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SOUTH CAUCASUS 2008-2013

ECONOMIC AND POLITICAL DEVELOPMENTS IN AZERBAIJAN,
GEORGIA AND ARMENIA

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Introduction

According to the Greek mythology Prometheus was a Titan who defied the will of gods by giving fire to humans, and consequently was severely punished by Zeus. The punishment for the transgression included chaining Prometheus to the peak of Mount Caucasus where the giant Caucasian Eagle ate the liver of the disobedient immortal Titan. Prometheus was exposed to perpetual torment as his liver would grow back each time it was pecked out. This lasted for thirty years until Heracles found him and set him free while bringing down the eagle with an arrow. The myth is a good illustration of contemporary history of the South Caucasus. The region that consists of three Caucasian states – Azerbaijan, Georgia and Armenia – was and to this day remains in the crossroads of great powers and great historical events. At least in the case of Azerbaijan it is also gifted with valuable and strategically important natural resources – oil and gas.

All three countries differ in their culture, language and history as well as their economic paths, domestic and foreign policies. The same is also true concerning the geopolitical situation that Azerbaijan, Georgia and Armenia find themselves in. In addition external political actors see each of the South Caucasian states in different light. Hence is it possible to think about the South Caucasus as homogeneous region? Is it fruitful to make comparisons between the three seemingly disparate neighbours?

Geography is not the only common feature that enables one to speak of the South Caucasus. All three countries share in the common Soviet history and encounter similar dilemmas as they cope with historic rights and wrongs to ensure economic growth, social development and national security. Today South Caucasus is a home to several complicated territorial conflicts. The Nagorno-Karabakh conflict between Azerbaijan and Armenia, Georgia-South Ossetia and Georgia-Abkhazia disputes (as well as the complex interests of the third parties involved) shape the political and economic landscape in South Caucasus. Thus the word 'geopolitics' here reverberates a lot louder than elsewhere.

Over the past few years the South Caucasian states had to cope with diverse

challenges. While Armenia felt the worst of the global financial crisis, Azerbaijan not only absorbed the economic shock unscathed, but also heavily invested abroad. Georgia, still bleeding after losing two takeaway regions, has seen the government change. And all three found themselves in the middle of colliding interests of regional and world powers. In this context, the report will analyse the latest economic and political developments in the region to properly evaluate how far and toward what direction each country of the South Caucasus have gone and will likely go in the near future.

Economic performance of the South Caucasus in 2009-2013

Georgia: a Double Tide Crisis

After the 2003 Rose Revolution in Georgia various anticorruption measures were carried out by the new government. The government chose to turn its country toward the neoliberal open-market path. This resulted in double-digit rapid economic growth which afterwards turned out to be hardly sustainable.

2008 was rather a nightmarish year for the Georgian economy and financial sector. The effects of the August War, combined with the hurricane of global financial crisis, swept away the much needed foreign direct investment (FDI) and drastically reduced consumer confidence. In 2009 the Georgian GDP fell by 3.9 percent. Foreign direct investment was replaced by foreign loans to help overcome the post-war situation. Georgia received 1 billion USD from the United States and 4.5 billion USD was handed out by the Donor Conference in Brussels. This expanded the economy by roughly 4 percent.¹ It is a great paradox that the post-war aid has actually helped Georgia to overcome the effects of financial crisis faster than it would have done so without the war.

Until the mid of 2008 the FDI was the main driving force behind Georgia's growth, whereas with the beginning of 2009 this role was already taken over by the government spending. This created an unusual situation when small liberal economy was almost solely dependent on public infrastructural projects. Spending was further increased in 2010 as the government launched additional stimulus package to fund various welfare programs.

The extensive spending had a negative effect on the national budget, forming a considerable deficit that peaked to 9.2 percent in 2009 but was later brought down to 3 percent in 2012. This was mainly achieved by introducing new taxes and implementing fiscal consolidation measures. Current expenditures were reduced from 30 percent in

¹ Revaz Sakevarishvili, "Georgia: Continued Reverberations of the Crisis", Caucasus analytical digest, No. 18, 5 July 2010, p. 15

2009 to 23.3 percent in 2011. As there was a sharp drop in private and foreign direct investments, capital expenditures remained at the height of 9 percent of GDP in 2011.

Trying to save the economy of Georgia, the government proceeded with further fiscal consolidation. The Georgian government aimed at lowering budget deficit, cutting central government debt from 34.6 percent of GDP in 2009 to 32.5 percent in 2011.² According to the International Monetary Fund (IMF), current account deficit decreased from -21.9 percent of GDP in 2008 to -10.2 percent in 2010 but then disappointingly rose again to -12.7 percent in 2011. The IMF estimates that the current account deficit will drop to still pretty high -9.9 percent of GDP by the end of 2013.

