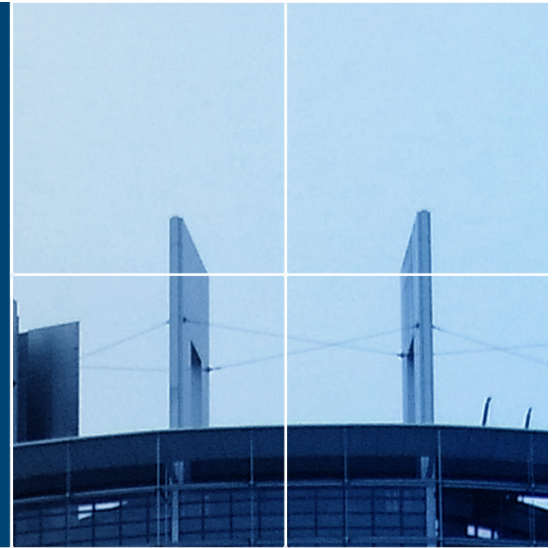




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EGF RESEARCH PAPER



## A PRAGMATIC REVIEW OF NAGORNO-KARABAKH CONFLICT RESOLUTION:

### COULD ECONOMIC INCENTIVES HELP BREAK THE CURRENT STALEMATE?

RESEARCH PAPER

DR. MARAT TERTEROV

AND

GEORGE NICULESCU

BRUSSELS | OCTOBER 1, 2012





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AND

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BRUSSELS | OCTOBER 1, 2012

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## Summary

In this research, we attempt to take a more pragmatic approach towards the topic of the conflict resolution process between Armenia and Azerbaijan over Nagorno-Karabakh. We believe this process remains in a dangerous state of stalemate at the time of writing. More specifically, we ask whether economic incentives could help break the current deadlock. In order to do this, we posed a series of questions to a notable range of international experts familiar with the conflict, asking as to whether an approach towards conflict resolution where Armenia would return some land to Azerbaijan in return for the latter providing access to regional energy and infrastructure projects could contribute towards breaking the stalemate. The “return of land”, in the context of our research, refers primarily to the seven districts of Azerbaijan which Armenian forces took during the Karabakh war of the 1990s and which remains under Armenian control to this day. We do not assume the “return of land” to mean the return of the Nagorno-Karabakh enclave itself. At the outset of our research, we were optimistic that the “economic incentives” approach could offer a fresh dimension to conflict resolution in relation to the current stalemate over Nagorno-Karabakh. We felt that all parties could exercise a degree of “Caucasus pragmatism” if the right arguments were appropriately presented to governments and public, bearing in mind the widespread desire to see the region “take off” economically.

Despite our initial optimism, the results of our research are less convincing than we had hoped. Some of the key-note findings in our work imply that economic incentives are likely to play more of a secondary, rather than leading role in any future efforts to resolve the Nagorno-Karabakh conflict. We found that although economic incentives were seen as a laudable concept, any sense of a “land for (access to regional energy and infrastructure) projects” formula could not break the deadlock on its own. It could only serve as an element of a wider-“Grand Bargain”, which would include political, economic, security, humanitarian, and democracy building aspects. We also found that Armenia is unlikely to endorse economic incentives as a factor of negotiations with Azerbaijan if this were to be seen as weakening its security. Such schemes could only work, from an Armenian perspective, upon prior resolution of the status of Nagorno-Karabakh. Further, while the inability of the Minsk Group to forge a breakthrough on Karabakh is noted, the research shows that consensus does not exist for taking the peace building process out of the hands of the OSCE.

However, the research also shows that an approach which refers to economic incentives may add value to current endeavours for conflict resolution over Karabakh. A strong level of sentiment exists which suggests that “discussions around economic issues” (between experts from Armenia and Azerbaijan under international auspices) should take place. Such discussions have the potential of building confidence and fostering

trust between the conflicting parties. The research brought out the view that starting a comprehensive dialogue on post-conflict scenarios involving joint regional energy and infrastructure projects would be a step in the right direction. The role of such dialogue in the context of the Karabakh conflict resolution process should not be underestimated, we feel. Most significantly, such measures could force a “shift of gear” in the prevailing political narrative over Karabakh at both governmental and non-governmental levels. The current narrative, promoted by both Baku and Yerevan in relation to their individual interests, is both dangerous and unproductive in terms of conflict resolution and subsequent peace building. It is comprised of bellicose, strident language which does little more than further heighten already elevated tension levels. Commencement of dialogue over a combination of post-conflict scenarios and economic incentives would also provide additional tools for the ongoing work of the Minsk Group. Moreover, it could complement the Minsk Group negotiations, since developing additional instruments where post-conflict scenarios could effectively be modelled, could itself provide a framework within which ‘conflict transformation approaches’ could take place.





