh. However, in the second part of the 2000s the two countries seemed to be on the road of normalising diplomatic ties and presidents exchanged unprecedented diplomatic visits. Nonetheless, the process quickly deteriorated and the normalisation process halted.

Placed between Turkey and Azerbaijan, Armenia developed political and trade ties on the North-South direction. Georgia came to be an inevitable partner for Armenia: trade with Russia necessarily transited through Georgian infrastructures or airspace. Moreover, the bulk of the

Armenian natural gas supply was carried from Russia by a pipeline laid across Georgia. Armenia retained decent relations with its northern neighbour even during and after the 2008 war between Tbilisi and Moscow.

More recently, Georgia's new course and its partial rapprochement with Russia favoured an improvement of the Georgian-Armenian relations and a steady growth of the total trade between the two countries. Indeed, between 2009 and 2012, total trade turnover increased from 124 to 227 million dollars.

Armenia also experienced a good relationship with Iran, which had sided with Yerevan in the war over Nagorno-Karabakh. Despite the international pressure on the Islamic Republic over the nuclear issue, Armenia kept a friendly stance towards Iran, consistently with Russian position. Moreover, a long term trade relation – based on energy – represented another relevant element strengthening the ties between Yerevan and Teheran: in 2009 a natural gas pipeline was completed, prompting an import flow in Armenia in exchange for electricity export into Iran.

Armenia's political and geographical position limited its cooperation with the West. This relative isolation was mitigated by the role of the substantial Armenian diaspora in the United States and France, which provided economic support and political lobbying for the country.

Economic performance

Armenian economy during the last decade performed quite well, averaging a compound annual growth rate of 6%. Between 2003 and 2012, per capita GDP grew from 874 to 2.991 dollars. However, in the Caucasian context Armenia experienced the weakest performance. Moreover, 2009 crisis had a much larger impact on Armenian economy, which lost 14% in one year, fully recovering only in 2013.

The explanation can be found first of all in the political and geographical relative isolation of the country, which limited trade opportunities and prevented land-locked Armenia from becoming a major transit point on the East-West direction. Secondly, the country had a limited endowment of natural resources and it could not exploit it in order to boost its economy.

Nonetheless, between 2003 and 2012 Armenian economy attracted roughly 5,1 billion dollars of foreign direct investment (FDIs), especially coming from Russia. Russian investors had significant control over several key sectors of the Armenian economy: energy, railways, mobile communication, mining, metallurgy and light industries. Russian pervasive presence in the business sectors contributed to strengthen political ties between Yerevan and Moscow.

Remittances were another fundamental source of capital for the small Armenian economy: between 2003 and 2012, approximately 8,2 billion dollars flowed in the country, making up more than 10% of the GDP. Again, Russian role was central: more than one million Armenians live and work in Russia, making the bulk of the overall flow of remittances.

Isolation and the special relationship with Moscow induced a heavy dependence on the Russia economic performance, making Armenia's

economy vulnerable to any slowdown in the Russian economy. Due to the relevance of oil and gas sector for the Russian economy, Armenia was indirectly vulnerable to the volatility of the international price of oil, especially in the case of a prolonged downward trend.

Unemployment was another relevant weakness of the Armenian economy. Despite a significant reduction from the beginning of the decade on, its level (19%) still remained sensibly higher than the average of the other two South Caucasus countries.

Armenia experienced a severe merchandise trade deficit throughout the past decade (2,8 billion dollars only in 2012), mainly due to its narrow export base: ores and metals (especially copper), beverages, tobacco and only limited amounts of machinery and other high-end manufactured goods. Instead, imports included substantial purchases of hydrocarbons, motor vehicles and food. Armenia's main trading partners were European Union (31%), Russian Federation (22%), Iran, China and Ukraine (approximately, 5% each).

The main source of diversification from Russian pre-eminence was Armenia's active role in multilateral economic institutions. In 2003, it joined WTO, preceding Russian accession of more than ten years and improving its integration in the global markets. Moreover, during the harshest moments of the financial crisis Yerevan successfully obtained loan packages from the IMF and other financial institutions, besides Russian support. However, the overall level of openness of the country remained low and the multilateral actions did not pose an existential threat to the intense and unbalanced relationship with Russia.