Despite the 2012 election and spending increases in specific welfare programs, the Georgian government proved to be capable of pushing through the much needed fiscal consolidation. Since Georgia does not possess substantial natural resources, whereas loans or remittances cannot provide a foundation of sustainable economy, attracting the FDI was and remains the most important challenge for the government. As data from National Statistics Office of Georgia suggests, Georgia has not succeeded in reaching the pre-war level of FDI. In 2012 FDI in Georgia was 1.1 billion USD lower than in 2007.³

Not only in 2012 but also in 2007, with record FDI figures, the government failed to effectively channel foreign investments toward job creation. The official unemployment in 2012 was 15 percent (even though some experts claim the real number to be closer to 34 percent)⁴ – that is 1.7 percent higher than in 2007. Although on-going structural reforms, comparatively low level of corruption and business-friendly environment makes Georgia attractive to foreign investors, tense political situation after the 2012 parliamentary elections and two unresolved territorial conflicts create uncertainty about the prospects of economic stability in the country.

² World Bank

³ “Foreign Direct Investments”, http://www.geostat.ge/index.php?action=page&p_id=140&lang=eng

⁴ “Georgia and the Global Economic Crisis”, Foreign Policy Research Institute, May 2013, <http://www.fpri.org/research/transitions/recent-findings/georgia-global-econ-crisis>

Armenia: an Economy of Remittances and Debts

Following the global financial crisis, Armenia underwent one of the world's most severe economic declines. 2009, by far the worst year for the country in the last decade, was marked by the sudden 14 percent drop in GDP. The steep contraction was accompanied by decrease in remittances which make up disproportionately important part of the Armenian economy. And unlike in Georgia, Armenia, an isolated economy and a country with two closed borders, could not rely on FDI as the flow of foreign investments was too small and mostly came from Russia.

Remittances play a very significant role in Armenian economy as the country is among the 15 largest remittances recipients in the world. Currently they make up no less than 14 percent of Armenia's GDP. Since remittances mainly came to the country from the Armenian workers in Russia, the effects of the global financial crisis in Armenia was also strengthened by the Russian economic decline. Twice as large as FDI inflows and four times the size of government income, remittances plunged by 28 percent in 2009.⁵

Even though Armenia is a largely isolated state due to historically strained relations with Turkey and, more recently, to the occupation of Azerbaijan's Nagorno-Karabakh region and surrounding territories, it positions itself as an open economy. However, just as the recent examples of Georgia and the Baltic States show, small liberal economies are more prone to boom and bust cycles than others. This, combined with the drainage of remittances and FDI from Russia, as well as subsequent problems in the real estate sector, had a debilitating effect on Armenia.

The severity of the economic crisis in Armenia can also be ascribed to the balance and composition of import and export. The weak spot of Armenia's exports is that it mainly relies on commodities (metals and minerals). Therefore decline in commodity prices and demand sent additional shock-waves across the Armenian economy. For example, trade imbalances in 2009 resulted in the stunning 15.8 percent of GDP current account deficit. The deficit later contracted, but still remained at the height of 11.1 percent in 2012.

⁵ <http://www.imf.org/external/country/arm/rr/2012/062012.pdf>

As there were no stabilisation measures (stabilisation fund) prepared in advance, Armenia, taken unawares by the economic crisis, responded by drastically increasing public spending. Between 2001 and 2008 Armenia's fiscal deficit averaged between 0 and 2.5 percent and total public debt decreased from 46 percent to 16 percent of GDP accordingly.⁶ This trend changed drastically in 2009 when, fuelled by extensive borrowing, fiscal deficit of the country reached 7.7 percent of GDP. Nevertheless, the impact of crisis was not mitigated and the effect of extensive public spending did not bring intended positive results. After the unsuccessful stimulus, Armenia turned to fiscal consolidation by mobilising budget revenue and cutting public spending. This was partially successful as the budget deficit contracted to 1.5 percent in 2012.

Negative effects, on the other hand, became clearly visible as the public debt hiked from 16 percent in 2007 to 45 percent in 2012.⁷ The strategy of extensive borrowing and spending in order to stimulate the declining economy has nearly shut the doors of international lenders to Armenia. With Moody's negative Ba2 credit rating,⁸ the interest rates became drastically higher than they were before the crisis. The other debt problem rests with Armenia's debt profile itself. The country is extremely sensitive to national currency devaluation as nearly 90 percent of Armenia's debt is in foreign currency. If the central bank were to decide to devalue Armenia's dram, that would push up the debt-to-GDP ratio considerably.⁹ For this and previously mentioned reasons Armenia currently has very limited options for coping with the future economic downturns.

