

ECONOMIC DEVELOPMENT OF THE SOUTH CAUCASUS EAST-WEST CROSSROAD

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Abstract

This article analyzes and discusses the possibilities of economic cooperation in South Caucasus within the framework of the economic partnership between Azerbaijan, Georgia, Armenia and Turkey in particular in terms of economic cooperation in transportation and energy and regional trade.

The South Caucasus region is located at the meeting point of the three regional powers Russian Federation, Iran, and Turkey. They are trying to increase their influence in the South Caucasus, while promoting their national interest at that strategic area. It's a geopolitically important region at the crossroads of Europe and Asia with strategic energy routes. To a considerable extent, the significant oil and gas reserves in the Caspian Sea, have amplified regional rivalries for political and economic influence in the region.

South Caucasus is a main part of strategic Southern Gas corridor, which will deliver Caspian-basin natural gas from Azerbaijan and later from Turkmenistan and Iraq to European Markets in the Balkans and Italy. It will be a major asset in European energy security.

Also, it's developing region which is situated on the "New Silk Road" from China to Europe.

The Motivation to study economic development and cooperation in the South Caucasus is the step to introduce more possibilities, partnerships and developing of this significant region.

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Introduction

The South Caucasus comprises the three states of Armenia, Azerbaijan and Georgia. It's a geopolitically important region at the crossroads of Europe and Asia with strategic energy and transport routes. Twenty years after the break-up of the Soviet Union, the Republics of Armenia, Azerbaijan and Georgia are still facing considerable challenges in creating sustainable and inclusive economic growth and in building democratic states and pluralistic societies. Yet the all of three countries have significant human capital, a rich cultural heritage and the economic potential to create a prosperous future.

The three countries of the South Caucasus, and former members of the Soviet Union, are in the midst of a challenging transition. The transformation to democratic systems and market economies in the Republics of Armenia, Azerbaijan and Georgia requires further reforms, and authorities and societies that are open for change. The transition from a centrally planned to a market economy wasn't an easy process and has required strong political aspiration and wide ranging economic reforms in the countries of South Caucasus. The boom years from 2000 up to the global financial crisis masked, to a certain extent, inherent weaknesses of the region's economies in two key areas: social policy issues, such as health, education and gender equality, and private sector competitiveness. However, the

2009 crisis brought these persistent structural challenges once again to the forefront.(OECD, 2011)

All three countries have enjoyed high growth rates in the past decade which have, however, substantially slowed down due to the severe financial and economic crises after 2008. The economic growth in Armenia and Georgia has so far not benefited the general population. Although progress towards democracy and civil rights has been made, none of the three countries is considered by international rankings as fully meeting democratic standards.(Swiss Agency for Development and Cooperation, 2012)

Since 2008, the importance of the South Caucasus has been increased, after the EU Eastern Partnership policy was launched. ¹ The EU is committed to building strong and mutually beneficial relations with this region, irrespective of their individual level of ambition in their relations with the EU. The Association Agreements/Deep and Comprehensive Free Trade Areas (AA/DCFTAs), concluded in 2014, have brought the relations between the EU and Georgia to a new level. These agreements aim at strengthened political association and economic integration and create new opportunities in the region as increasing economic development.

South Caucasus is faced with the strategic Southern Gas Corridor. After completion, it will deliver Caspian-basin natural gas (first from Azerbaijan, and later perhaps from Turkmenistan, northern Iraq or other regional producers) via Azerbaijan, Georgia and Turkey, to European markets in the Balkans and Italy. (Gurbanov, 2016)

Social and Political Landscape of the South Caucasus

The South Caucasus is situated at the meeting point of the Russian Federation, Iran, Turkey, Europe and Central Asia. The oil and gas reserves in the Caspian Sea and Central Asia and the pipelines to Europe through the South Caucasus East-West energy corridor emphasize the geopolitical importance of the region.