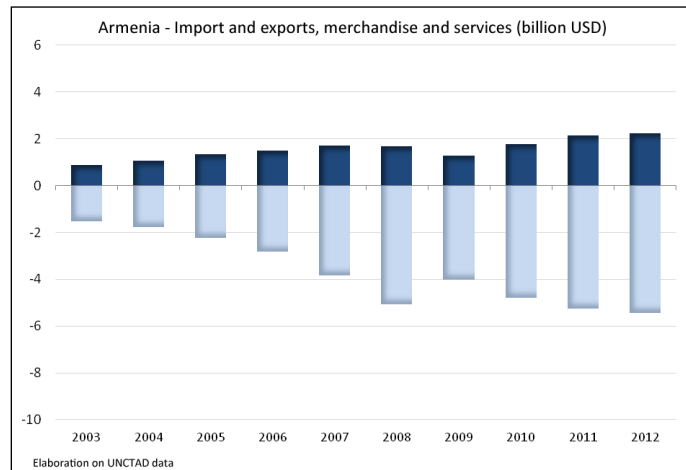


Figure 2

The next decade

Armenian politics showed a significant improvement in domestic stability in the aftermath of the 2013 elections and the political process is likely to show a high level of continuity in the next few years. Even if local and national protests will occur, opposition parties lack unity and leading figures which could pose a real challenge to the Sargsyan administration. Nevertheless, new challenges might arise in 2018, when Sargsyan will not be allowed to run for another term, given the current presidential electoral law. Transition could trigger instability, especially if the economic situation will remain fragile.

Relative stability is very likely to be the main trend in foreign policy, as well. The relationship with Russia has a very long term and strategic nature, based on history and geography. Indeed, economic and political interests in several domains are aligned, creating a strong incentive to tighten the cooperation at decision-making level. Actually, any foreseeable internal change is unlikely to significantly affect Armenian-Russian relations.

On the contrary, Yerevan is likely to increase its cooperation with Moscow, in particular in security issues, on a bilateral and multilateral level. Indeed, ongoing instability in the Greater Middle East area will increase the importance of the Russian presence in Armenia, both for Moscow – which can enjoy proximity – and Yerevan – which can enjoy protection. The outcome would be a further increase in the unbalanced nature of the relationship between the two countries.

Russian presence will also inevitably influence the single most relevant political and security issue for Armenia: Nagorno-Karabakh. As long as Russia will support the status quo, the situation will remain in a stalemate (see Chapter 5).

The lack of an agreed solution on Nagorno-Karabakh will continue to affect Armenia's economic development: relative isolation will hamper a diversification of trade and foreign investments, reinforcing ties with Russia and exposing Armenian economy to the risk of a dramatic crisis in the case of downturn of the Russian economy. Apart the continuing support from the diaspora in the West, the only significant source of diversification will be Georgia, but the small scale of its economy will limit its potential impact.

3. Azerbaijan

Azerbaijan experienced a decade of intense growth and development, achieving the best economic condition in the region. The main pillar of

the Azerbaijani remarkable performance has been the expansion of its energy sector, which drove the whole economy. A major breakthrough was the commissioning in 2006 of two new exporting pipelines.

The economic performance fostered the consolidation of Azerbaijan as an independent state and allowed a steep rise in government spending, which increased fourfold between 2006 and 2012. In the security and foreign policy domains, the main issue remained the stalemate in the situation on Nagorno-Karabakh.

Security issues

During the past decade – as in the previous one – Azerbaijani main security concern was the occupation of the South-western part of its territory by Armenia. Along with a complex regional context, this situation spurred an increasing attention to military and security spending. Since 2003, economic growth allowed a steady increase in Azerbaijani military procurement. Cumulated expenditure for the past decade exceeded 15 billion dollars. The increase was so relevant that since 2011 Azerbaijani military spending outpaced Armenian total government expenditure.

Despite such a massive military build-up, the situation stalled. As already noted, a powerful balancing factor was the Russian support for Armenia and the status quo. In particular, Russian military presence in Armenia deterred any unilateral action by Azerbaijan, despite potential capabilities. Inevitably, this situation created a complicated relation between Baku and Moscow. Indeed, as evident in the case of 2008 war between Georgia and Russia, Moscow was determined to use its troops in order to tilt the balance on the ground according to its vision of the post Soviet space.

Baku carefully avoided any direct confrontation with Russia, but it made several moves which aimed at reducing Russian presence in the Southern Caucasus. The most relevant was pushing Russia to abandon Gabala radar station. The early warning station was built in 1985 and its Daryal-type radar was part of the ballistic missile defence system which covered the southern flank of Russia. The station allowed Russian military to detect and track missile launches from the Greater Middle East region and the Indian Ocean.

In 1992, Russia and Azerbaijan reached an agreement allowing Russia to lease Gabala station until 2002. The agreement was extended for another decade downgrading the station to "Informative Analytic Centre", until December 2012. Moscow and Baku had been in talks about prolonging the lease on Gabala until 2025 for more than a year,

but they failed to reach a further agreement on the rental cost and operative conditions, leading to the expiration of the contract and the withdrawal of all Russian personnel.