The background behind Armenia's deep economic abyss is more political than economic. A landlocked country with closed Turkish and Azerbaijani borders, Armenia is especially susceptible to Russian economic perturbations. Open economy needs open borders, not isolation. Had the circumstances been different, Armenia's neighbours (and this is especially true about Azerbaijan) could have provided more stable

⁶ "Fiscal Consolidation and Recovery in Armenia: Impact of the Global Crisis on a Small Open Economy", The World Bank, 2011, p. 1

⁷ "CIS frontier countries", Deutsche Bank Research, 16 July 2013, p. 7

⁸ The negative rating was changed to Ba2 stable in 20 August 2013

⁹ "Armenia: Averting an Economic Catastrophe", Policy Forum Armenia, February 2012, p. 7

foundations for the country's economy through FDI, transit, and flow of goods. This might not have prevented crisis, but its effects would certainly have been less severe and definitely shorter.

Azerbaijan: Growth in the Time of Decline

The impact of the global financial crisis on Azerbaijan, unlike on its neighbours or on Central and Eastern European countries, was rather limited and delayed. The country has not experienced a sharp drop in GDP and the living standards of the local population, even despite the problem of one million internally displaced persons and refugees, continued to improve significantly. The main reasons behind the economic growth in the time of global decline are Azerbaijan's vast hydrocarbon reserves and the state's prudent strategy of managing the petrodollar flows into the country.

During the last decade Azerbaijan maintained an impressive economic growth that averaged almost 14 percent annually. This is direct effect of what is known in Azerbaijan as the "Contract of the Century" – an agreement signed in 1994 between the state of Azerbaijan and the Western Oil Consortium of 13 oil companies. The Production Sharing Agreement that effectively opened Azerbaijan's oil reserves to the world transformed the country's economy beyond recognition.

While GDP nearly tripled from 1994 to 2000, in 2008 it was already thirty times bigger than the figure recorded in 1994.¹⁰ Hard currency flow into Azerbaijan's economy significantly increased since the completion of oil (Baku-Tbilisi-Ceyhan) and gas (Baku-Tbilisi-Erzurum) pipelines via Georgia to Turkey in 2005 and 2007 respectively. Prior to that, during the first half of the 2000s, Azerbaijan successfully attracted massive foreign investments, most of which were directed toward oil extraction infrastructure.

Oil export generated revenues created an impressive 22.4 percent of GDP average of current account balance during the period of 2005-2012. Huge hydrocarbon-driven trade surplus allowed Azerbaijan to pile up foreign currency reserves and foreign assets equal to no less than 65 percent of GDP.¹¹ It must be emphasized that all the revenues

¹⁰ The State Statistical Committee of the Republic of Azerbaijan

¹¹ "CIS frontier countries", *ibid.*, p. 9

in connection with hydrocarbon resources are flowing into a special purpose state organisation SOFAZ (State Oil Fund of Azerbaijan) which was established by the President of Azerbaijan Heydar Aliyev back in 1999.

There is understandable concern in Azerbaijan that uncontrolled inflow of hydrocarbon-related revenues can potentially overheat and harm the country's economy. Therefore SOFAZ is used as a macroeconomic management tool either to channel energy resource-generated revenues toward public spending or to accumulate it in a reserve fund. Public spending through SOFAZ is usually directed toward the biggest infrastructure projects. Thus the government of Azerbaijan is attempting gradually to stimulate the economy while improving the country's infrastructure. A part of the SOFAZ funds is also used to improve the living standards of internally displaced persons – a problem which persists because of the prolonged Armenian occupation of Azerbaijan's Nagorno-Karabakh region.

The rapid growth of the Azerbaijan's economy was successfully used by the government substantially to reduce the levels of poverty. Poverty in Azerbaijan dropped from 49 percent in 2001 to 6 percent in 2012. The other notable drop was observed in the level of income inequality. In 2010 income difference in cities and rural areas was becoming comparatively small, with GINI index showing 33 percent and 27 percent accordingly.¹²

Created using the best examples of state energy funds of Norway and the U.S., SOFAZ has become an active investor in foreign assets. As of 2012 the total value of the State Oil Fund investment portfolio reached 34 billion USD.¹³ Along with SOCAR, an Azerbaijani state oil company, SOFAZ became a provider of FDI in the neighbouring countries. Since one of the main objectives of SOFAZ is to provide a lasting macroeconomic stability, the fund is not allowed to invest in Azerbaijani assets.

