

Turco-Caspian Energy Security & the Caucasus: Threats & Opportunities

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Abstract

The evolution of the situation in Azerbaijan, Georgia, and Turkey reveals that the decisions made in the early 1990s by former Soviet republics in the Caspian Sea littoral to develop their energy assets and to monetize them for export to Western markets were correct. They reached out to one another and beyond for economic and political cooperation. The first and perhaps most spectacular realization of such cooperation on the ground was the Baku-Tbilisi-Ceyhan oil export pipeline. This project has created the backbone for South Caucasus regional integration in the former Soviet area, also involving the participation of Turkey. However, threats against energy security in the region have evolved since then. Conflict situations involving occupation by foreign forces both in Georgia and in Azerbaijan have embedded themselves in the region. The eventual dangers here are arguably worse than they were eight years ago. At issue are not only the contested territories of Abkhazia, South Ossetia and Nagorno-Karabakh. Also, as documented in the article, Iran has increased and intensified its provocations against Azerbaijan. This is ominous since the last eight years mark Azerbaijan's emergence as a key actor in Turco-Caspian regional security, in both economic and political terms. When Iran promotes regional conflict in the Caucasus by threatening the territorial integrity, legitimacy and stability of the existing government, it threatens the energy security of the broader region, with the participation of Turkey. The strategy and practice of Turkey's foreign political and economic policy should recognize this fact and take it into account.

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The years 2003-2004 represent a turning point in the geo-economic evolution of the Caucasus and the Turco-Caspian region. Consequently, this article begins by reviewing the threats against and opportunities for energy security in the region at that time. The next part of the article presents an analysis of the evolution of the situation since then, looking at Azerbaijan, Georgia, and Turkey. On that basis, the third part of the article compares the situation today with the situation eight years ago. Since Azerbaijan emerges as a key player in regional security, both economically and politically, it is given further attention in the fourth section. A conclusion then follows.

Potential sources of crisis in the Caucasus

Eight years ago, I was asked to analyze the sources and regions of crisis in the Caucasus and their impact upon the security of Turkey. In particular, I was asked to consider and evaluate six potential sources of crisis in the Caucasus. These included two identity issues, which were ethnic conflict and religious fundamentalism; two socio-economic issues, which were organized crime and migration due to economic problems; and two energy issues, which were oil and power-line security.¹

¹ "The Sources and Regions of Crisis in the Caucasus," in N. Resat Ödün (ed.), *Examination of the Regions of Crisis from the Perspectives of Turkey, NATO and the European Union, and Their Impacts on the Security of Turkey* (Ankara: Turkish General Staff Printing House, 2004), pp. 105–126; Turkish translation, "Kafkasya'daki Kriz Kaynakları ve Bölgeleri,"

The best way to begin to address Turco-Caspian energy security and to Caucasus is, by way of introduction, to review briefly the conclusions from eight years ago, concerning oil and power-line security as a source of crisis in the Caucasus and its impact upon the security of Turkey. Eight and more years ago, oil was not a direct source of crisis in the Caucasus itself, because it was mostly controlled by national governments. Questions about oil seemed to lead to crisis only where the state apparatus was not firmly embedded, and did not wield a monopoly of coercive force.

The best example of such a situation is Chechnya in 1993. There, even local authority broke down as conflicts between clans concerning the physical control of land made it increasingly difficult for oil to flow through the established pipeline between Baku and Novorossiysk.² During the Soviet era, Grozny and its surrounding areas produced a high proportion of specialized petroleum products used, for example, in Soviet aviation. By the early 1990s, however, there was no obstacle to any individual blowing a hole in a pipeline, collecting what came out of it, and selling it by the roadside, sometimes distilled in homemade apparatus.

in N. Resat Ödün (ed.), *Türkiye, Nato ve Avrupa Birliği Perspektifinden Kriz Bölgelerinin İncelenmesi ve Türkiye'nin Güvenliğine Etkileri* (Ankara: Genelkurmay Basım Evi, 2004), pp. 105–126. The present text draws upon the 2004 chapter as appropriate.

