

*The Caucasus and  
its neighborhood:  
A region where economics  
and security collide*

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**Abstract**

*The article examines the current position of the South Caucasus, a region with a crucial role in driving global economic growth, innovation, and investment not only to the West, but also to Asia, particularly the dynamic economies of China and Korea. The author analyzes the three South Caucasus countries based on their political situations, their economies, and their role in shaping the future of region. Further, the author argues that complacency is not an option for the South Caucasus, where festering conflicts - notably between Azerbaijan and Armenia, and Georgia and Russia - are not simply matters of local concern; their escalations would have global consequences, not least because of the region's increasing geostrategic importance and its key role as an energy producer, with critical supply lines to the West.*

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The South Caucasus has historically been an area of extraordinary richness and diversity, and vast economic potential and opportunity— but also of conflict. Much like the Balkans, it is a region where East and West meet, and where three great empires—the Russian, the Ottoman, and the Safavid (Persian)—clashed in earlier times. With discovery of oil in Azerbaijan in the late nineteenth century, Russian ambitions to control the region intensified. The manipulation of ethno-religious differences by Russia and other external actors has long been part of imperial ambitions, from the Tsarist times, through the Bolshevik era, to the fall of the Berlin Wall.

Today, it is a region where many fires burn. These are the fires of economic ambition and growth, of political transformation and unrest, and of violent conflict resulting from uncontrolled assertions of identity and religion. The South Caucasus is also a region that demonstrates on a broader scale the way in which regional and global geopolitical tectonic plates are shifting, creating new opportunities for social, economic, and political interaction, while simultaneously igniting old tensions and rivalries. These tensions threaten regional political stability with larger global consequences. Left unchecked, they also threaten to jeopardize the huge strides in economic, social, and political development that the key

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countries of the region, notably Azerbaijan, have taken in recent years. Unfortunately, the efforts of various external actors to promote the resolution of the region's key disputes have been desultory and half-hearted of late. They will have to be reinvigorated and intensified. The European Union and the United States have a critical role to play in fostering negotiations between the warring parties, and they must provide leadership. The region's long-term prosperity and political future ultimately depend upon the successful resolution of its key disputes.

### **The Growing Global Importance of the South Caucasus**

The South Caucasus is a region of growing importance not only to the West but also to Asia, particularly the dynamic economies of China and Korea, which are increasingly important in driving global economic

growth, innovation and investment. The South Caucasus is also a region that increasingly sees itself—and is seen by others—as a strategic gateway between East and West, not least because of the wealth of natural resources, especially oil and gas, but also because it has the potential to serve as a key transit route for energy and resource shipments from Central Asia.

Three states—Azerbaijan, Georgia, and Armenia—form the South Caucasus region, which is delineated to the north by Russia, to the southeast and southwest by Iran and Turkey, and to the east and west by the brooding inland waters of the Black and Caspian seas. Some might argue that a region should be defined by its common values, shared interests, and a keen sense of identity; however the three countries of the South Caucasus are not necessarily unified by these elements.

What we do find is a “region” that is characterized by deep-rooted interdependent relationships which have developed over the years through the collision of culture and history, alongside shifting patterns of trade, investment, social migration and interaction. It is also an “open” region because of the special relationships that these three countries have forged with their neighbors and others—Azerbaijan with Turkey and Georgia, Armenia with Russia, Georgia with Azerbaijan and the West.

## **Azerbaijan**

Azerbaijan is the region’s most remarkable success story, thanks to its rich oil and gas resources. The ancient Persians called it Atupatakan, “a place where sacred fire is preserved.” In Greek mythology, Zeus chained Prometheus to the Caucasus mountain range because he had stolen fire from the gods. Today, there are a still number of sites in the South Caucasus where whole mountainsides are on fire, where escaping gases from the ground have been ignited.

Before gaining its independence from the Soviets in 1991, Azerbaijan enjoyed a brief period of independence from 1918 to 1921, as the first democracy in the Muslim world. The macroeconomic stability and consistently high rates of growth that Azerbaijan has enjoyed since 1995 are indeed impressive. National GDP is fast approaching US\$100 billion, dwarfing that of its neighbors. Its growth rates over the past decade have reached double-digits, the highest in the world, notwithstanding the recent global recession. The country’s booming oil exports have also contributed to growth in the construction, banking, transportation and real estate sectors. Although high rates of inflation accompanied Azerbaijan’s oil boom during the last decade, these have been brought under control over the past two years, though a spike in oil prices does present a future risk.