Russian exit from Azerbaijan had a relatively low strategic impact for the Russian defence system, which replaced Gabala radar with other stations. Nonetheless, Russian pull-out had a strong political and symbolic value, since Azerbaijan became the only Caucasian country from where Russia completely withdrew.

Azerbaijan's security concerns also included its southern neighbour, Iran. The Islamic Republic tried to influence Azerbaijan supporting religious and political groups (namely, the Islamic Party of Azerbaijan), but Azerbaijani security services cooperated with several international partners in order to limit this threat.

Azerbaijan also actively cooperated at international level with Western countries, especially through NATO. Unlike Georgia, full membership was not a target for Azerbaijan and national security concept did not contain any provision on it. Nonetheless, cooperation with NATO was an important part in the improvement of the military capabilities and standards of the Azerbaijani forces. Therefore, Azerbaijan signed an *Individual Partnership Action Plan* (IPAP) with NATO and undertook several activities with Western partners. Within this framework, Azerbaijani troops took also part into KFOR mission (Kosovo) between 1997 and 2008.

Since Baku could not balance Russian or Iranian weight by its own means, it also started a strong cooperation with Ankara. Azerbaijan and Turkey signed an *Agreement on Strategic Partnership and Mutual Assistance* in August 2010, which stated that the two countries would support each other "using all possibilities" in the case of a military aggression. Despite a full-fledged conflict would be an unlikely event, the agreement gave an important signal to the other regional players.

Another relevant partner for Baku in the security domain was Israel. Azerbaijan was a main oil supplier for Israel, which in turn provided high-technology weapon systems. In 2010, a deal worth 1,6 billion dollars for drones, anti-aircraft and anti-missile systems was signed. The access to last generation weapon systems strengthened Azerbaijani independent stance and its ability to maintain a credible military deterrent. At the same time, Baku carefully avoided to push too far its ties with Tel Aviv, in order to keep a balanced position vis-à-vis every actor in the region.

Political situation

Azerbaijani internal political development was marked by a consistent stability in the last years, underpinned by a flourishing economy. Nonetheless, the decade was opened by a potentially destabilising situation: a major power transition.

Indeed, after leading the country for a decade, Heydar Aliyev could not run the October 2003 elections, due to health problems. During the previous decade, president Aliyev managed to stabilize the country, which after the independence and the first post-Soviet popular election had struggled to maintain internal order under President Abulfaz Elchibey. Aliyev intervened in order to halt political chaos and he overwhelmingly won 1993 presidential election. Then he started a process of state-building and power concentration which stabilized the political system. The process progressively expanded the role of presidency as the fulcrum of the political system, and with it the role of the *New Azerbaijan Party*, while de facto reducing the importance of minor parties and their spaces. In its importance of the presidential role, Azerbaijani political system developed following a pattern which was common to other post-Soviet republics.

In October 2003, acting President Ilham Aliyev stood for the presidential elections as the candidate of the incumbent New Azerbaijan Party, winning with a large majority over the opposition leader, Isa Gambar. The election of the new president occurred without major episodes of violence and the opposition failed to stage a unitary strategy.

Aliyev and his New Azerbaijan Party won every following elections: 2008 presidential election, 2005 and 2010 parliamentary elections.

Oppositions continued to stage protests denouncing frauds and accusing media of unfair coverage, but without causing major accidents.

Marginalisation of the opposition parties in the political process continued, and they remained highly fragmented and also tended to compete among each other. In particular, opposition parties accuse the government of limiting political freedom, but failed to organise an effective political action and to pose any real challenge to the New Azerbaijan Party rule. In 2013 Presidential election, opposition candidate Rustam Ibrahimbayov has been unable to run due to its dual (Russia-Azerbaijani) citizenship, but – the backup candidacy of Camil Hasanli – he had no chances of winning the poll.

In the Azerbaijani political system, decision making is concentrated in the presidency, allowing to the administration in office a great latitude of action. President Ilham Aliyev used his power in order to continue the

economic and political strategy of his predecessor: attracting foreign investments (especially in the energy sector), curtailing the influence of key regional players in the Azerbaijani political process, and pursuing a solution to the Nagorno-Karabakh issue.

The economy was a relatively uncontested topic in the political debate, due to extraordinary growth boosted by the energy sector. Indeed, during the last decade the most debated domestic political issue remained Nagorno-Karabakh situation and its consequences. Out of a population of nine million people, Azerbaijani internally displaced persons and refugees were approximately one million. In spite of huge public spending and numerous state programs for improving life conditions of refugees and IDPs, the situation represented an important social problem.

Nagorno-Karabakh issue also dominated Azerbaijani foreign policy, but despite its efforts, Baku's diplomacy could not achieve any major result. Multilateral negotiation failed to single out a solution or to create the condition for an improvement of the bilateral relationship between Azerbaijan and Armenia.