² The Baku-Novorossiysk pipeline runs for 1,330 kilometres (km) from Azerbaijan's Sangachal Terminal to the Russian Black Sea port of Novorossiysk.

The case of Ajaria in Georgia provides the best contrast to the chaos in Chechnya. Even before Aslan Abashidze's³ downfall in 2004, oil from Kazakhstan was reaching Baku by barge across the Caspian Sea and, from there, was being loaded into railroad transport and taken across Georgia to Batumi for sale and transshipment. Oil from Baku also went to Supsa a few miles away, as well as to Novorossiysk after a railroad detour around Grozny was constructed through Dagestan.

The contrast between Chechnya and Ajaria motivated the conclusion that even where there was a separatist or autonomous movement in the Caucasus, oil did not have to be a catalyst to crisis if there existed a regional authority capable of enforcing order, reaching working agreements with the central authority, and implementing them.

The leading causes of the crisis in the Caucasus in 2004 were clearly domestic and transnational issues of identity, specifically, ethnic conflict and religious fundamentalism. State-level socio-economic issues of organized crime and migration due to ethnic problems were secondary. The crises in Abkhazia and Chechnya in the 1990s typified how the already-hot identity issues (later combined in the case of Chechnya with fundamentalism) could be kindled by socio-

³ Aslan Abashidze was the leader of the Ajarian Autonomous Republic in western Georgia from 1991 to May 5, 2004.

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economic issues (organized crime in particular) and then set alight by energy issues (especially oil).

International-level issues of oil and power-line security were in general only of tertiary significance in explaining the crisis for the people in the region, as important as they were to many external powers. Nevertheless, these international issues, and oil in particular, did play some role. There was even sometimes a direct influence, explaining the persistence of the crisis, since actors from outside became involved and all levels of conflict were simultaneously in play inside the region itself.

The Evolution of the Situation until the Present

The Example of Azerbaijan

Azerbaijan has been built with massive foreign investment flows into the energy sector from early in the last decade. Even though the 1994 “contract of the century” for the Azeri-Chirag-Guneshli (ACG) fields brought Azerbaijan the largest foreign investment in the former Soviet states (US\$8 billion in 1994 dollars), Azerbaijan’s

success is exceptional nevertheless. The country has recorded impressive 15 per cent real growth rates through most of the last decade, leading to a massive decline in poverty from over 50 percent to less than 10 per cent by World Bank standards.⁴

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came the law of the land through ratification by the national parliament. Indeed, this way of proceeding did more than create predictability of the business environment; it also ensured the sanctity of contract. Because of it, no one in Azerbaijan has ever mentioned the possibility of revising the ACG contract, although as it stands, it is very disadvantageous to Azerbaijan; no contract since has contained such disadvantageous provisions.

The question now is: How can Azerbaijan transform this natural resource wealth into ambitious targets for economic development? From 2005 through 2008, public spending

⁴ World Bank Group, "Azerbaijan – Country Program Snapshot," <<http://tinyurl.com/9z1q3z2>>. All URLs given in the notes are verified as of 24 August 2012 unless otherwise stated.

roughly doubled each year. Much-needed, this was and was devoted to high priority infrastructure, but it has also meant that growth so far has been built squarely on oil and on oil revenues.⁵

The public spending leading to the construction boom in the non-oil sector is impressive. It grew 20 per cent on average per year over the last 10 years, compared to 3 per cent growth in agriculture and 6 per cent growth in industry from a very small base. Current discussions of the country's economic development increasingly concern how private investment can start to substitute for some of the state spending, including a renewed focus on economic diversification.⁶

The number of Azerbaijan firms engaged in export in the non-oil sector has been declining for a decade for a number of reasons, not least the effects of the Dutch disease. The oil revenue fuelling public spending has led to some real exchange rate depreciation, damaging the competitiveness of agricultural manufacturing and tradable services.⁷

⁵ Maria Albino-War and Asghar Shahmoradi, "Republic of Azerbaijan: Selected Issues," IMF Country Report No. 12/6 (Washington, D.C.: International Monetary Fund, January 2012), <<http://www.imf.org/external/pubs/ft/scr/2012/cr1206.pdf>>, p. 15.