¹² "The Inclusiveness of Azerbaijan's Growth", International Monetary Fund, 20 December 2011, p. 2

¹³ "Energy and Azerbaijan: History Strategy and Cooperation", Center for Strategic Studies, ed. Rovshan Ibrahimov, Baku, 2013, p. 46

Despite this fact, the external public debt of Azerbaijan increased by nearly 25 percent in 2011,¹⁴ yet thanks to the massive trade surplus, it was only around 10 percent of GDP in 2012. Even though the shock of global economic crisis during the period of 2008-12 was absorbed by oil-generated revenues (and by comparatively small financial sector), the biggest threat to Azerbaijan's economy still lies with the country's dependence on hydrocarbons exports.

Thus the topics of Dutch disease and overheating economy cannot be escaped when talking about the economy of Azerbaijan. Owing to the increase in public spending, the inflation rate peaked to double-digit figure by 2008.¹⁵ Because the global crisis triggered a decrease in oil consumption, Azerbaijan's budget in 2009 was short of more than 15 percent of planned revenues.¹⁶ Due to the influx of foreign currency manat appreciated against the USD by nearly 20 percent which in turn increased the demand for the national currency of Azerbaijan. That way local goods and services became less competitive with foreign products.¹⁷

The prospects of currency appreciation, diminishing competitiveness of the local goods and services, and decline in oil production leave Azerbaijan with no other option but to actively cultivate other fields of the economy. Albeit crude oil and natural gas make up to 90 percent of Azerbaijan's exports, sectors unrelated to energy resource exports already generate 52.7 percent of the country's GDP. Driven by the aim to expand non-energy sectors of the economy, Azerbaijan in 2010 adopted the state programme to advance the IT and communication sectors with an emphasis to the state's very own space program.¹⁸

¹⁴ "Azerbaijan intends to keep ratio of external debt to GDP at no more than 10 percent level", 6 November 2012, <http://en.trend.az/capital/business/2084498.html>

¹⁵ The IMF provides 20.8 percent of average prices increase

¹⁶ "Energy and Azerbaijan: History Strategy and Cooperation", *ibid.*, p. 49

¹⁷ "Splendid isolation? Azerbaijan's Economy Between Crisis Resistance and Debased Performance", *Caucasus Analytical Digest*, June 2009, p. 13

¹⁸ The first commercial communications satellite was already launched into the orbit this year, and two more are planned in the next two years. <http://www.bloomberg.com/news/2013-02-08/first-azeri-satellite-launched-two-more-planned-in-2015-2016.html>

Over the last years Azerbaijan was rapidly improving in terms of competitiveness. In the latest Global Competitiveness Report 2013-2014, published by the World Economic Forum (WEF), competitiveness of the country's economy is ranked 39th out of 144 states. According to the WEF, in terms of competitiveness Azerbaijan is the leading regional and CIS economy.¹⁹ This is corroborated by the IMF, which especially praises the recent growth in productivity of the country's labour force.²⁰

As Azerbaijan's President Ilham Aliyev is willing to achieve the goal of doubling the size of non-energy sector in the economy in the next decade, the government is working to transform the country into a regional hub of transit and services. The new Baku-Tbilisi-Kars railway, for example, is planned to connect Turkey, South Caucasus and Central Asia with European Rail.

To sum up, Azerbaijan is proceeding with cautious strategy to use oil revenue in boosting the non-oil economic activities. The share of GDP generated through other than energy resources grew gradually even during the global financial crisis. If this trend persists, it is more than plausible that – all thanks to the careful management of oil revenue – Azerbaijan will largely become a non-oil dependent modern economy by the end of this decade.

A Comparative Look at the South Caucasian Economies in 2008-2013

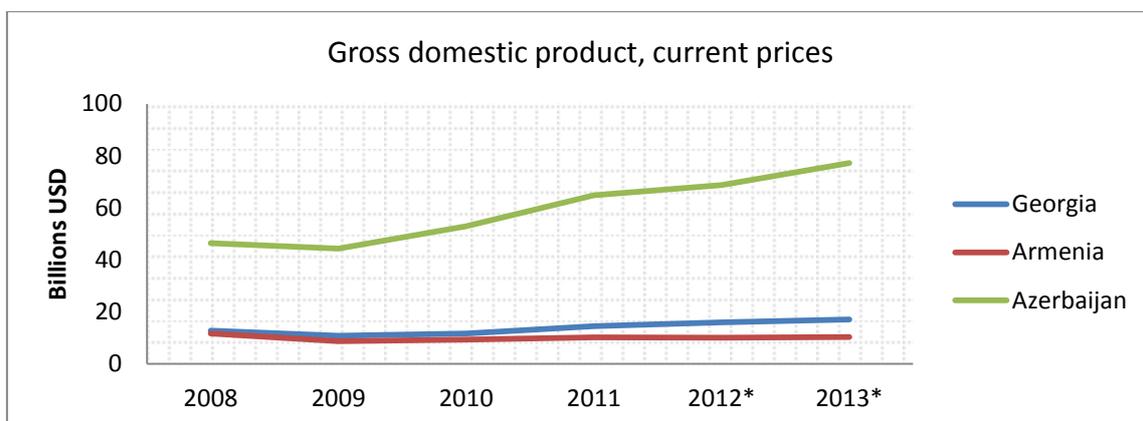


Figure 1. Source: the International Monetary Fund. * marks the IMF estimates.