The transition from the Soviet system to pluralistic democratic societies and functioning market economies have been going through with political and social disruption, governance deficits, wars, occupation and conflicts in different regions. For the last two decades the three South Caucasus countries has experienced very deeply social distress, severe armed conflicts and territorial disputes, namely with regard to Nagorno-Karabakh, Abkhazia and South Ossetia/Tskinvali Region and war against Russian Federation. Today there are still around 1.2 million internally displaced persons (IDPs) and refugees in the three countries. Despite international mediation, the conflicts are still frozen. During the last decade, they remain largely unresolved and continue to hamper regional economic development and political stability.

Armenia remains completely isolated mainly because its borders with Azerbaijan and Turkey are closed. The country has friendly relations with Iran and after joining to the Eurasian Economic Union,² continues to depend economically and politically on the Russian Federation. Due to regulatory reforms, an improved business environment and higher exports of commodities, Armenia's economy is slowly recovering. According to World Bank GDP (2015) is 10.561 \$billion. However, poverty and unemployment remain high, particularly in rural areas,

¹ The Eastern Partnership (EaP) is a joint initiative involving the EU, its member states and 6 eastern European partners: Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine.

² In 2013, President of Armenia Serzh Sargsyan announced in Moscow that Armenia will join the Customs Union of Belarus, Kazakhstan, and Russia.

and have further increased over the last few years. Remittances from working migrants and the Armenian diaspora play an important role for family income support and investments in the country. Subsistence agriculture remains the major employment sector, accounting for 45% of the working population. Market liberalization has placed large constraints on the once heavily subsidized agricultural sector and colluding interests pose threats to fair competition. The political climate remains difficult: According to Freedom House Armenia is rated as 'partly free' and its media as 'not free'. The parliamentary elections in May 2012 were characterized by a competitive, vibrant and largely peaceful campaign. (OSCE, 2012)

Azerbaijan mainly derives its revenues from oil and gas exports. Its considerable economic growth in the mid-2000s slowed down after 2006, partially due to reduced oil production. This reflects the high dependence of Azerbaijan's economy on natural resources. Pressure to diversify its economy is increasing. The non-oil sector, in particular construction, telecommunications and banking services, is steadily growing, however it is mainly supported by oil-financed, unsustainable government spending. The agricultural sector employs 40% of the population but contributes only 5.2% to the gross domestic product (GDP). Azerbaijan was declared as the world's top regulatory reformer in the World Bank's 2009 Doing Business Report, but competition is still hampered. While Azerbaijan is compliant with the Extractive Industries Transparency Initiative (EITI) and has introduced some formal anti-corruption measures, it continues to suffer from high perceived levels of corruption. The general Azerbaijani population is benefiting to some degree from the large revenues derived from natural resources. This positive development is reflected in the country's decreasing poverty rate, from 43.7% in 2003 to 7.6% in 2011. IDPs and refugees constitute the poorest and most vulnerable segment of the population. The human rights situation in Azerbaijan is viewed critically and the country has consistently been ranked as "non-free" by Freedom House since 2003.

After destruction of Soviet Union and since announced the state independence, Georgia has been going through very damaged and difficult stage of development. During the yearly period, it was involved two ethno-conflicts, into the different part of state, which was encouraged by Russia. Georgia was faced to necessity of launched new trade connections and find new partners. From that period Georgia set up and has experienced pro-western foreign policy. Today, Georgia is strongly striving towards Euro-Atlantic integration. Apart the other neighbors, it has the deepest relations with EU.