⁶ World Bank Group, "[Country Partnership Strategy (CPS) for Azerbaijan:] Country Context," <<http://tinyurl.com/98ve236>>, p. 1.

⁷ Albino-War and Shahmoradi, "Republic of Azerbaijan: Selected Issues," pp. 8-14, which also discusses some of the points that follow here.

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Although Azerbaijan has made important strides in reducing poverty, the question now is how to sustain and consolidate them. Job creation is very important, but it is unlikely that oil construction will provide the options that the young and growing population needs. Consequently, today at issue is how to give the emerging and growing and young middle class a way to satisfy their aspirations. The objective of a new growth model would thus be a more diversified economic structure, including the creation of a business environment that enables innovation, facilitates investment, and fosters entrepreneurship.

Azerbaijan has started to strengthen its market institutions, but the challenge is to build the right institutions for the country and to do so quickly. Another important aspect of economic diversification is human capital, which requires a highly educated and skilled workforce, and thus a modern education system, in order to help the country compete in global markets. Azerbaijan has already demonstrated a potentially valuable model for social development, combining

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It will take a generation or more for history's verdict on those processes currently underway in Azerbaijan to become clear. Today's favorable

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signs signal only a potential that is in the process of being born. The situation in Georgia reminds an observer how fluid, delicate, and vulnerable these things are.

A Few Words on Georgia

Georgia emerged from the Soviet era as a Western-oriented country, but eight or ten years ago it was still suffering under extremely heavy burdens from its Soviet legacy, and had few friends in the West. Georgia's political evolution manifests two cycles of development. The first ended in state failure, and the second began with the Rose Revolution. Independent Georgia was reborn without any expertise in fiscal or economic policies. It also lacked a foreign policy. Not Georgian but rather Russian elites emerged as the leaders of the domestic economy.

The country suffered three civil wars and their devastating consequences. Indeed, the case could be made that Georgia's only recognized asset was its aspiration towards Western institutions and its commitment to a Western model of society and its international institutions.

A window of opportunity opened when people began to see that Georgia had value as a transit country for energy routes running from East to West. Based upon the development of Azerbaijan's offshore resources and cooperation with Turkey, Georgia developed a niche as a transit country with the construction and operation of the Baku-Tbilisi-Ceyhan (BTC) pipeline. Yet it could build little upon that foundation, and almost became a failed state towards the end of the Shevardnadze regime.

At the time of the Rose Revolution, Georgia faced an empty treasury and an overwhelming level of foreign debt. However, it had enormous leadership potential, significant popular support for a Western-oriented policy, and strong and important friends. Today, the World Bank judges Georgia to be the most successful reformer in the post-Soviet sphere, with the most liberal tax codes and an excellent business environment.⁸

This progress has occurred under difficult circumstances. The coun-

⁸ World Bank Group, "Ranking of Economies – Doing Business," <<http://www.doingbusiness.org/rankings>>.

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try's territorial integrity remains under constant threat. However, none of these opportunities would exist if not for the cooperation with Azerbaijan and Turkey on energy development and transit. Indeed, Azerbaijan agreed several years ago to supply all of Georgia's gas needs, an extraordinary achievement following the Russian invasion in 2008, helping the country both from the standpoint of political stability and from that of energy diversity.⁹

Western powers do not always tend to see the details very well, but the unresolved status of the potentially explosive situation in Georgia clearly threatens not only the successful domestic reforms but the very existence of the state itself. This is a reality to which Western powers, not just in Europe but also the United States, too easily shut their eyes. The threat posed by this unresolved conflict cannot be ignored, and it reminds the observer of the possible consequences of renewed hostilities between Azerbaijan and Armenia as well.

⁹ Robert M. Cutler, "Euro-Caspian energy plans inch forward," *Asia Times Online* (27 November 2008), <http://www.atimes.com/atimes/Central_Asia/JK27Ag01.html>.