¹⁹ Global Competitiveness Report 2013-2014, World Economic Forum, September 2013, p. 15

²⁰ "The Inclusiveness of Azerbaijan's Growth", *ibid.*, p. 3

There is no doubt that the key common feature of the 2008-13 period in South Caucasus was the global economic and financial crisis. The crisis had an impact on each of three countries. It was, however, very different in terms of severity, effects and response. As Georgia and Armenia had to borrow extensively from the international creditors to fill in the budget deficit gap, Azerbaijan could wait the difficult period out mostly by using its oil-generated revenues.

After the 2008 August War, Georgia had a difficult time coping with the tide of crisis. As a small open economy, Georgia was (and still is) very dependent on FDI, therefore it responded immediately with the “European style” fiscal consolidation measures while further proceeding with structural reforms. However, because of political instability, the level of FDI has not returned to the pre-war levels. The difficult situation was partially relieved by neighbouring Azerbaijan who provided cheap natural gas and whose national energy company SOCAR was the biggest taxpayer in Georgia during the crisis.

Armenia’s economy was mostly impacted through the crisis in Russia. The lower level of remittances and the global decline in commodity demand made Armenia’s economic contraction one of the worst in the world and definitely the worst among the South Caucasus states. Because of the on-going occupation of Nagorno-Karabakh, Armenia could not rely on economic benefits from neighbouring countries, especially from energy resources-rich Azerbaijan, as it was in the Georgian case. The strategy of the Armenian government to stimulate the crisis-hit economy with foreign credits was not only fruitless, but also created a huge (in terms of a developing economy) sovereign debt. This debt in turn pushed down the sovereign outlook of credit rating, which was only uplifted from negative to stable in August 2013. Even though the government managed to bring down the budget deficit, the economic situation nonetheless remains highly volatile due to Armenia’s isolation and dependence on commodities and remittances.

Compared to the other two South Caucasian neighbours, Azerbaijan stands out as a star economic performer. The global financial crisis had only a limited negative impact

on the Azerbaijani economy. Unlike the Georgian and Armenian cases, it stemmed from the decrease of global demand for crude oil. As there was no foreseeable need to cut drastically the public spending, cautious expansive financial policy was implemented by channelling part of oil revenues to infrastructure projects. Nevertheless, Azerbaijan managed to accumulate huge foreign assets reserve that prevents the country's economy from possible future shocks arising out of negative dynamics in crude oil demand. The biggest challenges for the government of Azerbaijan were and remain the prevention of overheating and the conversion of massive oil revenues into sustainable economic growth. With sustained levels of inflation and continued high oil prices, Azerbaijan is well prepared to lead the region economically in the foreseeable future.

Behind the Politics of South Caucasus in 2008-2013

South Caucasus is a region where seemingly clear boundaries between domestic and external vectors of politics usually overlap. Major and world powers pay close attention to the region because of its geopolitical significance. All three countries are located in a highly complex international environment. Because of this, they have no other choice but to manoeuvre taking into account the interests of the greater forces. Nevertheless as the last four years were politically intense, each country found its own way to cope with the external challenges.

Georgia: Growing Uncertainty

After the August War in 2008, Georgia's territorial issues with South Ossetia and Abkhazia become much more complicated than they were before. This left the country in unfavourable position in terms of its stated ambition to join the NATO and the European Union. Subsequent developments in the domestic political arena prior and after the parliamentary election in 2012 raised a number of questions about the position of the new Georgian government on this issue. As Georgia is set for Presidential elections this year, the country is moving towards unprecedented political shift not seen since 2003. This is being closely followed by the outside powers of which Russia is both one of the most interested and the most involved.

Since Russia officially recognized the independence of South Ossetia and Abkhazia, it became clear that the Georgian government cannot hope to solve both territorial disputes without Moscow's participation. Russia insisted that Georgia must officially renounce the military option for bringing back the two separatist regions. Moscow nevertheless did not follow its own suggestions of publicly guaranteeing that the conflicts will be resolved free of violence. Moreover, Russia did not pretend to hide its interest in both regions. By installing puppet regimes and stationing military units inside the territories of South Ossetia and Abkhazia, Moscow showed that both territories will forcefully exist as quasi-regions of mainland Russia.²¹

²¹ Stephen Blank, "Georgia's Precarious Security", *The Geopolitical Scene of the Caucasus. A Decade of Perspectives*, April 2013, Istanbul, p. 217

Continuing pressure applied by Moscow to Tbilisi in order to end Georgia's strategic alignment with the West de facto hides Russia's wish to undermine Georgian sovereignty. Thus it is not surprising that the Georgian government was unwilling to enter into serious negotiations with Russia. The stalemate between the two neighbours seriously undermined the security of all South Caucasus region. The frozen conflicts in South Ossetia and Abkhazia have created points of tension that decoy Moscow and Tbilisi into a new dangerous standoff.

