

THE SOUTH CAUCASUS *in* 2020

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Since 1991, the South Caucasus has embarked on an entirely new historical path. The name “South Caucasus” itself indicates that the era that began in 1801—during which the region was called by its Russocentric name, the “Transcaucasus,” and was implicitly linked to Russia—is now over. The region has regained the “in-between” status it had in 1918–1921, whereby it is no longer part of any neighboring power but the object of the competing interests of several. However, this time there is an important difference: The independence of the three states of Armenia, Azerbaijan, and Georgia is internationally recognized; and they are being given the chance, slowly, to build viable states. This is the long-term trajectory within which all other developments fall. State building will be slow and painful, and the three states will still lag economically and politically behind Turkey and the western Balkan countries, let alone the EU member states. There is a small chance of renewed fighting. But there is at least no prospect of a return to the complete collapse of 1918–1921. The three countries’ sovereignty is no longer in question, and state institutions have the capacity to deliver basic services to citizens.

However, a number of uncertain factors make for a picture of “predictable unpredictability.” The borders of Azerbaijan and Georgia are still disputed. The Nagorno-Karabakh conflict is a dormant volcano, which, if it erupts, would have a disastrous impact on literally every other aspect of

life in the region. A new Russia-Georgia crisis, a crisis in Iran, or a major terrorist incident could all quickly destabilize a region where state authority is fragile and democratic institutions are weak or nonexistent.

Of all these shocks, the most obvious and probably the most dangerous is renewed fighting over Nagorno-Karabakh. This could happen because of a deterioration on the cease-fire line (the Line of Contact) or a direct Azerbaijani offensive. A resumption of the conflict would be very dangerous and highly unpredictable. The only thing that could be safely assumed is that it would be very destructive, causing ripples far beyond the immediate region, and that neither side would fully win. Outside powers, Russia and the United States in the first instance, would act to suppress the conflict but not before much damage had been done. The “five-day war” over South Ossetia illustrates how catastrophic even a limited conflict can be.

Russia and the Region

A long-term trend that will be more marked by 2020 is the region’s growing detachment from Russia. Russia’s dominance of the region, both in the Tsarist and Soviet eras, was always much weaker than it was perceived to be. Saint Petersburg and Moscow relied on co-opted elites to govern and, with some exceptions, accommodated national aspirations and built local institutions within a colonial project. Since the turbulent early 1990s, when the Russian military (as opposed to the Russian state) was a major actor in the region, Russia’s influence has been in steady decline, although Russian assumptions that the region is “ours” are still prevalent among the members of the older generation.

“De-Russianization” manifests itself in a number of ways. Ethnic Russians now number less than 2 percent of the population—a strong contrast to Kazakhstan or the Baltic states. The Russian language is in decline, despite being a lingua franca for the older generation and in part because the Russian government does little to support linguistic and cultural initiatives. Russian television channels are still watched in Armenia, but hardly in Azerbaijan and Georgia. The younger generation, even in Armenia, derives its cultural diet from globalized and national media and decreasingly from Russia.

In their foreign policy choices, the three countries are less reliant on Russia than they were, and this trend is also set to continue. Georgia has made a strong break with Russia, and the Russian economic embargo has forced it to diversify exports away from Russia. In the next few years, links of some kind will resume—and Russian business in fact still has a strong presence in Georgia. But the events of the last few years have ensured that in outlook at least, Georgia and Russia have moved far apart. Baku balances its relationship with Moscow with its relations with Brussels, Washington, and Ankara. Russia is Armenia's closest ally, and the two countries signed an agreement extending Russia's lease of the military base in Gyumri until 2042. Notwithstanding that, Yerevan is also careful to cultivate other relationships, being a big recipient of U.S. aid, an active participant in NATO's Partnership for Peace program, and a partner of Iran.

All this is slowly forcing Russia to enter into new “rules of engagement” in the South Caucasus with other powers, understanding that the locals want to balance their interests and other outsiders are here to stay. It is part of Russia's painful transition to being what Dmitri Trenin describes as a “postimperial power,” which seeks to be the most powerful actor in its neighborhood but no longer wants to reestablish an empire, with all the colonial burdens that that would bring.