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The Transformation of Turkey

In 1980, the estimated gross domestic product of Turkey was \$70 billion; now it is \$700 billion. Exports during the same period grew from \$3 billion to \$300 billion. The Turkish economy leapt from the 25th largest to the 16th largest in the world. According to the World Bank, Turkey's recent growth rate is second only to China, as is the urbanization rate. Such traditional population centers as Ankara and Istanbul have grown rapidly, but also in Anatolia many industrial centers are growing in size and influence. This is a remarkable transformation.¹⁰

All these developments have influenced the country's large current account deficit, to which the financial press gives much attention. The share of energy in the current account deficit as well as in the trade deficit has

10 International Monetary Fund, "Report for Selected Countries and Subjects", <<http://tinyurl.com/brw6nw6>>; World Bank Group, "Prospects for the Global Economy - Table 1. The global outlook in summary, 2010-2014", <<http://go.worldbank.org/JGD8ZACBC0>>; United Nations Economic and Social Commission for Asia and the Pacific, "Urbanization - Statistical Yearbook for Asia and the Pacific 2011", <<http://www.unescap.org/stat/data/syb2011/I-People/Urbanization.asp>>.

recently declined, but oil and gas still represent about 20 per cent of all imports and 50 per cent of the current-account deficit.¹¹

For Turkey, there is a close relationship between growth and the sustainability of energy supply. In particular, it bears noting that Turkey is a relatively energy-intensive economy. Every \$1000 of GDP requires 0.26 tons of oil equivalent, compared to the OECD the average of 0.18. Energy demand and electricity demand may grow as much as 7 per cent per year, if recent trends continue.¹²

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Today, gas from the first stage of the Shah Deniz offshore development ("Shah Deniz One") goes to Georgia and Turkey. That gas provides a substantial supply for Turkey's growing demand and additional supply as from 2017, not to mention the export, for the first time, of natural gas from the Caspian Sea region into European markets. Shah Deniz Two will provide six billion cubic meters per

11 Katy Barnato, "Europe's Fastest-Growing Economy Needs More Oil" (CNBC, 21 August 2012), <<http://finance.yahoo.com/news/europes-fastest-growing-economy-needs-182744342.html>>.

12 Ulrich Zachau (World Bank Group), "Turkey's Energy Agenda - Some Possible Directions", presentation at Conference Game Changing Energy Dynamics in the World and in Turkey, STEAM (Strategic Technical Economic Research Center) 13th Energy Arena, 8-9 September 2011, Istanbul, <<http://tinyurl.com/cebmcme>>, p. 1.

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year of additional gas for Turkey's growing demand, helping to diversify import markets and to reduce dependency on other sources.

Turkey and Azerbaijan have signed an intergovernmental agreement for Azerbaijan's gas to transit through Turkey to European markets. This is itself a new development for Turkey. It marks the first time Turkey has committed politically and comprehensively to fulfill the role of a transit country; Turkey imports gas from Russia, Iran, and Algeria, but all of that gas stays in Turkey. Gas from Azerbaijan's offshore in the Caspian Sea, however, will move through Turkey for sale in European markets.

Such a fundamental change in favor of this economic and political cooperation is driven by energy projects. Oil provides the liquidity for a transport system, while gas provides for industrial development, diversification, heat, electricity, and other residential uses of energy. Azerbaijan remains at the forefront of tackling enormous political challenges, with its political commitment to develop offshore natural gas for export to the West.

Azerbaijan is today the largest taxpayer in Georgia through SOCAR, and the development of energy in the Caspian has contributed enormously to the development of Georgia. With the Trans-Anatolian Gas Pipeline and other, related industrial projects totaling \$17 billion, Azerbaijan is set in the relatively near future to become the largest investor in the Turkish economy.

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A Recent Historical Perspective on the Current Situation

In the twenty years since the South Caucasus countries gained independence, with the legitimate exception of Georgia, observers have gone from worrying about their survival to worrying about their choice of development model. No one today calls into question the decisions made in the early 1990s by such countries as Azerbaijan or Kazakhstan to develop their energy assets and to monetize them for export to Western markets. At the same time, these countries reached out to other newly independent states in the former Soviet area for economic and political cooperation for mutual benefit.