Albeit Georgia aims to become a part of the Western economic and security structures, it already had a chance to learn that by mere waiting and hoping for "the West" to come it put itself in a dangerous situation. This is especially true after the U.S. presence started to wane in the region with G. W. Bush stepping down and the Barack Obama administration taking power in D.C. Since Mikheil Saakashvili's government felt the power vacuum left by the U.S., Tbilisi understood that Georgia had all but one mean to resist the Russian influence - i.e. working democratic institutions. Georgia could turn neither Azerbaijani nor Armenian way of dealing with the big neighbour. In Azerbaijan's case it lacked the leverage of energy resources, in Armenian case – the wish to at least partially sacrifice its sovereignty.

In 2010 the Georgian Parliament, dominated by Saakashvili's United National Movement (UNM) party, changed the Georgian Constitution. The essence of the changes was a transfer of most of the executive powers held by the President to the Prime Minister's institution. While in 2010 and even in the beginning of 2012 it looked as though the UNM will secure the governing position in the parliament, everything turned upside down with the majority of voters favouring a new political party called The Georgian Dream. While it seems that a mysterious video footage of prison rape was partially to blame for the UNM defeat, the elections and the first peaceful handover of power became symbols of established Georgian democracy.

In spite of smooth democratic transition, it did not take long for the new Bidzina Ivanishvili-led governing coalition to start political persecutions against its UNM opponents. What is more, representatives of the new government, including Ivanishvili,

on several cases made careful statements about the possibility to re-approach Russia.²² In fact, some contacts are already being established by gradually resuming trade, transport links and easing visa regimes. While this certainly sounds as a new trend, at least for now the new government does not back off from Georgia's commitments toward NATO and the EU integration.

Armenia: a Leap Backward

The present situation in Armenia has been defined by the series of historic events beginning with the earthquake of 1988, proceeding to the dissolution of the Soviet Union, the aggression against Azerbaijan and the occupation of Nagorno-Karabakh together with other surrounding Azerbaijani territories. Since the borders with Turkey and Azerbaijan remain sealed, Armenia traditionally relies on Russia. After the presidential election in February this year expectedly ended with Serzh Sargsyan's victory that effectively secured the second term for the candidate, the country is set to continue to live with no significant political changes.

Armenia states that it promotes complementary foreign policy. According to the Armenian foreign policy establishment, complementary policy means that foreign relations should be based upon cooperation and complementarity rather than on competition between different powers.²³ Such foreign policy aims at retaining regional balance and rejects the polarisation of geopolitical interests. Even though Yerevan positions itself as being open to cooperation with any country, facts show a completely different reality.

Despite the 2009 diplomatic talks between Turkey and Armenia about the opening of the border, there had been no final agreement on the preliminary steps to normalise the relations. The tensions with neighbouring Azerbaijan over the Armenian-occupied Nagorno-Karabakh remained high. Yerevan did not show its intentions to cede Azerbaijani territories or to initiate a peace settlement with its neighbour. Being a

²² Brian Whitmore, "Georgia's Changing Russia Policy", <http://www.rferl.org/content/georgia-russia-foreign-policy-ivanishvili-saakashvili/24971738.html>

²³ Donatas Vainalavičius, "Diplomatijos vaidmuo ir saugomo politikos sprendimai Pietų Kaukazo regione", *Daktaro disertacija, Vytauto Didžiojo universitetas, Kaunas, 2008*, p. 58

landlocked and mostly geographically isolated country with two closed borders, Armenia relied upon Russia's military and economic presence in its territory.

Indeed just as in the first half of the 90s, Russia remains the sole pillar to support Armenia's defence capabilities. Currently there are around 5,000²⁴ Russian soldiers dislocated in Armenia's territory. Given the massive military build-up of Azerbaijan (the defence spending this year is expected to reach 3.7 billion USD)²⁵ and its repeated warnings to Armenia to return the occupied territories, Russia's support to Armenia is the only factor that prevents reigniting the frozen conflict.