Yet, in 2012 Freedom House qualified Georgia as only 'partly free'. The lack of independence of the judiciary remains a major concern. The armed hostilities with the Russian Federation in 2008 and the economic crisis at that time pushed the country into a deep recession. However, in the past few years the Georgian economy has slowly recovered with a growth rate of above 5%. According to World Bank, GDP is 13.965 \$ billion (2015). Major reforms are being carried out following a neo-liberal approach, including in social services. Agriculture remains one of the sectors with the biggest growth potential, employing almost half of the total working population. Rural poverty will remain a significant challenge in Georgia in the coming years. Income disparity is widening, and the country has the highest Gini index (4.160) for the region (2015). Although the living conditions of IDPs are steadily improving, in many cases they still cannot fully exercise their social and economic rights and are suffering from a lack of employment opportunities. IDPs still belong to the most vulnerable segment of the Georgian population. The parliamentary elections in October 2012 marked the first democratic transfer of power in Georgia's post-Soviet history and led to co-governed (named a cohabitation) between the president and the prime minister. The new coalition government has declared its intention to focus on Euro-Atlantic integration, rural development and improve economic relations with the Russian Federation. (Benashvili, 2015) After signing Association Agreements/Deep and Comprehensive Free Trade with EU, Georgia remains to get visa free regime with Schengen area.

Regional Snapshot of Economy

Following the breaking up of the Soviet Union, the South Caucasus experienced a full economic fragmentation. The cooperation chains of enterprises and states dramatically decreased between the different parts of the former Soviet Union. On the other hand, some trade partnerships were used for political pressure. Former Soviet States were faced to necessity of launched new trade connections and agreements. Additionally, the political elites were vigorously engaged in building ethnically-defined nation states, whereas the strenuous battle to getting power. They also struggle for domination over the economic resources of the newly independent states (Jijavadze, 2016) In the South Caucasus, these processes were exaggerated by nationalistic rhetoric and policies that led to violent conflicts.