## Starting on a Sour Note: No Immediate Light at the End of the Tunnel for Karabakh

It is becoming increasingly clear that there is little immediate “light at the end of the tunnel” in relation to peaceful settlement of the unresolved conflict between Armenia and Azerbaijan over Nagorno-Karabakh. To the contrary, experts speak of the risk of a return to all out hostilities, citing factors such as failure of last year’s peace talks between the two countries hosted by the Russian Federation to achieve a breakthrough, Armenia’s continued reluctance to surrender land gains made at Azerbaijan’s expense following the war the two countries fought in the early 1990s, and the increasing concern that Azerbaijan may have little choice but to turn to force in order to regain territory lost to Armenia. Further, as recent roundtables between Caucasus experts have demonstrated, both the bilateral Azerbaijani-Armenian conflict resolution negotiations process and the wider relationship between the two countries is now governed by a severe lack of trust. Meetings involving the conflicting parties which have taken place under the auspices of neutral arbiters often result in little more than reciprocal accusation rounds – an environment in which any mutually acceptable confidence building measures and steps towards conflict resolution are extremely difficult to develop.

Border skirmishes, artillery shelling and “ongoing provocations” at the line of contact between the two sides are frequently reported in the international media, while the leaderships of both countries appear to be unmovable in their uncompromising positions towards each other. The present-day narrative which has emerged around the “Karabakh story”, consumed by the respective populations of Armenia and Azerbaijan, does little more than breed hostility and escalate already heightened tension levels, merely threatening to pour fuel onto the fire. The prospect of either forcing through the unconditional return of Nagorno-Karabakh (by Azerbaijan) or protecting the status quo of land gains (by Armenia) risks plunging the two countries back into the vortex of another violent conflict. Another Karabakh war would have extremely dangerous “knock-on” effects for the security of the entire South Caucasus region and well beyond. Some experts suggest that if no further progress is made towards a resolution of the Karabakh dispute soon, Azerbaijan could resort to hostilities in order to take back its lost territories.<sup>1</sup>

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<sup>1</sup> “Security in the South Caucasus”, Wilton Park Round Table, Tbilisi, Georgia, March 20-22, 2012.

## Economic Pragmatism as a Means of Addressing Unresolved Disputes

While it seems that only the most extreme optimist would be brave enough to believe that a resolution to one of the world's most intransigent unresolved conflicts looms somewhere on the horizon, all logic supports the view that there are massive, long term gains to be made by both sides – as well as for the South Caucasus region as a whole – in seeking to speedily resolve the Karabakh conflict. In a recent article, one Caucasus scholar spoke of “a deep history of pragmatism in the Caucasus which is there, just below the surface, if you care to look for it”.<sup>2</sup> This comment does not, necessarily, imply that “miracles can occur overnight” in the context of the Karabakh conflict. The Karabakh case has become far too complex not just from its own internal dynamics, in this regard. The role of external stakeholders and their geopolitical interests in the region also need to be taken into account strongly when contemplating the obstacles currently standing in the way of any binding resolution to the conflict. That being said, if, for example, both the political elites and mainstream populations of both Armenia and Azerbaijan would be persuaded to believe that after a further 20 years they would achieve wide-scale economic development, experience significant wealth and prosperity at the expense of surrendering mutual plans of belligerence, could such pragmatism come to the forefront?

While the answer to this question is more likely to be yes than no, since all parties to the Karabakh dispute often talk of peace as the precursor to a wealthy, economically integrated and dynamic South Caucasus region, a further question immediately arises: how do we get there? The Karabakh dispute today is essentially seen as a political conflict, where one side argues the right to self-determination and calls for recognition of status, while the other will not accept anything less than the return of its territory, the forceful occupation of which has been widely condemned.

Given that overcoming these barriers in a political context has proven to be elusive for some two decades, which has itself led to a narrative of heightening tension and greater risk of all out war, is it not time to consider putting economic questions besides the political ones? With no light at the end of the tunnel towards conflict resolution in the OSCE Minsk Group framework, in order to prevent Azerbaijan's ongoing sense of “national crisis” over Karabakh from tipping over the edge, is there no added value for Armenia, Azerbaijan and the international community to start talking about “jumping over the fire”: the vision of a prosperous, integrated South Caucasus region governed by free trade and open borders? Europe, after all, has passed through a similarly eliminating transformation in recent decades. Why should Armenia and Azerbaijan, as two states embracing European-style modernisation and nation building, not share the experience and benefits of the European transformation in this day and age?