Despite its relative strengths, Azerbaijan could not linger on a confrontational position against any of the major regional players, while looking for a negotiated solution for the Nagorno-Karabakh issue. As a consequence, the balancing strategy which dominated Baku's security policy also shaped its political relations with the key regional players. Moreover, Baku's short- and mid-term priority was granting the integrity and viability of its energy production and transport infrastructures. Indeed, considering the relevance of the oil and gas exports for the economic development and the government budget, any disruption could cause major damages to Azerbaijan. Therefore, avoiding any confrontation represented per se a strategic goal in Baku's foreign policy.

Azerbaijani-Russian relationship was the most controversial for Baku. Russia was the most important supporter of the status quo in Nagorno-Karabakh but, at the same time, was also an unavoidable partner for every state in the post-Soviet space. Azerbaijan succeeded in keeping a balanced stance, even finding a common ground for significant cooperation, as in the case of Russian military supplies (over 700 million dollars in the last two years), in the case of the 2009 agreement for the northbound natural gas exports and – since the August 2013 agreement – in the case of the cooperation agreement between the national oil companies, SOCAR and Rosneft.

Russia was also involved in the stalemate over the legal status of the Caspian. During the last decade, Azerbaijani foreign policy aimed at finding a common legal framework between the littoral states. A solution could allow an uncontroversial exploitation of the hydrocarbons under the seabed in the contested areas, as well as the realisation of a pipeline linking Eastern and Western shores, fostering cooperation between Azerbaijan, Kazakhstan and Turkmenistan. Since Iranian and Russian sides would not particularly benefit from a solution, no significant progress was made during the past decade.

In order to balance Russia, Baku actively pursued a growing cooperation on a bilateral and multilateral basis with Western countries, even if Azerbaijan had no plan of immediately reaching a full membership in Western organisations, such as NATO and EU. The main pillar of this cooperation was made up by energy projects: expanding the involvement of the international oil companies, Azerbaijan also deepened its ties with their governments. The construction and commissioning of two big pipelines and new multi-billion dollars investments in exploration and production capacity gave to this relationship a long term perspective, strengthening the position of the independent Azerbaijan.

Moreover, all westbound projects involved a growing cooperation with Turkey, which during the last decade confirmed its special role in the Azerbaijan international action. Cultural ties and geographical factors favoured cooperation between the two countries. For example, SOCAR planned industrial investments, among which Petkim complex, which will make it the single greatest foreign investors in Turkey.

Furthermore, despite a short-lived rapprochement between Ankara and Yerevan in 2009, Turkey openly and consistently supported Azerbaijani in its stance on the issue of Nagorno-Karabakh. More generally, Ankara represented the single most important political partner for Azerbaijan, confirming a well established trend.

Economic performance

Azerbaijani economy had an extraordinary performance during the past decade, experiencing a compound annual growth rate of 12,2%, twice the level of the other Caucasian economies. As a consequence, between 2003 and 2012 per capita GDP grew from 880 to 7.450 dollars, i.e. from the lowest to the highest ranking in the Southern Caucasus. At the same time, unemployment dropped from 10 to 6%.

Energy exports were the key of Azerbaijan's success. During the past decade, new production capacity came on stream, while international oil prices reached historically high levels. The combined effect was a surge in

export revenues and a switch from a trade balance deficit of 2 billion dollars in 2003 to massive trade balance surplus of 20 billion dollars in 2012.

Such a performance was possible due to two energy transport projects which were commissioned in 2006: Baku-Tbilisi-Ceyhan oil pipeline (BTC) and Baku-Tbilisi-Erzurum gas pipeline (BTE). BTC was built in order to transport crude oil – mainly from the Azeri-Chirag-Guneshli offshore field in the Caspian – to the Mediterranean Turkish terminal of Ceyhan. The pipeline had a length of 1.768 km and a capacity of 1 million barrels per day, virtually enough for the transit of the whole current Azerbaijani exporting demand, making it the single most important infrastructure in the whole region.

BTE was a 692 km pipeline linking the Shah Deniz offshore field in the Caspian to the Georgian and Turkish markets, with a actual capacity of 7 billion cubic metres of gas per year (upgradable to 16). While the construction of BTC allowed the massive export increase experienced by Azerbaijan (from 200 to 800 thousand barrels per day) which boosted the economy, BTE created a more political link between Azerbaijan and its neighbours, offering a reliable alternative to Russian natural gas supplies.