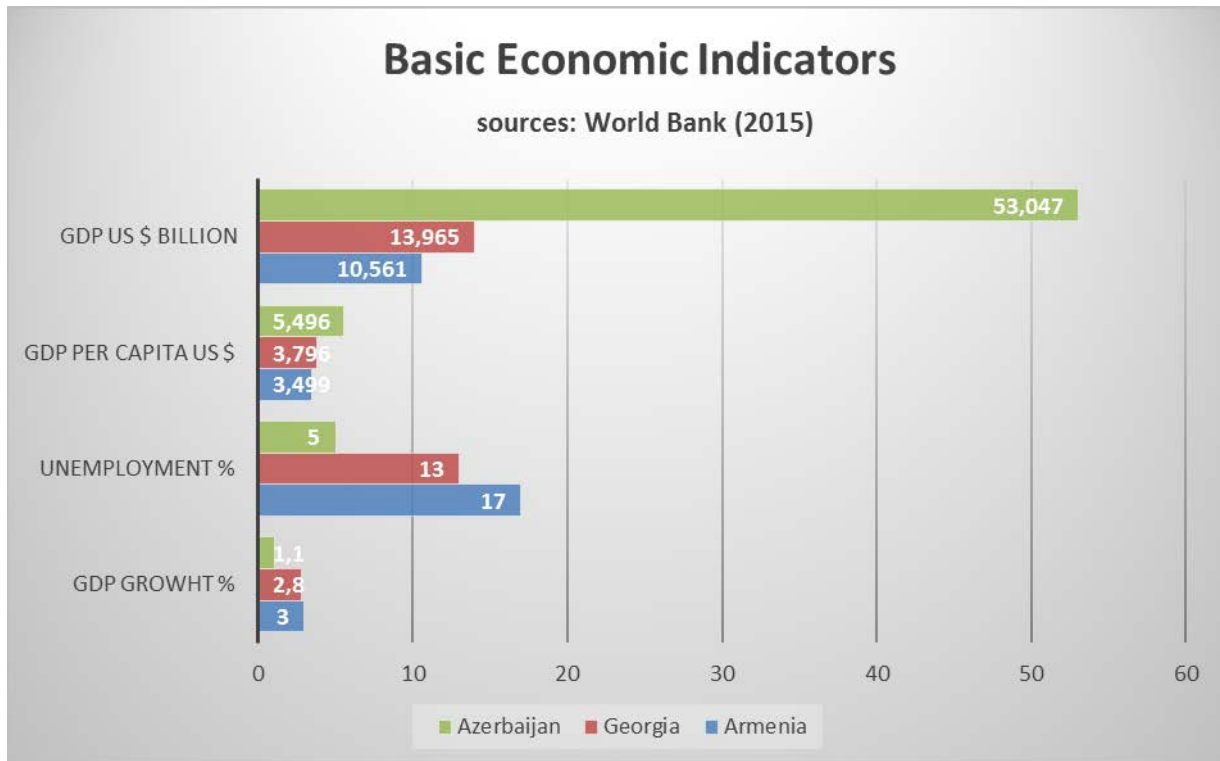


Table 1

One of those conflicts has been over the Nagorno-Karabakh region between Armenia and Azerbaijan.³ Turkey closed the rail and air connections with Armenia and halted the transit of humanitarian aid through its territory to Armenia in 1993. Today, Armenia has two “gates” to the world – Georgia to the north and Iran to the south. These “gates” are largely inappropriate for the establishment of regional economic cooperation and the implementation of transnational projects. (Muradyan, 2016) Out of the 1,500 kilometers of land border that Armenia shares with its four neighbors, only about 250 kilometers are open for transnational economic relations. Armenia has well-established relations with Georgia and their current economic ties are crucially important for Armenia, as Georgia is the main transit country for Armenia. Iran and Armenia have developed energy and trade cooperation even though Armenia’s major trade and economic partners for either state or private business actors is Russia. With an active flow of remittances and investments from Russia, its role in Armenia’s economy is major. Recently Armenia deepened its economic integration with Russia within the framework of the EAEU along with Belarus, Kazakhstan, and Kyrgyzstan. In this context, Armenia could potentially benefit from new opportunities gaining access to the EAEU markets. On the other hand, Armenian businesses have almost one-sided economic relations with their Turkish counterparts. Goods from Turkey enter Armenia, but no major trade flows are going from Armenia to Turkey. Georgia plays an important role in the socio-economic relations of the South Caucasus since it is the transit country for regional transport and energy projects. Currently, Georgia has substantial socio-economic cooperation with all neighboring countries.

³ As a consequence of which the borders between the countries were sealed off in the early 1990s.