Russia's influence on the region will increasingly be as an economic actor. Russians own or manage most of Armenia's major assets, including its railways, telecommunications companies, and nuclear power plant. Russia still owns assets in Georgia. It is now buying gas from Azerbaijan and is offering to buy more. This approach corresponds to the strategy outlined in the leaked Russian foreign policy doctrine, whereby the Foreign Ministry increasingly sees its main goal to be in forging “modernization alliances” to facilitate the economic transformation of Russia. Even Armenia fits within this vision, given that the doctrine sees the expertise that Russia gains from Yerevan's relations with the EU and NATO as an asset and identifies Armenia as a useful conduit for importing technology into Russia.

Migrants

The subject of migration to Russia deserves special attention because this is likely to be the main way ordinary Russians and South Caucasians interact

over the next decade. There may be up to 5 million Armenians, Azerbaijanis, and Georgians living in Russia, both as new Russian citizens and as migrants. This in effect creates a “mini-Caucasia” on Russian territory, which has both good and bad consequences for both sides.

On the positive side, the migrants make for a healthy interdependence between the South Caucasus and Russia. Opinion polls suggest there is a more positive attitude among the general population in Azerbaijan and Georgia toward Russia than among the political elite. Economically speaking, the migrants provide a vital source of revenue to the three South Caucasian countries through remittances; estimates vary, but they may be more than \$1 billion a year for each country, or equivalent to almost half the Armenian state budget. In Russia, these migrants perform the role of *gast-arbeiter* anywhere, doing the jobs that locals would rather not do and providing much-needed labor power for agriculture and the construction industry.

One negative aspect of this phenomenon is that migration drains the South Caucasus of its most useful workers. The main category of migrants is young men between the ages of twenty and thirty-five years, who leave a big gap in the workforce back home and consequently make small towns and villages across the South Caucasus (but not the capital cities) dismal semi-abandoned zones. Other professionals seek to assimilate in Russia, rather than returning home. A bigger problem is that “people of Caucasian nationality” are a major target of racial and xenophobic discrimination and violence. This applies equally to everybody from the region—a skinhead will not discriminate between an Armenian student and an Azerbaijani market worker. It only takes a small spark to ignite ethnic violence, as happened during the Georgian-Russian crisis of 2006, when hundreds of Georgians were forcibly deported from Russia. So what economics brings together, politics can still drive apart. A domestic nationalist backlash in Russia, caused by an economic downturn, in which Caucasian migrants were victimized or forced to flee, could spark a serious crisis in bilateral relations with all three South Caucasus countries.

Abkhazia and South Ossetia

Abkhazia and South Ossetia are the big exceptions to the trend of diminishing Russian influence in the South Caucasus, having been de facto

annexed by Russia since 2008. Arguably, the Russian takeover began long before that, and it could be argued that in 2008 Moscow was not so much redrawing the map as aggressively reasserting the status quo that had been in place since 1992–1993, when the two territories *de facto* seceded from Georgia.

Both territories are now parts of the Russian economic, military, and media space, although Abkhazia's political institutions are still basically autonomous. However, the prospect of the two ever formally joining Russia is very remote. Currently, there is far less engagement between the West and Georgia with South Ossetia than with Abkhazia, but during the next decade that is likely to reverse. South Ossetia is small and poor and of far lesser strategic importance to Russia than Abkhazia, whereas Ossetians and Georgians have much stronger traditions of intermarriage and trade than do Abkhaz and Georgians. That suggests that if and when a small thaw occurs in Georgian-Russian relations (something that both sides need to happen but that is unlikely to occur before Mikheil Saakashvili leaves office in 2013), they will begin to make a deal on South Ossetia and open up South Ossetia to trade from Georgia. Abkhazia is stronger, bigger, and more strategically important to Russia. Its population of Georgian internally displaced persons is bigger and less welcome to return. This means that a breakthrough on conflict resolution is very unlikely and the best either side can hope for is that Abkhazia achieves the status of the Turkish Republic of Northern Cyprus, a peaceful territory with certain links to the south and to the international community and certain opportunities to develop economically.