Oil and gas made up for the bulk of this export surge (more than 90% of the commodity exports), with food and other agricultural commodities playing a residual role. Between 2003 and 2012, imports were instead more diversified, including manufactured goods (22%), chemicals (10%), food and live animals (10%). Azerbaijan's main trading partners was the EU (47%), and especially Italy (18%). Other relevant partners were India, US, Russia and Turkey (all above 5%). Considering that Iran and Georgia were also among its relevant trading partners,

Azerbaijan avoided isolating any of its larger neighbours and showed a balanced attitude also in its trade policy. Azerbaijani trade potential could have been even higher: unlike other Caucasian countries, Azerbaijan was not a WTO member. Accession talks were underway, even if at a slow pace.

Azerbaijani growth was possible also because the economy received substantial foreign investments: a net flow of 7,7 billion dollars, mainly

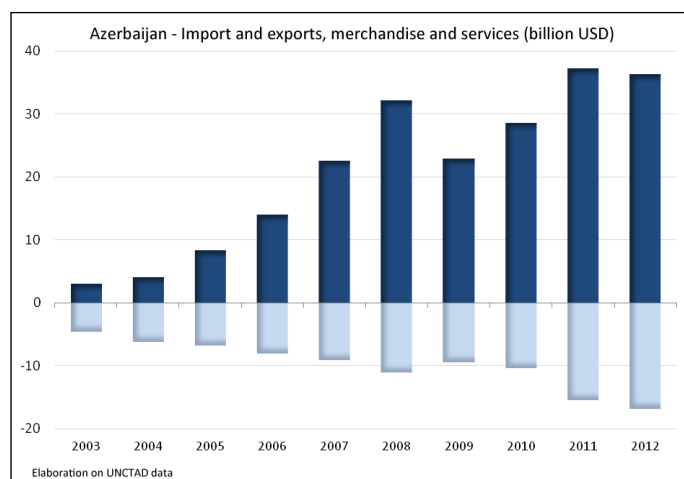


Figure 3

directed to the energy and the construction sectors. The main sources of FDI were Turkey, US, UK and Netherlands.

Remittances were another relevant source of capital: 11,2 billion dollars between 2003 and 2012, mainly coming from Azerbaijanis living or working in Russia. However, due to the size of the Azerbaijani economy, the share of GDP made up by remittances was the lowest (3,1%) in the Caucasian region.

The next decade

Azerbaijani political system experienced the highest level of stability during the past decade, which is likely to continue during the next decade. The main challenges to the Azerbaijani leadership will come from the economy: diversification will need be the main driver of the political economy for years, in order to reduce the share of GDP represented by the energy sector (currently, 45%).

Reducing reliance on energy while keeping a double-digit growth will be a major challenge, also because oil production is unlikely to increase beyond 2010 record level. Another potential risk will come from low oil price, but there is little or no sign of such an occurrence at the moment. Therefore Azerbaijan is likely to enjoy a comfortable – even if shrinking – trade surplus for the years to come, which will buy time for economic reforms and diversification.

Moreover, new investments in the energy sector will led to a significant increase in the export of natural gas. By 2019, new infrastructures will bring the production of the Caspian fields to the EU markets. Namely, the combination of the upgrade of the South Caucasus Pipeline (through Azerbaijan and Georgia), the construction of the Trans Anatolian Pipeline (through Turkey) and the construction of the Trans Adriatic Pipeline (through Greece, Albania and Italy) will allow to bring up to 10 billion cubic metres per years on the Western European markets, strengthening the relation between Baku and its European partners. Azerbaijani security concerns will be more difficult to tackle. A diplomatic solution of the Nagorno-Karabakh issue which could satisfy all major actors doesn't seem to be possible under the current situation. Russian backing to the Armenian side deters all the parties from a unilateral action, but at the same time it seems to hamper any major progress towards a quick negotiated solution between the parties.

4. Georgia

The last decade was particularly dynamic for Georgia. It was opened by

a political revolution, then continued with a war with Russia, and eventually closed with a meaningful political transition. The overall balance is mixed: the economy grew and consolidated, as the political system. However, at the same time, two regions actually broke up their ties with Tbilisi, with little or no prospect of a reversal in the foreseeable future.

Security issues

Since the collapse of the Soviet Union, Georgian security context was dominated by the issue of its breakaway regions, Abkhazia and South Ossetia. Tbilisi continuously tried to re-establish its rule over the two regions, which legally remained under its authority.

The situation dramatically deteriorated in August 2008, with a five-day war with Russia over South Ossetia. After weeks of low intensity skirmishes around Tskhinvali, Georgian troops shelled Ossetian rebels and tried to gain back control of the town. Moscow promptly reacted, supporting the breakaway region and sending its troops to support Russian peacekeepers deployed in the area since 1992. Russian military operation was carefully planned and executed and Georgian forces – partially deployed in Iraq – were quickly defeated.