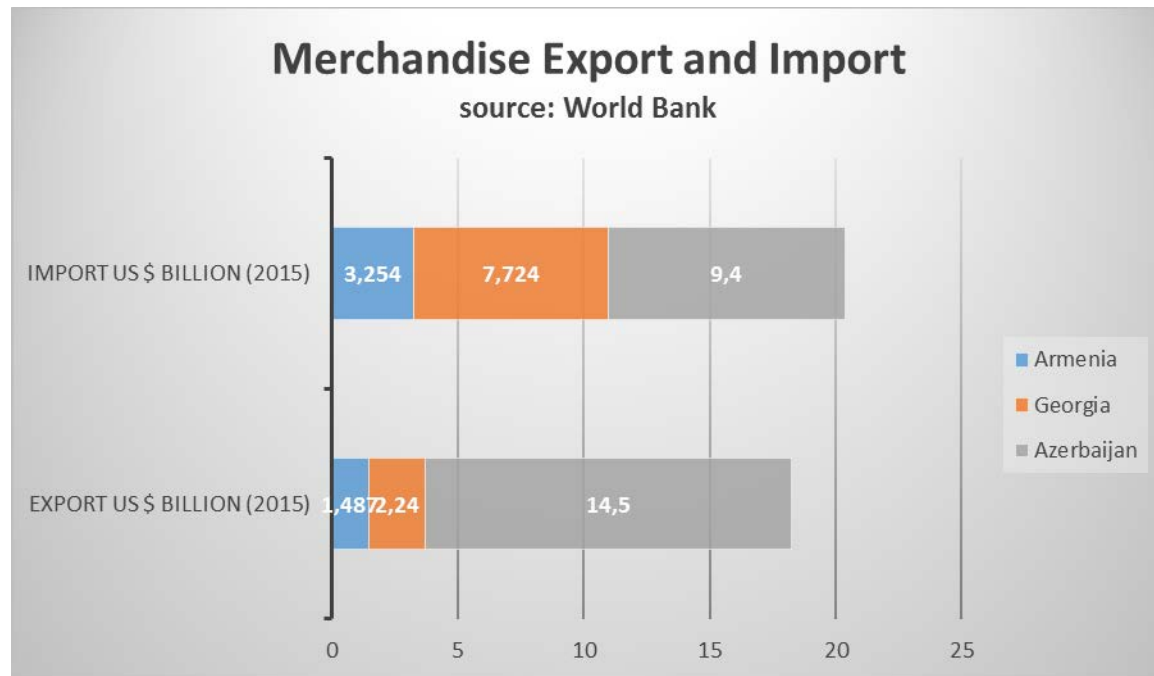


Table 2

There are various motivations for economic cooperation between countries in South Caucasus. Economic factors, historical links, cultural ties and social factors are stimulating and necessitating economic cooperation between countries. In addition to this, the geographical proximity and unity of the countries in the region is a conducive and encouraging factor for the formation of economic co-operation agreements.

Although, there are no economic or diplomatic relations between Azerbaijan and Armenia. It means that Armenia doesn't participate in any regional or transitional projects. It has resulted during the formation of a new East-West Silk Road through Georgia to Europe via Turkey. As a network of major present transportation corridors, Azerbaijan and Georgia are becoming vital transit links between East and West.

The economic cooperation between Azerbaijan, Turkey and Georgia has been developed through mega projects in energy transportation, There are free trade agreement between Turkey and Georgia now, but it hasn't reached yet between Azerbaijan and Turkey. As well, Georgia and Turkey get visa free regime for their citizens. All of this three country are trying to get benefit from the recent regional connectivity initiatives to boost trade, increase foreign direct investments and growth its economy.

Azerbaijan has borders with Kazakhstan and Turkmenistan via the Caspian Sea and it has land borders with Georgia, Russia, Iran, Armenia, and Turkey. Azerbaijan's cooperation with Georgia and Turkey is focused on natural resources and excludes Armenia due to the Nagorno-Karabakh conflict. Azerbaijan has the richest oil and gas reserves in the region and therefore plays an important role in major energy projects. Access to these resources explains the Azerbaijani regime's claim for a leading role in the South Caucasus and its attempts to influence the policies of the big neighbors, particularly those of Turkey and Georgia.

In particular, Azerbaijan is one of the sponsors of the East-West and North-South transport corridors. This effort will require improvements in infrastructure and logistics performance for trans-border trade. The rich oil and gas reserves of Azerbaijan and purposeful policy have created opportunities for doing huge amount of works in the energy sphere as well. If we look through the energy security issue, it is clearly seen that Azerbaijan already plays an important role in the energy security of Europe. Azerbaijan has large gas reserves, and in September 2014 BP began construction of the Southern Gas Corridor to supply Europe directly by 2019, bypassing Russia. From this standpoint, starting the implementation of the "Southern gas corridor"⁴ project has been a historic event. Caspian oil is now flowing through a pipeline running from Baku through Georgia to the Turkish port of Ceyhan, providing western countries with ready access to a vast new source of supply.

⁴ The Southern Gas Corridor (SGC) is a term used to describe planned infrastructure projects aimed at improving the security and diversity of the EU's energy supply by bringing natural gas from the Caspian region to Europe.

The development of transport infrastructure is also one of the main priority of Azerbaijan. Today it is restoring the historical Silk Way with the application of modern technologies and the participation of neighboring countries. At present, the Baku-Tbilisi-Kars railway – running from Azerbaijan through Georgia and into Turkey - is under construction and will for the first time connect Azerbaijan with Europe by train.