Such cooperation must be tangibly and effectively realized on the ground for it to have roots and take hold, and in this region, that has been the BTC oil export pipeline. The BTC energy project has done nothing less than to lay the backbone for South Caucasus regional integration in the former Soviet area, with the participation of Turkey. It has promoted voluntary and mutually beneficial cooperation based upon an understanding of common benefits for populations of these countries.

In the absence of resolution of the occupation by foreign forces of national territory in both Georgia and in Azerbaijan, conflict situations have embedded themselves in the region.

Comparing the current dynamic with the situation eight years ago along the lines of the six analytical issues identified at the beginning of this article, one finds an evolutionary process that conserves some aspects of what went before but also introduces new aspects. Identity issues have remained relatively dormant but continue ominously to fester. Socio-economic issues have been in large part and sometimes impressively overcome, while the energy issues as well as other international aspects of the situation have only grown in delicacy with the increasing self-insertion of external powers into the region.

Problems concerning organized crime and migration due to economic problems remain a source of crisis but they have improved in both general and specific instances. Both Azerbaijan and Georgia have addressed their domestic economic and institutional problems with definite success, on the basis of the positive development of oil and now also natural gas resources. It is unfortunate that the territorial bases for those economic problems have not been resolved.

In the absence of resolution of the occupation by foreign forces of national territory in both Georgia and in Azerbaijan, conflict situations have embedded themselves in the region. This remains a heavy shadow that too many outside the region fail to notice, because they have simply had too much time to get used to it, or even because they willingly blind themselves through identification with the interests of larger countries rather than the smaller ones.

Those conflict situations draw the observer's attention to the other two sources of crisis outlined above, i.e. ethnic and religious issues. Arguably, the situation here is worse, or at least more dangerous, than it was eight years ago. Russia threatens the territorial integrity of Georgia not only in word but in deed, and those deeds only underline the long-term problems of failure to resolve such issues. The situation in Nagorno-Karabakh remains unchanged, and also Iran has

increased its provocations against Azerbaijan, including on the territory of Azerbaijan itself.

Iran and Azerbaijan

There is thus another conflict in the Caucasus that affects Turco-Caspian energy security on the territory of the Caucasus and, like the threats against Georgia's territorial integrity, it involves a non-South Caucasus country: Iran.¹³ Iran is endangering Azerbaijan's position as a post-Soviet state with a secular Muslim identity and constructive foreign policy orientation.

Iran has been threatening Azerbaijan for over a decade. In the energy sphere, the best-known incident of aggression occurred in the summer of 2001, when the deployment of Iranian military force in the Caspian Sea - and the threat of action - compelled a BP-led exploration mission including an Azerbaijani vessel to cease its work on the offshore Alov hydrocarbon deposit in the Azerbaijani sector.

As far back as 1999, referring to the Russian-leased Gabala radar station in Azerbaijan, the chairman of the joint chiefs of staff of the Iranian armed forces threatened the Baku government by pointing to the presence of "Shiite Azeris with Iranian

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blood in their veins" in the region of the station. He never apologized for these provocative remarks, and remains in office. In August 2011, he personally threatened Azerbaijan's president Ilham Aliyev with a "dark future" if the latter did not "pay heed" to his words.

In 2007, fifteen Iranians and Azerbaijanis were convicted in Azerbaijan of spying on U.S. and other Western interests, including state oil facilities, and conspiring to overthrow the government. In 2008, Azerbaijani authorities exposed and thwarted a plot by Hezbollah operatives with Iranian assistance to blow up the Israeli Embassy in Baku. Towards the end of last year, the Azerbaijani journalist Rafiq Tagi was murdered in a knife attack in Baku soon after publishing an article critical of Iran's president Mahmoud Ahmadinejad for "discrediting Islam." The subject of a death-penalty fatwa from Grand Ayatollah Fazel Lankarani since 2006, Tagi stated one day before his death his belief his killing could have been retaliation for that article.¹⁴ At the be-

¹³ For source documentation of the facts set out below, see the references in Robert M. Cutler, "Iran muscles in on Azerbaijan," *Asia Times Online* (7 March 2012), <http://www.atimes.com/atimes/Central_Asia/NC07Ag01.html>, upon which the present text also draws.