The central role of Russia in Armenia is preserved not only by direct presence of the troops but also through a membership in Collective Security Treaty Organisation (CSTO). In 2012 President Sargsyan noted that the only reason his country belonged to CSTO was the defence guarantees in case of Azerbaijan's military attack. In relation to a possible conflict between the two countries over Nagorno-Karabakh, representatives of the Russian armed forces stated that they would be ready to act if the political decision was made.²⁶

Even though Armenia was known for its involvement in the EU's Eastern Partnership (EaP) initiative, in the beginning of September 2013 the country announced its decision to join the Russian-led Customs Union (CU). The quite unexpected move by Yerevan can be taken as another geopolitical victory of Russia in the South Caucasus.²⁷ Armenia's membership in the CU means Yerevan has backed off from the free trade and association agreements that should have been signed during the EaP Vilnius summit this November. If Armenia will successfully integrate into the CU, the

²⁴"In the Caucasus, Russia Secures Its Position by Exploiting Regional Tensions", Stratfor, 26 June 2013, <http://www.stratfor.com/analysis/caucasus-russia-secures-its-position-exploiting-regional-tensions>

²⁵ <http://www.news.az/articles/politics/80938>

²⁶ Jim Nichol, Armenia, Azerbaijan, and Georgia: Political Developments and Implications, Congressional Research Service, 24 January 2013, p. 11

²⁷ It can be noted that prior to formally joining the CU, Armenia suffered a temporary increase in Russian natural gas prices. See: <http://www.stratfor.com/geopolitical-diary/other-us-russia-proxy-battle>

current Georgian government might also be tempted to follow the example of Yerevan.²⁸

Azerbaijan: Balancing Great Powers

Over the course of 2009-2013 Azerbaijan continued to pursue its balancing strategy. Being the biggest and wealthiest country of all the three South Caucasus states, Azerbaijan successfully used its energy lever to maintain third party-independent foreign policy. Azerbaijan's regional stability is directly related to the political consistency of the ruling elite. It is plausible to say the country remains on the same political and economic track since 1993 when President Heydar Aliyev came to power. Therefore as Azerbaijan is set for presidential election this year it is more than likely that Ilham Aliyev will secure its presidential seat for the third consecutive term.

The current Azerbaijani foreign and domestic policy has its roots in the early 90s. The political logic behind Azerbaijan's strategy in dealing with major regional and world powers can be called either balancing or oscillation. Such politics was introduced after the early ill successes of the openly pro-Russian policies of the first Azerbaijani President Ayaz Mutalibov and "pro-Western" and "pro-Turkish" policies of the President Abulfaz Elchibey. In the 1993, when the war over Nagorno-Karabakh was in full swing and the President Heydar Aliyev came to power, both ways of Mutalibov and Elchibey were denounced as being dangerous to the sovereignty of Azerbaijan. Instead a policy of careful balancing between Russia, Turkey, Iran and the U.S. with an emphasis on economic growth was implemented.

From the moment petrodollars began to surge into Azerbaijan, the Baku used its energy exports to strengthen the political ties with Tbilisi, Ankara and Tel Aviv. Through BTC pipeline it created a strong regional bond with friendly Georgia and culturally-close Turkey. With every third barrel of Azerbaijani oil exported to Israel, a strategic partnership between the countries was sealed. Together with Turkey Israel became a major military hardware supplier to Azerbaijan. In 2012 the countries signed a 1.6

²⁸ "The Effects of Armenia's Decision to Join the Customs Union", Stratfor, 5 September 2013, <http://www.stratfor.com/analysis/effects-armenias-decision-join-customs-union>

billion USD deal that includes selling Israeli-made drones, anti-aircraft and missile defence systems to Azerbaijan.²⁹

Because of energy lever Azerbaijan was capable to successfully balance the interests of three different powers - the U.S., Russia and Iran. Seeing waning U.S. presence in the region and the example of neighbouring Georgia, Azerbaijan drew a conclusion about the dangers of too close alignment with the U.S. Because of this reason, in case of the U.S. military strikes against Iran, Baku refused to compromise its military security and let Washington hit Tehran from the territory of Azerbaijan.³⁰ Nevertheless, the U.S. sees Azerbaijan as a critically important state in South Caucasian and tries (though often inconsistently) to pay sufficient attention to the country.³¹

Azerbaijan's relations with Russia are uniquely complex compared to other regional powers. Since Russia backed Armenia during the Nagorno-Karabakh war and still ensures Yerevan's security, Azerbaijan understands well that the only possible way to solve the question of occupied territories goes through Moscow. Because Nagorno-Karabakh conflict constitutes the most important challenge to Azerbaijan's national security and stability, Baku tries to stay at cooperative but not subordinate terms with Russia. Moscow on the other hand tries to seize the opportunity to preserve the status quo of the present enmity over Nagorno-Karabakh in order to sustain the deep rifts between Baku and Yerevan. This leaves Armenia closely tied to Moscow and stops Azerbaijan from reigniting the war. The latest developments in Azerbaijan's relations with Russia show an intensifying cooperation between the two states. This year Moscow supplied Baku with 1 billion USD arms shipment while Azerbaijani SOCAR and Russian Rosneft signed a deal to establish a joint venture.³²