After securing control of South Ossetia, Russian forces extended their offensive outside the northern region, arriving 65 km from Tbilisi before stopping and forcing Georgian troops to systematically retreat. In the meantime, Russian forces also secured full control of the other Georgian breakaway region, Abkhazia, where a second front was opened against Georgian army.

The outcome of the 2008 war was a de facto independence of South Ossetia and Abkhazia. Both were recognised as sovereign states by Russia, Venezuela and Nicaragua. A small minority in the international community, but enough to give some political legitimacy to the Kremlin. Russia also created permanent military bases in South Ossetia and Abkhazia and stationed 1.500 troops in each region, in order to dissuade Tbilisi from trying a military offensive.

Russian upgraded military presence created a very tough security environment in Georgia. Indeed, Russia showed an impressive effectiveness in projecting military power in the region, questioning the real scope of the autonomy of Georgia.

Georgian leadership adopted a strong pro-Western balancing strategy. Indeed, the main strategic goal during the last decade was a progressive integration within NATO. From a geopolitical perspective, Eastern expansion of the alliance could have represented a strong guarantee to

Georgian autonomy, providing an effective and long term balance to Russia influence in the region.

However, Western countries failed to give any military support to Georgia during the war, highlighting the lack of real commitment to the security of the country. Indeed, since August 2008 war, any hypothesis of balancing Russia with a stronger Western involvement in Georgian security appeared to be unrealistic, as a full membership in the alliance.

Political situation

The decade between 2003 and 2013 coincided with the political parable of Mikheil Saakashvili, who led the Revolution of the Roses, then becoming president for two terms. The revolution started in November 2003, when Parties that supported then-President Eduard Shevardnadze (*For a New Georgia Party* and *Democratic Union for Revival*) won the most seats the parliamentary elections, but the *United National Movement* and its leader, Saakashvili, denounced frauds and vote rigging. Rallies and protests spread through Georgia, forcing Shevardnadze to resign. New presidential elections were held on January 2004, and Saakashvili won with 96% of the vote.

Under Saakashvili first term, political situation in Georgia was stable, allowing several important achievements. Indeed, the new president pushed for several key reforms, under a liberal and market oriented agenda, which contributed to the good economic performance of Georgia up to 2008. Saakashvili administration also distinguished for public security and anti-corruption improvements.

The *United National Movement* won several local and national elections against a fragmented opposition, including the re-election of Saakashvili for a second term in January 2008. During his period in full charge, Saakashvili adopted a hawkish position towards the breakaway regions, in order to draw domestic support. However, his stance eventually led to the escalation of 2008.

In foreign policy, Saakashvili's decade was marked by a strongly pro-Western foreign policy, openly aiming at a full membership in the NATO and the EU. Georgian troops took part in Iraqi and Afghanistan NATO operations, extensively training with US and Turkish troops. Moreover, Georgia began an intense process of adaptation to the EU legislation.

This stance directly collided with Moscow, which opposed any Western penetration in the post Soviet space and in 2006 started blocking Georgian food and beverage exports. Pro-Western economic and foreign policy attracted political support against Russia and direct investments

in the country.

However, when the conflict with Russia began, Western support for Tbilisi became essentially formal. Thus, the global dimension of the Russian operations in Georgia became evident: Western expansion was weak and unconvincing and Moscow muscular reaction clearly exposed the situation.

The defeat in the August 2008 war with Russia and the incoming consequences of the financial crisis eroded Saakashvili's support. During the following years, opposition became more assertive and eventually unified around *Georgian Dream* movement and its leader, Bidzina Ivanishvili, a billionaire tycoon. *Georgian Dream* won October 2012 parliamentary elections and Ivanishvili became prime minister, starting a co-habitation with Saakashvili. Despite Ivanishvili position appeared to be less confrontational with Russia, this rebalance did not stop Western ambitions of Georgia, but placed it into a more realist context.

Economic performance

Georgia's economy experienced a steady growth during the last decade, averaging a compound annual growth rate of 6,1%. Between 2003 and 2012, per capita GDP grew from 919 to 3.543 dollars. Georgian good performance was partially hampered by the consequences of the conflict, combined with the international financial crisis, in 2008-2009.

Consistently high unemployment (above 12%) represented the other main economic problem of the country during the past decade.

Nonetheless, Georgia's dynamic economy benefited from an extensive privatisation and liberalisation process, which attracted substantial FDIs. Between 2003 and 2012, direct investments in Georgia amounted to 12,8 billion dollars, the highest level in the Caucasus. Banking, finance, energy and transport infrastructures were the sectors where international capitals concentrated.

The most important investors in Georgia were Western companies, mainly from UK, US and Netherlands. They mainly concentrated in the energy sector, but also interested other relevant sectors. Among the neighbouring countries, the most active was Turkey, especially from mid-2000s. Turkish companies were interested both in domestic final markets (telecommunications, constructions) and in production capacity for export (mainly in the bordering region of Ajaria).