Baku-Tbilisi-Kars Railway

The Baku- Tbilisi- Kars Railway is a new corridor that will connect Azerbaijan, Georgian and Turkish railways. The project implementation began in 2007 and construction began in 2008 and it foresees the rehabilitation and reconstruction of 178 km-long railway between Marabda and Akhalkalaki and construction of a new railway from Akhalkalaki to the Turkish border.

The Kars-Akhalkalaki route is expected to fully replace the inactive Kars-Gyumri-Tbilisi line, which was the only rail route the USSR used to reach Turkey. Istanbul unilaterally halted traffic on this route after Armenian-Turkish relations deteriorated due to the Armenian-Azerbaijani war in Karabakh.

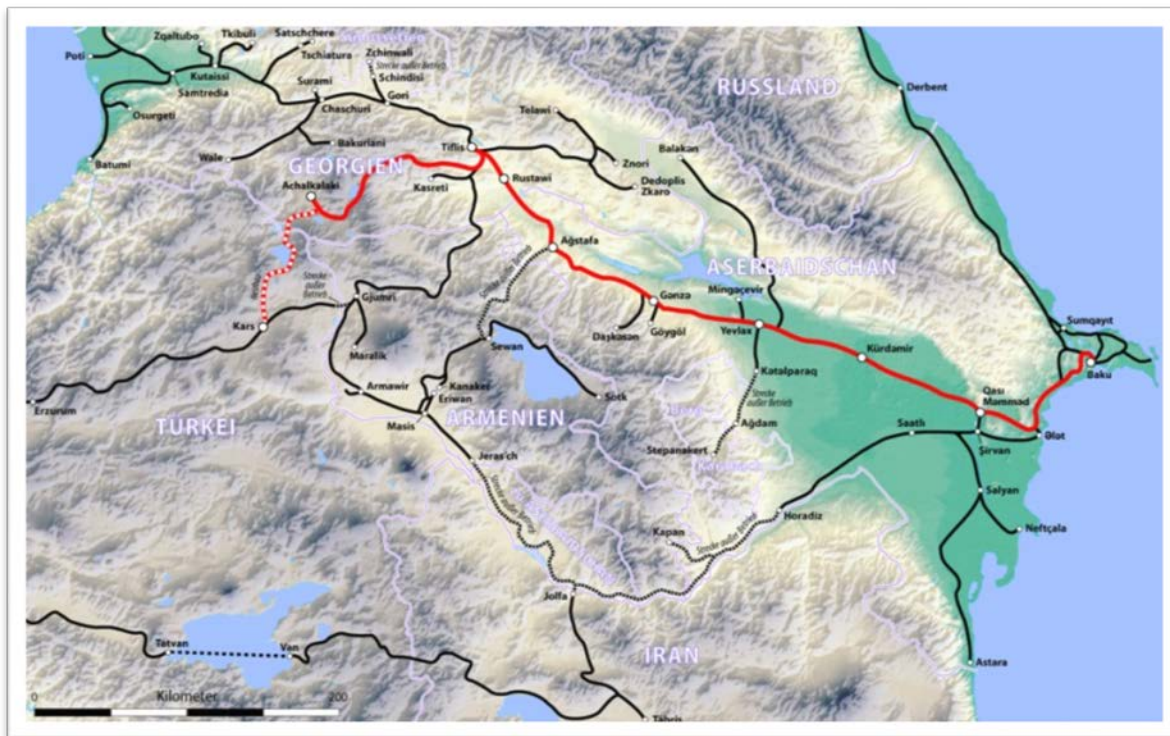


Figure 1

This project will effectively open a new rail-only corridor from the Caspian Sea to Europe via Turkey, eventually excluding the need for sea transportation once the planned rail tunnel under the Bosphorus Strait in Istanbul is complete. Once the railway was fully operational, all three countries will mutually benefit from improved trade and economic relations and gain additional Foreign Direct Investments (FDI) through the new railway connecting Europe and Asia.