Sound fiscal and monetary management by the government have been crucial to Azerbaijan's economic success. Privatization is a key element of the government's economic reform strategy. In 2000, the private sector made up 68% of the country's GDP. The second phase of privatization is currently underway, and for the most part envisages the privatization of medium and large-scale enterprises. As a result of this policy, the private sector generated 81% of GDP in 2007.

The 2011 *Index of Economic Freedom* gives Azerbaijan an overall economic freedom score of 59.7, placing it 92<sup>nd</sup> out of the 183 countries included in the 2011 *Index*.<sup>1</sup> Azerbaijan's score rose by one percent between 2010 and 2011, which indicates that it is making steady progress in achieving key reforms in the areas of fiscal and monetary policy, while also tackling regulatory reform and corruption. It is ranked in the top third of all countries in the Asia-Pacific region, and significantly above most of its immediate neighbors. Azerbaijan has also been working steadily to secure World Trade Organization membership. The accession process began in 1997, and is supported by a wide range of bilateral and multilateral trade treaties.

<sup>1</sup> "Azerbaijan," 2011 *Index of Economic Freedom*. Published by The Heritage Foundation & the Wall Street Journal. Available at: <http://www.heritage.org/index/country/azerbaijan>.

Azerbaijan's private banking sector continues to grow, despite the major role played by state-owned banks, particularly the International Bank of Azerbaijan. This growth has increased the supply of credit, though not yet to the degree necessary to enhance the growth of small and medium-sized enterprises in the economy. The government and private bond market also remains small and somewhat underdeveloped. In spite of these continuing challenges, Azerbaijan's banking system is generally quite stable, and the government is moving in the right direction by privatizing some of its state-owned banks.

Energy is the core of the Azerbaijani economy. Azerbaijan produces just over 1 million barrels of oil a day. It ranks 23<sup>rd</sup> among the world's major oil producers. More than half

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of Azerbaijani oil goes for export, given its relatively modest domestic consumption. Its proven oil reserves have been calculated at 7 billion bar-

rels, placing it 19<sup>th</sup> in the world.<sup>2</sup>

Azerbaijan's natural gas reserves also put it amongst of the world's major oil producers. Proven gas reserves are estimated at 849.5 billion cubic meters (27<sup>th</sup> in the world) and its natural gas exports amount to roughly 5.6 billion cubic meters annually (25<sup>th</sup> in the world). Much of Azerbaijan's oil is exported via the Baku-Tbilisi-Ceyhan Pipeline, which crosses through Georgia and Turkey, before being shipped by tanker to western destinations. The discovery of deep reservoirs in the Caspian Sea have set in motion plans boost Azerbaijan's natural gas production with.

In recent years, the government has made a concerted effort to use its oil and gas revenues to diversify the country's economic base in order to promote sustainable, long-term growth. The key policy instruments for promoting diversification are the State Programs on Economic Development, Small and Medium Entrepreneurship Development and Social and Economic Development of the Regions of Azerbaijan. Educational reforms and major investments in higher education and research are key components of Azerbaijan's growth strategy. The country is also becoming a focus for Chinese, Korean and other sources of foreign investment.

<sup>2</sup> "Oil Production Rankings." *CIA World Factbook*. Available at: <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2173rank.html>.

In addition to oil and natural gas, Azerbaijan exports machinery, cotton, and foodstuffs. Its main export partners are Italy (20.69%), India (10.67%), US (9.24%), France (8.15%), Germany (7.62%), Indonesia (6.63%), and Canada (5.13%). Its key import commodities are machinery and equipment, oil products, foodstuffs, metals, and chemicals, which come from Turkey (18.69%), Russia (16.98%), Germany (7.87%), Ukraine (7.3%), China (6.18%), and the UK (5.73%).

Years of Soviet rule left a legacy of entitlement and corruption in the public and private sectors that Azerbaijan has found hard to shake; however, it is making solid progress on these fronts. Visitors are struck by the vigorous animation of Azerbaijani people, particularly the youth, who identify strongly with Western culture and values, and aspire to live in a country that upholds democratic principles and human rights.

Azerbaijan might be characterized as one of the world's "mini BRICs"—a term that has been used to describe the large, dynamic and influential large transitional economies that are emerging from the developing world (Brazil, Russia, India, and China). Azerbaijan's rapid economic growth over the past two decades has catapulted it into a position of growing prominence, not only at a regional level but also internationally. As the

country begins to enjoy its newfound stature and influence, it finds itself wrestling with the many challenges

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that come with greater visibility, attention, and integration into the global economy.