Another relevant source of capitals was Azerbaijan. In particular, SOCAR invested in gas stations and natural gas distribution networks, exploiting its favourable position of supplier.

Georgia's economy also received consistent cash flow as remittances.

Between 2003 and 2012, approximately 6,5 billion dollars flowed in the country, making up more 6,6% of the GDP. More than half of the money came from Georgian working or living in the Russian Federation. Georgia had a small industrial base, and its economy was heavily dependent on agriculture and services. Opening to international trade was another key future of Georgian economy, and during the past decade it experienced a constantly growing trade deficit, despite its growing export.

Georgian main comparative advantage was geography, for two reasons. Firstly, its climate traditionally allows high quality grocery and beverages production, mainly exported within the former Soviet space. Food and beverages accounted for one fifth of the total: the relevance of those exports appeared particularly evident in 2006, when Russia – Georgia's traditional main market – stopped its imports of wine, mineral water and agricultural products as a retaliation against Tbilisi's Western-oriented policies. In the following years, exports found other markets outside Russia, but in the short term the damage was considerable.

The second geographical advantage of Georgia was its location as an inevitable trade route for Azerbaijan and Armenia. Indeed, imports directed to the other Caucasian countries transited through Georgian harbours, roads and railways. Even more importantly, Georgia was the main (and almost only) export route for Azerbaijani oil and gas directed to the international markets. Tbilisi happened to be a key point in the steel link between Azerbaijan and its Western partners. Baku-Tbilisi-Ceyhan oil pipeline and Baku-Tbilisi-Erzurum gas pipeline became operative in 2006, both transiting across Georgia for several hundred kilometres. Consequently, Georgian economy benefited from transit fees and from discounted energy supplies. Nevertheless, even if discounted, energy represented the main Georgian import during the last decade. Other main imports were manufactured goods, food and chemicals.

Georgia's main trading partners were European Union (27%), Turkey (14%) and Azerbaijan (12%). Other significant partners were Ukraine,

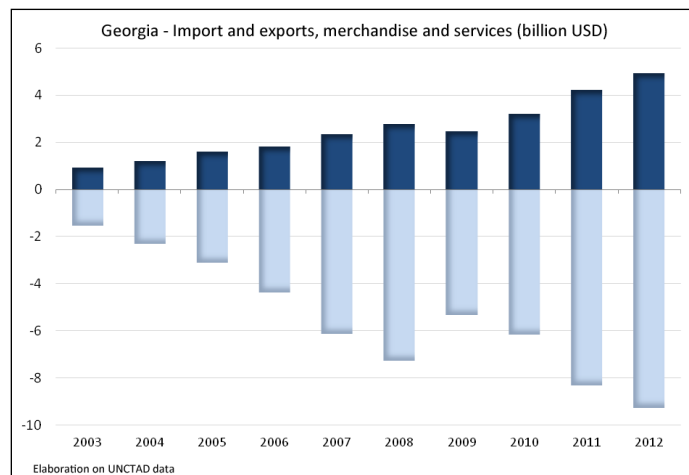


Figure 4

China and Russian Federation (5% each).

The next decade

Despite alleged pro-Russian orientation, prime minister Bidzina Ivanishvili seems to keep a pragmatically Western-oriented foreign policy, while trying to mend relations with Moscow. Next presidential elections are due in October 2013. Saakashvili cannot legally run for a third term and *Georgian Dream's* candidate (Giorgi Margvelashvili) is likely to become the new president. However, due to several constitutional amendments, prime minister will be the centre of the political system, relegating the presidency to a largely symbolic function. The key issues which will dominate the next decade are bound to be the status of the breakaway regions and the extent of Russian involvement in Georgian politics. Moscow is unlikely to withdraw its support to the Abkhazian and South Ossetian self-proclaimed states, therefore leading to an entrenchment of the status quo. Conflict has been an endemic condition for more than twenty years and no quick solution is likely to come, especially without Russian cooperation. Therefore, a positive relationship at political and economic level with Moscow is strategically inevitable. Thus, the leading objective for Tbilisi is curtailing Russian leverage on the domestic political process and keeping the breakaway regions isolated within the international community, while avoiding any direct confrontation with Moscow. Such a balance is the precondition for continuing internal reforms, fostering economic growth and attracting foreign investments.

Despite internal rhetoric, Georgia's full membership in Western organisations is at the moment an unlikely prospect. Nonetheless, cooperation with Western countries will be necessary in order to get political support and to create the right environment for direct investments.

Turkey and Azerbaijan are bound to play a major role in Georgian future. Shared energy and transport infrastructures and current investment stocks in Georgia provide a common interest in the long run, which is likely to lead to an improvement of the economic and political relations between Georgia and its neighbours, in the East as in the West.