Two factors will bear on the future of Abkhazia and South Ossetia. The first is the unstable situation in the North Caucasus. Russia has increasingly lost levers of control in the North Caucasus, and there is no sign of the low-level insurgency abating there. The Russian government's recognition of the independence of Abkhazia and South Ossetia has only complicated matters there, sowing resentment in Chechnya, Ingushetia, and the three Circassian regions of Adygeia, Kabardino-Balkaria, and Karachaevo-Cherkessia about Russian "double standards" in suppressing nationalism on its own territory while encouraging it on the territory of Georgia. At some point, Russia may need to turn to both Georgia and Western countries for help in stabilizing the North Caucasus—which will in turn require it to be more flexible over Abkhazia and South Ossetia.

The second factor is the Sochi Winter Olympics in 2014. The Russian government wants to be able to rely on Abkhazia, which is just a few kilometers to the south, to help make them work. On the one hand, Russia wants to be able to depend on infrastructure in Abkhazia to supplement what is available in and around Sochi, whether it is the Sukhumi airport (which is better able to receive airplanes than the Adler airport near Sochi) or hotels that can accommodate thousands of guests. This means that in the short term, Russia will continue to try and consolidate its economic hold on Abkhazia. On the other hand, the Russian government will want to invite foreign as well as Russian visitors to stay in Abkhazia—which would involve some kind of consent from the Georgian government on the use of what most of the world still regards as sovereign Georgian territory. For both these reasons, there will be an incentive for Russia to be more flexible after 2013.

State Fragility

Governments in the South Caucasus are strong but brittle. Power is mainly exercised through a classic post-Soviet “state vertical,” beginning with the president. There are few safety valves (with the partial exception of Georgia), with the result that elections still have the potential to turn into crises, as happened in Azerbaijan and Georgia in 2003 and Armenia in 2008.

Azerbaijan

Azerbaijan presents the starkest case of this duality of strength and weakness, and is the strongest candidate for a major crisis before 2020. Increasing energy wealth and sharpening social divisions go hand in hand. The Azerbaijani elite looks much stronger and richer than it was a decade ago. The old opposition has been marginalized, and political space has narrowed to the point that even a dozen people cannot demonstrate in favor of the Musavat Party in central Baku without being detained by police. The removal of presidential term limits from the Constitution means that Ilham Aliiev (who will turn 58 in December 2019) can be elected leader of Azerbaijan almost indefinitely. Even if he were to leave the scene, a successor (perhaps his wife) can be found from his family or network.

The future stability or instability of Azerbaijan depends in large part on how far its oil and gas revenues will stretch. According to one projection, the country could earn as much as \$400 billion over the next twenty years from the Azeri-Chirag-Guneshli oil fields in the Caspian Sea, whose oil is exported through the Baku-Tbilisi-Ceyhan pipeline. When it comes to oil revenues, there are two main variables: Will the price of oil hold up? And how long will reserves last? The first question is unanswerable; suffice it to say that if the oil price dips to below \$50 a barrel, revenues will also fall considerably. When the world oil price fell sharply in 1998, a string of foreign companies left Azerbaijan.

As for oil reserves, two recent predictions say that “at 2009 production levels, the country’s oil reserves will be depleted in eighteen years” and that they will be exhausted in twenty to twenty-five years barring new discoveries. The decline of “peak oil” is expected to begin in about 2014. BP has indicated that it may be able to increase the life of the Azeri-Chirag-Guneshli field by deeper drilling and thus extend peak oil until about 2019.

Azerbaijan’s hope is that by that time, rising gas revenues will have filled the gap left by falling oil revenues. The country has plentiful reserves of gas, and production is expected to increase to about 20 billion cubic meters a year in 2015 and beyond that when the second phase from the Shah Deniz field begins in about 2017. This should potentially give Azerbaijan a stable source of income—although not as spectacular as that from oil. However, Azerbaijan’s hopes for gas prosperity are dependent on factors completely beyond its control—the changing gas market and, in particular, whether new shale-gas technology will open up a new worldwide energy source and cause a dramatic dip in world gas prices.