According to the international interest of Georgia, the Baku- Tbilisi- Kars Railway is expected to enhance Georgia's status as a transit country, and developing a strategic alliance with Turkey and Azerbaijan. The Kars-Akhalkalaki-Baku railway line promises other benefits for Georgia. As well, railway line is the direct ground route between Baku and Istanbul. According to analysts, the railway has the potential to attract freight, including oil, from Central Asia to Turkey by offering a further outlet to the sea. Caspian traders have a possibility to deliver its oil by rail directly to European purchasers. They will obviously save money and time if skip tanker routes by The Black Sea. Georgia could offer two different oil transit routes to Europe, by sea and by land. It's making the country an important part of the transport corridor linking Asia, the Caucasus, and Europe. (Anjaparidze, 2005)

The Baku-Tbilisi-Kars project, which facilitates the transport of passengers and goods between Azerbaijan, Georgia and Turkey, will be fully commissioned at the beginning of 2017.

Southern Gas Corridor

The Southern Gas Corridor (SGC) is a term used to describe planned infrastructure projects aimed at improving the security and diversity of the EU's energy supply by bringing natural gas from the Caspian region to Europe. Due to stretching over 3,500 kilometers, the Southern Gas Corridor is one of the most complex gas value chains ever developed in the world. It is comprised of several separate energy projects, which representing a total investment of approximately 45 US\$ billion. This Corridor includes 3 pipeline projects from Shah Deniz Stage 2: **South Caucasus Pipeline (SCP)** – Azerbaijan, Georgia; **Trans Anatolian Pipeline (TANAP)** – Turkey; and **Trans Adriatic Pipeline (TAP)** – Greece, Albania and Italy. Also, it has Possibilities for further connection to gas networks in South Eastern, Central and Western Europe.



Figure 2 (BP Azerbaijan)

The South Caucasus Pipeline (SCP) was built to export Shah Deniz gas from Azerbaijan to Georgia and Turkey. The pipeline starts from the Sangachal terminal near Baku. It follows the route of the Baku-Tbilisi-Ceyhan (BTC) crude oil pipeline through Azerbaijan and Georgia to Turkey, where it is linked to the Turkish gas distribution system. The pipeline has been operational since late 2006 transporting gas to Azerbaijan and Georgia, and starting from July 2007 to Turkey from Shah Deniz Stage 1. The length of the pipeline is 691km, with 443 km in Azerbaijan and 248 km in Georgia. The diameter is a 42-inch. According to BP Azerbaijan, in the first half of 2016, SCP spent about \$13 million in operating expenditure and around \$498 million in capital expenditure. SCP's daily average throughput was about 20.1 million cubic metres of gas per day in the first half of 2016.

The Second project is the "Trans-Anatolian gas pipeline" (TANAP). According to this project signed by Azerbaijan and Turkey in 2012, the gas pipeline will extend from Turkey-Georgia border till Turkey-Greece border. The fourth project is the "Trans-Adriatic pipeline" (TAP). The pipeline will extend from Greece to Albania and coming to Italy beneath the Adriatic Sea. All these 3 projects are the parts of the "Southern gas corridor". Azerbaijan is an important shareholder in these 3 projects and the major shareholder in the TANAP project. As a result of the implementation of the "Southern gas corridor", a number of countries will gain access to the Azerbaijani gas as an alternative gas reserve. Georgia, Turkey, Greece, Bulgaria, Albania and Italy are among the participants of the "Southern gas corridor" project. So Azerbaijan and Georgia become a very important and reliable partner for providing the energy security policy of Europe.