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<sup>2</sup> Thomas de Waal, “The Lightness of History in the Caucasus”, 2010, extracted from [www.opendemocracy.net](http://www.opendemocracy.net),

Although we realise that the “Karabakh volcano remains a simmering one”, one does not have to look far for practical examples where a sense of economic normality – as well as pragmatism – has been achieved between countries which have failed to settle likewise challenging political disputes. They are present in the South Caucasus itself. Georgia and Russia fought a short but damaging war in August 2008, resulting in Moscow-backed statelets, Abkhazia and South Ossetia, breaking away from Tbilisi. Although Abkhazia and South Ossetia were the scene of separatist conflicts with Tbilisi during the 1990s, the arrangement brought about by the August (2008) war purports to become a permanent one. The two entities have been recognised by Russia as sovereign states – to the chagrin of Tbilisi, which argues Russian-backed occupation of Georgian national territory.

Like Armenia and Azerbaijan, Russia and Georgia are engaged in negotiations to resolve the conflict under international auspices: the so-called Geneva Process. This has not stopped Russia and Georgia, however, from exercising extensive economic ties with one another, despite Tbilisi’s argumentation of Russia’s occupation of its land in the international context. The Russian state-owned power company, RAO UES, is a key supplier of electricity to Georgia, while Russian private firms are well established in a number of sectors of the Georgian economy. Although relations between Tbilisi and Moscow remain, at best, frosty, senior Georgian government officials assert that Russian business is welcome in the country as long as it “engages in business for the good of the Georgian economy”.<sup>3</sup> Furthermore, Georgia has recently lifted visa bans on Russian citizens and around 300,000 Russians visited Georgia in 2011.<sup>4</sup>

Are there no lessons to be learned for Armenia and Azerbaijan from the Georgian-Russian experience of an unresolved political dispute running in parallel to extensive economic ties? We believe that compromise and (the type of) pragmatism (for which the region is known to insiders) will be inevitable if meaningful strides are to be taken forward in order to resolve the Karabakh conflict. That being said, we feel that there is currently no sign that a political settlement is in sight. Further, we are not convinced that a ‘political settlement’, in its own right, will be sufficient to resolve this most intractable of disputes. Economic, social and even psychological elements will have to be factored into the equation of the final ‘Grand Bargain’. Of these, economic incentives may be the most alluring given the region’s remaining state of under-development and the mutual desire of both the political and civil societies in all of the South Caucasus to see the region move forward.

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<sup>3</sup> “Security in the South Caucasus”, Wilton Park Round Table, op.cit;

<sup>4</sup> Damien McGuinness, “Russians tourists return to Georgia despite 2008 war”, extracted from <http://www.bbc.co.uk/news/world-europe-18285840>

## The Ensuing Research: Does a Basis of Economic Pragmatism Exist for Karabakh?

In this research, therefore, we wanted to test the idea of whether economic incentives could help break the current deadlock between Armenia and Azerbaijan over Nagorno-Karabakh. More specifically, we posed ourselves the question of whether an approach towards conflict resolution where Armenia would return some land to Azerbaijan in return for the latter providing access to regional energy and infrastructure projects could contribute towards breaking the current stalemate. We should state from the outset that our question did not relate to the Nagorno-Karabakh entity itself, but rather to the seven districts of Azerbaijan which Armenian forces took during the Karabakh war of the 1990s and over which Yerevan has maintained control since that time – buttressed by military power and in contradiction to a range of international resolutions. The seven districts of Azerbaijan which Armenia seized included Agdam, Qubadli, Jabrayil, Zangilan, Kalbajar, Lachin, and Fizuli. In the context of the current stage of the Karabakh dispute, Armenia refers to these territories as a buffer, or security zone.

We felt there was an evident basis for posing such a question, given our regular contact with both Azerbaijani and Armenia diplomats during the last year, as well as stakeholders from the international community, in the context of previous research we had conducted on security in the wider-Black Sea region. We acknowledge that like the case of the Zionists in the Holy Land, especially following Israel's takeover of Jerusalem in 1967, for many Armenians the prospect of returning land to Azerbaijan would be the equivalent of heresy. The hoisting of the Star of David over Jerusalem, however, has not prevented Israeli-Palestinian peace talks from continuing, nor of Palestinians' diverse attempts at pushing for international recognition of their aspired statehood.

Thus it is worth mentioning, at this point, that we have also been told by very senior Armenian diplomats that they foresee Yerevan returning (either all or part of) the occupied buffer zone around Nagorno-Karabakh to Azerbaijan upon adoption of the peace package proposed in the so-called Madrid Principles.<sup>5</sup> Indeed, this (not fully transparent) package mentions that the seven occupied districts of Azerbaijan will be returned and that borders, transportation links and lines of communication (currently closed between Armenia and Azerbaijan, as well as between Armenia and Turkey) will be reopened.