¹⁴ Frances Harrison, "Iran issues fatwa on Azeri writer," *BBC News* (29 November 2006), <http://news.bbc.co.uk/2/hi/middle_east/6158195.stm>; Ilgar Rasul, "Rafiq Tagi rasskazal o pokrushenii" [Rafiq Tagi Talked about the Attack], *Radio Liberty* (22 November 2011), <<http://www.radioazadlyg.org/content/article/24398750.html>>.

ginning of March this year, members of a terrorist cell created by the Iranian Revolutionary Guards together with the Lebanese Hezbollah were arrested in Azerbaijan.

Is there any justification for these words and deeds? Azerbaijan has supported Iran's right to a peaceful nuclear program. In January 2011, it signed a five-year agreement to supply at least one billion cubic meters of natural gas annually to Iran. In addition, most notably, it has pledged that its territory would not be used for military purposes against Iran.

It would seem odd that Iran has favored "Christian" Armenia over "Muslim" Azerbaijan from the start of the conflict between the two South Caucasus countries. However, this tilt only reveals that the Tehran regime's advocacy of Islamic unity is but a thin tissue that barely covers over the assertion and pursuit of Persian national interests as conceived by the ruling elite of multinational Iran.

Just a few recent examples of Iran's undeviating support for Armenia include: its opening, in 2007, of a crucial gas pipeline to Armenia, providing an energy lifeline; its construction of two hydroelectric plants on the Araks River, which marks their common border; and its building of highway and railroad links between the two countries. Indeed, in March 2011 Armenia's president Serzh Sargsyan accepted the invitation of Iran's

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president Mahmoud Ahmadinejad to celebrate Novruz in Tehran, where as a guest he publicly underlined that the Iranian government "has placed no limits on the development of cooperation with Yerevan".

The secularism of the Azerbaijani model of development gives the lie to the millenarian pretensions of the Tehran elite, who see Azerbaijan as all the more dangerous to themselves because it is a state with a majority Shiite population that has chosen secularism.

Conclusion: Iran, A Threat to Turkey and the Caucasus

When Iran promotes such a regional conflict in the Caucasus, it threatens the energy security of the broader region including Turkey. As an active threat to Turkey and its economic prosperity, Iran threatens the country's political well-being. The foregoing glance at the energy dependence of the Turkish economy makes this clear. How should Turkey consider this problem and respond?

Long-term Turkish national interests would be best served by increased economic sanctions against Iran, not increased economic trade.

Turkey has undertaken successful economic reforms, not because the European Union has said this must be done, but because this has been in Turkey's national interest. Turkey has also applied UN sanctions against Iran. Turkey chose earlier this year to reject further sanctions against Iran, such as those advocated by the U.S. It preferred to increase trade with Iran for private short-term economic gain. Yet Iran refuses to allow Turkey to have "zero problems".

Long-term Turkish national interests would be best served by increased economic sanctions against Iran, not increased economic trade. That is not because the U.S. or some other country wishes it to be so, but because it is in accordance with the Turkey's strategic interests: just as Turkey undertakes, for its own reasons, economic reforms that happen to be encouraged by the EU.

It is alarming to imagine the behavior of the regime in Tehran towards Azerbaijan, should it succeed in developing nuclear weapons. It is frightening to consider the consequences of that development, not least including the pursuit of nuclear armaments by other countries in the broader region.

It is moreover depressing to consider the effects of such developments upon the economic well being of Turkey. That is because Turkey's success in becoming an energy center for the region is based mainly on the hydrocarbon resources of the Caspian Sea basin, and Azerbaijan in particular.

There are increasing levels of interdependence between Turkey and its South Caucasus partners for its own economic well being, especially but not exclusively in the energy sector. Since before the end of the last century, Iran has posed a daily threat to the Turkish state and society, through its unceasing hostile acts against the secular state Republic of Azerbaijan, with its majority Shiite Muslim population. As such, it is a threat to the South Caucasus, to Turkey, and to the populations of the region.