Azerbaijan has a large, Turkic-majority, Muslim-majority population, but it is also one of the world's most moderate Muslim countries. The country's commitment to secularism is to some extent the product of years of communist rule and Soviet hostility to Islamic culture and traditions. According to the government, approximately 96% of the population is Muslim. The remaining 4% consists mainly of Russian Orthodox Christians who live in Baku and Sumgayit. Almost two-thirds of Muslims are Shi'a, and the rest are Sunni, though the differences between these two groups are not as sharply defined as they are in some other countries. Local and external observers report that religious observance has traditionally been quite low and identities tend to be constructed around culture and ethnicity rather than religion per se. However, attitudes and religious practices in some of the more rural parts of the country in the south may be changing as a result of external in-

fluences and pressures. The country clearly faces some major challenges as a result of cross-border fundamentalist pressures emanating from the large Azerbaijani community concentrated around Tabriz, which constitutes almost one-third of the population of neighboring Iran.

The Azerbaijani Constitution allows religious groups freedom of affiliation and expression without interference from the state. The exceptions to this, under the law on religious freedom, pertain to the activities of religious groups that "threaten public order and stability." The government has tried to enforce these provisions by preserving a clear distinction between church and state and taking measures to keep religious groups out of politics. Religious groups have to register with the State Committee for Work with Religious Associations (SCWRA) and the publication, importation, and distribution of religious literature are carefully monitored by government authorities.<sup>3</sup>

## **Georgia**

Georgia was seized by the Russian tsars in the 19<sup>th</sup> Century. It enjoyed a brief period of independence from 1918-1921, after which it fell under Soviet rule. When the Soviet Union collapsed, Georgia struggled to assert its independence. Its current

<sup>3</sup> See US Department of State, "Azerbaijan: Freedom of Religion Report 2006." Washington, D.C. Available at: <http://www.state.gov/drl/rls/irf/2006/71368.htm>.



president, Mikheil Saakashvili, was elected to power in 2004.

Although the country has embarked on a series of widespread reforms to liberalize and open the economy to foreign investment and to promote democratic development, it has struggled against Russian support for secessionist movements in Abkhazia and South Ossetia. Following military action by the Georgian military in South Ossetia, Russian forces intervened in 2008. Though Russian troops have since been “withdrawn”, Russia has unilaterally chosen to recognize the independence of these two breakaway regions.

Like Azerbaijan, the Georgian economy has witnessed unprecedented growth in recent years, supported, in part, by its role as a transit point for Azerbaijani oil and gas exports. Mining (manganese and copper in particular) and agriculture are the mainstays of the economy, with construction and financial services developing into important new sectors. Georgia’s economy experienced high levels of GDP growth (more than 10%) just before the global economic recession of 2008-09. Much of this growth was spurred by high levels of foreign direct investment and rising government expenditures. But the economy took a serious hit during the global recession and matters were made worse by the August 2008 conflict with Russia. Economic growth

was negative in 2009 as foreign di-

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rect investment and foreign workers’ remittances declined. The economy has since rebounded, although the prospects for sustained growth will depend on internal political stability.

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In the late spring of 2011, the country’s capital, Tbilisi, was shaken by widespread public protests calling for the resignation of President Mikheil Saakashvili, in a “Day of Rage” styled after the revolutions that have swept the Arab world. The protesters accused Mr. Saakashvili of turning away from democracy and blamed him for what they viewed as Georgia’s humiliating defeat in the war with Russia.<sup>5</sup>

## Armenia

Armenia possesses the weakest economy in the region and was hit hard by the global recession, having enjoyed

4 .” Central Intelligence Agency, “Georgia,” *The World Factbook*. Available at: <https://www.cia.gov/library/publications/the-world-factbook/geos/gg.html>.

5 George Lomsadze, “Two Die as Police Break Up Georgia Protest,” *Wall Street Journal*, May 26, 2011. Available at: [http://online.wsj.com/article/SB10001424052702304520804576346870952340708.html?mod=googlenews\\_wsj](http://online.wsj.com/article/SB10001424052702304520804576346870952340708.html?mod=googlenews_wsj).

high levels of growth before the crisis. The country has paid a high economic price for its ongoing conflict with Azerbaijan. Following Armenia's invasion of Nagorno-Karabakh in 1994, Turkey closed its border crossings. Countervailing pressures from Azerbaijan have thwarted recent Turkish efforts, supported by the US, to re-open its border with

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Armenia and improve relations. Armenia continues to depend heavily on its commercial and aid links with Russia, as well as the remittances it receives from the large Armenian diaspora.