All this underlines the reality that Azerbaijan’s future is much too reliant on an unpredictable commodity. A worrying omen is that Azerbaijan’s once-rapid growth of gross domestic product has slowed considerably in the last few years. After growth averaging more than 21 percent a year in the period 2005–2009, growth in 2010 was a modest 5 percent and International Monetary Fund predictions put it at below 3 percent in 2011. The creation of a State Oil Fund, SOFAZ, was supposed to mitigate the effects of this. The government drew heavily on SOFAZ in 2009, spending almost AZN 5 billion to close the budget deficit, but it cannot intervene this heavily every year without rapidly depleting the fund.

Worryingly, beyond energy products, the rest of the economy is extremely weak. In 2009, oil and gas contributed 95 percent of Azerbaijan's total export revenue. Agriculture and the non-oil industry are both very poorly developed. Even at the moment, this creates problems as oil and gas are not good creators of employment, providing only about 1.5 percent of jobs in the economy. Oil and gas have also skewed the situation by concentrating almost the entire economy of Azerbaijan in the capital, Baku. According to various estimates, between 55 and 80 percent of the population now lives in and around the city.

Islam and Iran

Surveys of Azerbaijani youth indicate high levels of cynicism and a worrying "values gap." Young people believe that money and connections are more important attributes than natural talent. They take little interest in politics and show distrust for both Russia and the West.¹ Whereas Russia has the taint of being the former colonial power, the West has the associations of being the friend of the ruling elite and the oil companies. These attitudes as well as the country's growing social divisions and the prospect of falling oil revenues in about 2020 are bound to boost political Islam as a force in Azerbaijan.

Up until now, political Islam has been weak in Azerbaijan, in comparison with Uzbekistan, for example. But a social base for it is now forming. In 2006, a poll by the Far Center in Baku found that 19 percent of respondents favored establishing an Islamic state in Azerbaijan and 30 percent more favored introducing more Islamic elements into public life. Since then, such attitudes will undoubtedly have been strengthened. The government has acted clumsily, closing several mosques, while continuing to ally itself closely with the official clerical establishment it inherited from the Soviet era. New, younger articulate and educated mullahs are emerging. Most are moderate, but some are not.

Political Islam comes from both the north and the south. In the north, it is Sunni and linked to the most Islamic part of the Russian Federation, Dagestan. New instability in Dagestan could have a direct impact on Azerbaijan via their shared Lezghin population. In the south, political Islam is Shia and intersects with Azerbaijan's other major challenge in the next

decade, Iran. Iran and Azerbaijan—which used to be part of the same empire until the early nineteenth century—are vulnerable to one another, and a crisis in one is likely to have an impact on the other. There are upward of 20 million Azeris in Iran (the numbers are strongly disputed because most are heavily assimilated), and occasional unrest in northern Iran suggests that many of them want more rights to speak and teach their language than are being given them by the Iranian government. The Republic of Azerbaijan has the capacity to manipulate this.

For its part, Iran has the capacity to disturb Azerbaijan by preaching its strong Shia Islam to what is both a Shia and a secular state. The television channel Sahar-2 broadcasts in Azeri to southern Azerbaijan and sends the propaganda message that the current ruling elite in Baku are “friends of Israel” and “enemies of Islam.” Opposition leaders such as Isa Gambar, who are now barred from the mainstream media, give interviews to Sahar-2. The Iranians also influence the Talysh minority, who are estimated to be 200,000 to 250,000 strong. They speak a language related to Farsi and live in southern Azerbaijan.

In theory, Azerbaijan and Iran have a shared interest in mutual stability. When tensions were high between Iran and the United States in 2006, the Azerbaijani government reaffirmed that it would stay out of any potential U.S. military action against Iran. However, events have a tendency to get out of control, and there are plenty of possible flashpoints. In the last decade, there have been a number of serious incidents—including an Iranian warship confronting an Azerbaijani survey vessel in the Caspian Sea in 2001; up to 60,000 Iranian Azerbaijanis crossing the border into Nakhichevan in 2005–2006, when Iranian-U.S. tensions were high; and demonstrations and mutual accusations after cartoons that Azerbaijanis found insulting were published in an official Iranian newspaper in 2006.