Iran's perspective in the South Caucasus

The South Caucasus region was one of the primary influenced regions by such a sharp turn in the history of Iran. (Mamadov, 2016) Iran's interests in the region and ties with three Caucasus states (Armenia, Azerbaijan, Georgia) date back to the early 19th century when the region was a part of the Persian Empire. One of the main reasons of increased interests of Iran towards the South Caucasian region was related with the fact, that Caucasus was historically known to be a crossroads of trade from the Mediterranean to China and from the Baltic Sea to the Arabic world. (Chitadze, 2012) Because of its strategic importance, Russia fought with Iran in order to conquer the region. The fights usually brought high costs to the local people.

Turning back to the recent history of Iran's foreign policy towards the South Caucasus, it can be seen that Tehran was in unpleasant situation and unprepared to build up effective connections with the countries. Compared to other regional and global powers, Iran was following a defensive policy by offsetting external threats in the region. The Western powers (mainly the US-Turkey-Israel) were presenting a major source of threat to Iran in Georgia and Azerbaijan, where they could allocate their resources and isolate Tehran to participate into the regional energy projects. During the last two decades, Iran did not have sufficient economic and political resources to play a key role in the South Caucasus. After January 16, 2016 since the senior diplomats in Vienna formally announced the lifting of sanctions against the country, following confirmations from the UN that Tehran had fulfilled its obligations under the last year's nuclear accord, Iran will again have a chance to engage in the regional political and economic processes with its significant geographic location and landmass positioning in the east-west route. Iran will have enough capacity and potential to play an important role in geopolitical process of the South Caucasus due to the growing economy, increasing foreign investment and reestablished friendly relations with Western powers. The Iranian Nuclear Agreement it is not only about preventing Iran from developing nuclear weapons but about huge economic projects and diversification of the European gas supplies as well. It should be accentuated that, especially after the Crimean crisis, the US and EU countries openly impose the sanctions and embargos on Russia. They attempt to find a political solution for better relations with Iran in order to eliminate the Russian oil and natural gas monopoly in Europe. Iran holds the world's fourth-largest proved crude oil reserves and the world's second largest natural gas reserves. Which means that Iran has the potential to replace Russian gas in Europe and become a serious player in the European energy security. Furthermore, Iranians are also interested in getting into the European gas market, which could bring billions of dollars to the country's economy. But in order to bring its gas to Europe Iran needs access to the South Caucasus first. Either through Armenia to Georgia and then from the Black Sea to the European continent or by working together with Azerbaijan using the TANAP pipeline (Trans-Anatolian Natural Gas Pipeline is a natural gas pipeline from Azerbaijan through Georgia and Turkey to Europe). It may sound easy for Iran to choose one or the other route, but it will definitely have to take into consideration of the Russian influence in the region because till now Russia is the main influential and aggressive actor in the region. Iran seems to once again integrate in the world affairs and global economy. This integration will have consequences for the South Caucasus as well. The region lies at the cross roads between the East and the West and has a considerable geostrategic importance. On the other hand, there are very strong grounds for closer cooperation perspective between the South Caucasian countries and Iran. As well Georgia has visa free regime Iran, it started new negotiations in 2015 to import Iranian gas. (Gurbanov, 2016)

Conclusion

In this paper we discussed about the current situation in the South Caucasus, as well as the prospects for regional cooperation and integration. The article diversified some strategic directions, which would have significant mean for future development of this region, meanwhile it depends on European Security policy and also global trade routes.

Considering the recent economic developments and attempts towards economic integration between Azerbaijan, Turkey and Georgia and other mega projects from Central Asia to Europe making the South Caucasus a transit region, showed that this transportation corridor is a new strategic and significant one for Western and European countries in energy security policy.

Convinced that regional economic cooperation could be an important step towards conflict transformation in the South Caucasus, this paper suggests that the prospects of such integration be considered.

South Caucasus which has function as a bridge between Europe and Central Asia, has been improved its strategic importance through mega pipeline projects, which are transporting crude oil and natural gas from Central Asia, Caspian and Iran to Europe.

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