### **Influence and Ongoing Challenge**

The foreign policies of countries in the South Caucasus region are becoming increasingly assertive, self-confident, and independent, driven by changing notions of their own national interest along with newfound sources of power and leverage. They are moving from being pawns in the global power game to being independent and influential actors in their own right. Azerbaijan and Georgia in particular are looking to expand and

strengthen their ties with the European and the Atlantic region through energy exports, trade, investment, the development of new transportation corridors, and security cooperation. Azerbaijan's policies are driven by the strength of its energy sector, its desire to diversify its economy, and the fact that it, like Georgia, sees itself as a bridge between Europe and Asia. Its influence also derives from close relations with Turkey.

Armenia's influence comes largely from the strength of its diaspora, which is seen by many to be an obstacle to the resolution of the Nagorno-Karabakh dispute. This interethnic dispute between Armenia and Azerbaijan has a long and complex history. Towards the end of the Soviet era in the mid to late 1980s, violence erupted in the region when the Nagorno-Karabakh parliament voted to join Armenia. Tens of thousands of people died in the ensuing conflict as ethnic Armenians took control of the region. Immediately following the collapse of the Soviet Union in 1991, the region declared itself an independent republic. The death toll rose in the full-scale war that ensued between Armenia and Azerbaijan. Although a truce brokered by Russia was negotiated in 1994, the ceasefire has been an uneasy one. The threat of a renewed outbreak of violence and conflict remains, with wider consequences for regional stability.



In 1992, the OSCE (Organization for Security and Cooperation in Europe) established the “Minsk Group” to provide an appropriate framework for the peaceful resolution of the conflict. The Minsk Group is co-chaired by France, Russia and the United States. The other participants include Belarus, Germany, Italy, Portugal, the Netherlands, Sweden, Finland, and Turkey, as well as Armenia and Azerbaijan. Although the Group has met repeatedly and arranged successive rounds of negotiations, it has made little progress, largely because negotiations have been derailed by conflicting motivations and domestic pressure amongst key members.

Part of the reason for this is the presence of powerful Armenian diaspora communities in France, Russia and the US, which are keen to see Armenia maintain control over the Nagorno-Karabakh region, and do

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*The trans-Caucasus region still lacks a robust mechanism for conflict management*

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not want to jeopardize relations with Yerevan. Some believe that Russia is also using the continuing dispute to exert pressure on Baku, which has been trying to reduce Russian influence over its energy sector and export markets. The European Union, which could potentially play an important role in resolving the conflict, has been kept at bay by France and

Russia—the latter has objected to the deployment of a full-scale EU mission. The United States has been less engaged in conflict management and security of the region in recent years, distracted by its ongoing problems in Afghanistan and Iraq and its own domestic economic difficulties. As Thomas de Waal, a close observer of this conflict writes: “Although the Minsk Process has appeared poised to deliver success on several occasions, it seems stuck in a perpetual cycle of frustration and disappointment.”<sup>6</sup>

**The Broader Consequences of Regional Instability and Need for Engagement**

The festering conflicts in the South Caucasus region, notably between Azerbaijan and Armenia and Georgia and Russia, are not simply matters of local concern; their escalations would have global consequences, not least because of the region’s growing geostrategic importance and key role as an energy producer with critical supply lines to the West. Complacency is not an option. There is continuing risk that the conflict will be manipulated by elites who see opportunities for personal political gain and/or by external actors who do not want to see the region become stronger. The South Caucasus cannot live up to its full economic and social potential until these problems are addressed.

6 Thomas de Waal, ‘Remaking the Nagorno-Karabakh peace process’, *Survival* 52: 4, 2010, p. 160.

The trans-Caucasus region still lacks a robust mechanism for conflict management. Moreover, the region's main powerful actors are all—in one way or another—affected by conflicting pressures and short-term political motivations. They seem incapable, at least for the time being, of pursuing a long-term strategy that will benefit the region as a whole.

However, the threats and challenges confronting the trans-Caucasus region today are beyond the capability of local actors. Their resolution will require positive, sustained engagement from a wider group of committed international actors to help address the region's long-running conflicts. We can only hope that such engagement will emerge soon and that key 'lead nations' will move an effective conflict management response forward.