All this underlines the fact that Azerbaijan currently has what the International Crisis Group aptly calls “vulnerable stability.” The present system is built to accommodate the political and economic agenda of the current elite. By 2020, the system is likely to be more fragile and vulnerable to internal and external shocks. The risk this poses is not just to Azerbaijan itself, because if there is a domestic crisis inside the country, a leader may be tempted to play the “Karabakh card” and unite Azerbaijanis around the prospect of a new war with Armenia.

Armenia

Armenia is the most ethnically homogeneous of the three states but is also politically fragile. Serzh Sarkisian came to power as president amid arrests of the opposition, following the violent street clashes in Yerevan on March 1, 2008, and he has established himself as the undisputed leader of the country. But his perceived legitimacy is still low, although the opposition has not managed to keep up the momentum of protest against him. Disastrous economic news (a double-digit fall in gross domestic product) and the halting of the Armenia-Turkey rapprochement mean that he is still vulnerable. The chances of an opposition candidate being able to mobilize street power and take office in 2013 or 2018 are not insignificant. There is also a possibility of a split within the governing elite—a factor that reinforces Sarkisian’s very cautious attitude to both the Turkey and Nagorno-Karabakh issues, because he does not want to be challenged by anyone playing a “patriotic card” against him.

Armenia’s survival as a state is assured—something that could not have been said with certainty during the cold, dark winters of 1991–1993. Yerevan is a properly functioning city, although the surrounding regions are still sunk in poverty. The main issue facing the country is whether it can break out of regional isolation through the normalization of relations with Turkey and resolution of the Nagorno-Karabakh conflict. In particular, Armenia needs the route to Europe that lies through Turkey to have any hope of future prosperity.

However, Armenian leaders of all parties are clear that they will not make what they regard as unjust concessions over key issues of Armenian identity to Azerbaijan and Turkey for the sake of economic benefits. Specifically, they would rather pay the price of isolation than unilaterally give up Azerbaijani territories conquered during the Karabakh conflict that they say are an essential “security zone” to protect the Karabakh Armenians. This does not inspire any hope for the resolution of the Nagorno-Karabakh conflict—particularly given that the Azerbaijani side is, if anything, even more intransigent.

There is more cause to be optimistic over Armenia-Turkey normalization. Here the cards are very much in Turkey’s hands. Opening the Armenia-Turkey border and establishing diplomatic relations with Armenia would hurt Ankara’s relations with Baku, but would bring Turkey other

benefits. It would rid Turkey of the continuing agony of genocide resolutions in foreign parliaments and take the country one step closer to the European Union. However, Turkey's decisions will stem from domestic political factors. Currently only the Justice and Development Party (AKP) would take this step, and even it feels constrained by Azerbaijani lobbying. Effectively, this means that Armenia must wait for events beyond its control—a better political climate in Turkey—to be assured of open borders to the West and its own economic transformation.

Georgia

Georgia is a much more open society than its neighbors, but it is still a long way from being a full democracy. Its system of government has been aptly called a “pluralistic feudalism,” in which politicians are allowed to compete for power but are barely accountable to the public when they achieve it. Centralization never fully works in Georgia, and there are competing interests and players, both from the opposition, in the regions and within the ruling elite who can challenge Saakashvili's grip on power and ability to name a successor. The president is working hard to ensure that his people inherit the levers of power when he leaves office in January 2013, but he needs to do so in a way that does not invite Western condemnation. Constitutional amendments have enhanced the future powers of the prime minister so that Saakashvili can emulate Putin and switch roles, if he wants to.