Being landlocked with only access to enclosed Caspian Sea, Baku sees Turkey as the key country to ensure Azerbaijani energy exports to the West. Turkey maintains a closed

²⁹ <http://www.haaretz.com/news/diplomacy-defense/israel-signs-1-6-billion-arms-deal-with-azerbaijan-1.414916>

³⁰ <http://en.trend.az/regions/scaucasus/azerbaijan/2152157.html>

³¹ "Geopolitical Journey: Azerbaijan and America", Stratfor, 11 June 2013, <http://www.stratfor.com/weekly/geopolitical-journey-azerbaijan-and-america>

³² "Azerbaijan's Cautious Cooperation with Russia", Stratfor, 14 August 2013, <http://www.stratfor.com/analysis/azerbaijans-cautious-cooperation-russia>

border with Armenia and has continuously supported Azerbaijan over Armenian-occupied Nagorno-Karabakh. However, the 2009 Turkish-Armenian talks about normalisation of bilateral relations and border opening caused some friction between Baku and Ankara. Since the negotiations between Turkey and Armenia proved to be unfruitful, at least for the time being the cause of Azerbaijani concern has disappeared.

Azerbaijan's relations with Iran are marked with constant tensions. This is not surprising given that Iran was supporting Armenia during the Nagorno-Karabakh war and because it still maintains quite warm relations with Yerevan.³³ Even though Azerbaijan and Iran are countries with Muslim majority, Baku was always emphasising Azerbaijan's secular tradition. This clearly contradicts Iran's theocratic agenda and causes further disagreement as, albeit with very limited success, Tehran tries to influence religious groups inside Azerbaijan's territory.³⁴ Because there are more ethnic Azeris living in Iran than in Azerbaijan, Iran feels uncomfortable about the growing influence of its neighbour.

Over the last years Azerbaijan maintained comparatively close relations to the EU. Despite Baku's participation in Eastern Partnership Programme (EaP), Azerbaijan is not among the EaP members which are willing to sign the free trade and association agreements with the European Union anytime soon. Nevertheless, as the Shah Deniz consortium selected the Trans-Adriatic Pipeline (TAP) to be implemented in order to supply the South European countries with Azerbaijan's natural gas, there are good prospects for increased partnership between Baku and Brussels.

In general, Azerbaijan was successful with its balancing strategy. Although Nagorno-Karabakh remains the biggest security problem for Baku, the issue of the Armenian-occupied territories did not significantly undermine Azerbaijan's structural power. Over the recent years the energy lever of Azerbaijan allowed the country to balance between the interests of greater powers, thus sustaining political independence of Baku. Because such strategy proved to be effective in the past, Azerbaijan will continue

³³ "Iran is ready to exchange natural gas with Armenian rubber", <http://tehrantimes.com/economy-and-business/110715-iran-is-ready-to-exchange-natural-gas-with-armenian-rubber>

³⁴ "The Caucasus Today and in the Coming Years", Stratfor, 8 July 2013, <http://www.stratfor.com/analysis/caucasus-today-and-coming-years>

to use energy as a tool to ensure the safe external environment and internal stability for the country.

In Place of Conclusions

In 2008-13 South Caucasus was a vibrant region where Azerbaijan, Georgia and Armenia manoeuvred between the colliding interests of major regional and world powers. Despite the similar regional environment all three used different political strategies to secure their sovereignty. Georgia, at least until the last parliamentary elections, continued to implement democratic reforms and to side with the West. Isolated Armenia gradually moved closer to Russia, while Azerbaijan maintained its independent status.

All three countries had to deal with the frozen conflicts as a potentially destabilising factor. These frozen conflicts were further deepened by the Russian mediation and involvement. It is clear that through the territorial disputes of Nagorno-Karabakh, South Ossetia and Abkhazia, South Caucasus became more dependent on outside powers. This is especially true about Armenia whose leap towards Russia is a direct consequence of the prolonged occupation of Azerbaijani territories.

Westward-directed energy exports and cautious balancing in foreign policy made Azerbaijan the most stable and prosperous South Caucasus state. Nevertheless, Baku takes a careful note of the current political developments in Tbilisi. Since the border with Armenia remains sealed, Georgia is critically important for hydrocarbon exports to Turkey. If Russia would be able to get the upper hand on the new Georgian political establishment, it can compromise the security of oil and gas transit towards the West.