5. Ten years ahead

The coming decade has a big potential for the Southern Caucasus. Caspian energy resources need to flow towards international customers,

while many investments are going in the direction of enhancing the role of the region as a transit hub in the East-West direction. The single most important regional infrastructure will probably be the Baku-Tbilisi-Kars railway, which is due to be completed in 2014 and which will connect Azerbaijan, Georgia and Turkey. Other energy, transport and ICT infrastructures are currently under construction, improving in perspective the economic potential of the region.

International trade also need a stronger legal and political framework in order to benefit the countries involved. A first step should be reached in November 2013, when Armenia and Georgia are expected sign two separate *Deep and Comprehensive Free Trade Areas* (DCFTA) agreements with the EU, with the aim of reaching an *Association Agreement*. DCFTA will cover trade in goods and will ease trade between EU and non-EU partners, eliminating custom duties and improving custom procedures. However, Armenian signature is strongly questioned (and increasingly unlikely), since Yerevan announced in September its will to join Russia-sponsored *Eurasian Custom Union*, which is a completely alternative framework to the EU.

In the meantime, with Azerbaijan the EU is negotiating a non-preferential trade and investment agreement, as Azerbaijan is not yet a member of the WTO. Joining WTO and signing a DCFTA would represent major improvements in the process of opening the Azerbaijani economy to the world trade, beyond its energy exports.

More growth and a more efficient trade system will not protect Southern Caucasian economies from the major risk of a global economic slowdown. Such an occurrence – currently unlikely – would deeply affect the economies of the region, with negative consequences on the domestic political processes.

Nonetheless, the outlook for the Caucasian economies remains positive, forecasting a steady growth in the next year. Economic development will also have a potentially huge impact on living standards, since GDP is expected to expand much more than population (see Fig. 5).

From the domestic politics perspective, the outlook for the next decade is mixed. In Azerbaijan, 2013 presidential elections, with the expected victory of the incumbent

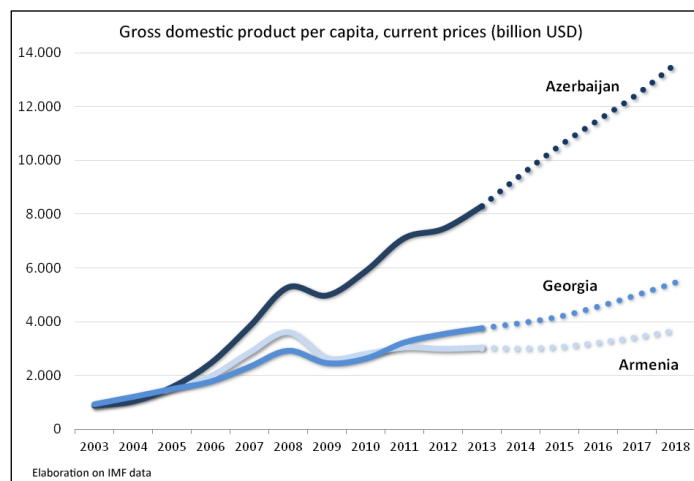


Figure 5

President Ilham Aliyev, will confirm the overall stability of the political system, which is bound to continue during the current decade, providing a positive environment for investments.

In the same period, Georgian elections are expected to mark the end of the power shift from Saakashvili to Ivanishvili. The outcome is likely to be a period of internal stability, even if continuing pro-market reforms and dealing with the consequences of the 2008 conflicts will be challenging.

Eventually, the most uncertain situation will be to be the evolution of the Armenian political system. President Sargsyan will need to confront with the weaknesses of the economy (especially its narrow export base) and with the political consequences of the Armenian involvement in the Nagorno-Karabakh issue. The situation is challenging and the Armenian political system will be tested.

However, the single most relevant risk for Southern Caucasus is a worsening of the security situation in the breakaway regions. While Baku and Tbilisi are currently forced by Russia to hold on, a weakening of the Russian position could push all the actors involved to more assertive behaviours, triggering new high-intensity conflicts.

Also a significant strengthening of Russian position could entail significant risks, since it would create a tension between the will of Moscow of promoting its interests in the near abroad area and the will of the Caucasian states of preserving part of their autonomy. On a wider scale, a worsening of the security context in the bordering Greater Middle East area could undermine stability in South Caucasus as well. Currently, there are little signs of such a scenario, but its impact would be extremely negative. Only a growing international cooperation could help Caucasian countries to effectively curtail those security challenges. In conclusion, despite some risks, the coming decade will present an opportunity to further consolidate internal political stability and economic growth within Southern Caucasian countries, exploiting their geographical position and the direct investments which several key international partners are planning to make.