Barring a new flare-up over Abkhazia or South Ossetia (which is not in the strategic interests of either Georgia or Russia, and which Western powers and the European Union Monitoring Mission will do their best to avert), Georgia is unlikely to face a major conflict in the next decade. The major issue facing the country is whether it can make progress economically and politically or whether the current governing elite will merely entrench itself in power, leaving Georgia as a hybrid country, still relatively pluralist but neither fully democratic nor fully European. Currently, Georgia is basically a one-party democracy of extremely youthful politicians, who will not be easily dislodged and still have a solid base of popular support. Their presentation skills and useful friends (especially in Washington), and the fact that they are relatively more democratic than Georgia's neighbors, spare them from strong criticism.

The country is proud of its economic record, of having posted double-digit growth figures and massively increased the state budget. But the easiest part is now behind them. Much of the growth in state revenue was due to parts of the gray or black economy being legalized in 2004–2005. The major privatizations—which former economics minister Kakha Bendukidze described as “selling everything except our conscience”—have now all gone through. U.S. and EU aid, which Georgia was lucky to receive before the world financial crisis hit in the autumn of 2008, is unlikely to be given again in such large quantities. The economy has improved substantially in the last few years but still faces major problems—90 percent of businesses are concentrated in Tbilisi, and unemployment remains high. This suggests that Georgia needs a sustained long-term strategy for economic transformation. Currently, the government seems insufficiently professional to come up with one. The appointment of an inexperienced twenty-eight-year-old from Canada to be economics minister does not inspire optimism.

The key challenge for Georgia is whether it can and wants to pursue economic integration with the European Union, as the Baltic states did in the early 1990s. Currently, there is an ideological divide within the Georgian governing elite. Some want to pursue European integration, beginning with a free trade agreement with the EU. Others (led by the libertarian Kakha Bendukidze) see European integration as a straitjacket and dream that Georgia will become, in President Saakashvili’s words, “Switzerland with elements of Singapore.” In practical terms, this has resulted in disputes in Brussels and Tbilisi about the launch of negotiations on a Deep and Comprehensive Free Trade Area that would grant Georgia privileged access to the EU single market.

Optimistic Scenarios

There is a strong pull toward inertia in this region. Ruling elites are well established and see little incentive to invite change that would unseat them.

Optimistic scenarios for the South Caucasus rest on the twin interrelated goals of a resolution of the region’s economic and security problems. The most benign scenario is an economic transformation from below, with

the region following the path of Turkey during the past decade in achieving strong economic growth. The drivers for this would be the owners of small and medium-sized businesses given the political space and incentives to pursue their natural entrepreneurialism. Turkey itself could play a positive role in helping make this happen, but only if it succeeds in normalizing its relations with Armenia and becoming a neutral regional power.

The main actor that could help make this kind of transformation happen would be the European Union, if it robustly pursued free trade and association agreements that opened up European markets, gave the countries a stronger legal framework, and empowered local businesspeople. Successful EU engagement in the South Caucasus requires goodwill from both sides. From Brussels, it means the will to offer better visa facilitation and trade privileges and to be willing to engage with a region that defies easy solutions. From the South Caucasian side, it means a willingness to strike a bargain that involves economic and political liberalization (with the accompanying weakening of power of elites) in return for the economic and security benefits that the EU can offer.

When it comes to security, the benign role here could be played jointly by Russia and the United States, as well as the EU, if relations continue to improve, in agreeing on a shared security arrangement that could jointly support Armenia, Azerbaijan, and Karabakh. In other words, the latter-day great powers could agree on a robust peacekeeping force or security regime that would be sufficient to persuade the Armenians to give up the Azerbaijani-occupied territories in favor of a status solution for Nagorno-Karabakh that falls short of independence. In this way, the “reset,” combined with Russia’s acceptance of the end of its dominant role in the region, could pave the way for a more stable regional security framework.

Note

1. See, for instance, “Public Opinion Survey on Moral and Social Stance of Azerbaijani Youth,” *Turkhan’s Blog: Independent News from Azerbaijan*, June 4–July 4, 2009, <http://turkhan.wordpress.com/2010/06/12/public-opinion-survey-on-moral-and-social-stance-of-azerbaijani-youth>.

POLITICAL ECONOMY *and* ECONOMICS

PART II