Similarly, we have been told by Azerbaijani diplomats, who often echo the positions of top decision makers in Baku, that they would potentially welcome the involvement of Armenia in Azerbaijan-driven energy infrastructure projects in the event that Armenia

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<sup>5</sup> See page 16 of this study/text below for an elaboration of the Madrid Principles

would make some concessions on land.<sup>6</sup> Azerbaijan would see it to be a major confidence building measure if Armenia were to return one, or more, of the seven occupied districts, for which Baku would be prepared to make reciprocal concessions by way of joint Armenian-Azerbaijani cooperation in the energy-economic sphere. Diplomats and decision makers from both countries are aware of Russian-Georgian energy sector cooperation, as mentioned above. Other sources have echoed this last point and experts cite the energy ministers of Armenia and Azerbaijan both stating that deep and mutual energy cooperation between the two countries could take place if movement towards a settlement over the Karabakh dispute would be made.<sup>7</sup>

While we, again, realise that a thick layer of public opinion inside Armenia would be reluctant to risk compromising the status quo of Armenia's security buffer in return for possible "economic marriage" with Azerbaijan, it is worth bearing in mind two further issues in this respect. Azerbaijan, as well as Turkey, are steadfastly moving forward towards becoming the new focal points of the regional energy economies on the Western side of the Caspian Sea, superseding Russia, to some degree. The most significant energy projects the two countries will develop in the foreseeable future will, by their nature, be cross-border oil and gas transportation initiatives, with considerable economic benefits for the South Caucasus region as a whole seemingly in the offering.

Although there will be no shortage of Armenians who will find discomfort in the prospect of Yerevan's Turkic neighbours moving towards a more salient position in the region's energy sector, it is worth reminding that other nations in wider-Europe – bearing no less historical enmity than Armenia and the Turkic nations – have put the burdens of the past behind them and are moving forward with profound economic cooperation. Examples in the European Union abound, former-Yugoslav states and entities are moving ahead economically whilst also seeking EU entry, while Russia conducts deep economic affairs with Poland, despite numerous historical "incidents" having taken place between the two countries.

Second, geopolitical realities in the South Caucasus are not remaining constant. In fact they are changing rapidly and are most fluid. We continue to acknowledge the present-day importance – as well as historical weight – of Armenia in the changing geopolitical context. As geopolitical analysts of the region, however, we feel that Azerbaijan's importance is set to increase. This is already happening on the back of the country's rapid economic development and regional energy leadership, while this year Baku has also assumed rotational membership of pivotal international institutions such as the United Nations Security Council.

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<sup>6</sup> "The unresolved conflicts in the South Caucasus: Implications for European and Eurasian Integration", European Geopolitical Forum Seminar held at the University of Kent in Brussels, December 8, 2011.

<sup>7</sup> "Security in the South Caucasus", Wilton Park Round Table, op.cit;

While these developments will undoubtedly make Baku a more confident actor in the South Caucasus geopolitical landscape, an elevated international role will likewise call for greater responsibility. It will also require that Azerbaijan demonstrates greater adherence to internationally acceptable norms and practices. The settlement of conflict by the promotion of exclusively peaceful means would be amongst the “values” that the international community would expect from Baku, the more Azerbaijan becomes visible internationally and assumes a higher profile in regional and world affairs. These developments could, in principle, mitigate some level of concern which Armenia may have on the security side, if the two sides were to engage in concerted acts of confidence building over Karabakh by starting to trade land with economic incentives – or at least scoping out pilot projects in this respect.

## Methodology: Setting Out to Test the Water

In order to test the usefulness of the “economic incentives” argument, which we felt had been often mentioned but rarely researched in depth, we set out to interview around 50 international experts and other relevant stakeholders familiar with the Nagorno-Karabakh conflict. We invited them to respond to a set of identical questions, some of the most important ones are listed below:

- What do you understand by the concept of economic incentives in the Nagorno-Karabakh conflict resolution process?
- Is there a role for such incentives, in your opinion?
- Are there any specific types of economic incentives which might overwrite Armenian conditionality to return these territories to Azerbaijan?
- Would you support their inclusion as potential tools somewhere down the line of the conflict resolution process?
- What is the impact of the conflict on local and regional economic development?
- What practical scope is there for regional energy and infrastructure projects to become open to Armenia?
- What might some examples of such projects be?
- What is the anticipated impact of economic incentives on the OSCE-led negotiation process under the Minsk Group?
- What is the strategic relevance of the occupied territories around Nagorno-Karabakh?

Around half of the people we invited for interview participated in the research.<sup>8</sup> They included experts from Armenia, Azerbaijan, NATO and EU specialists, as well as representatives of relevant NGOs, business circles, and academics from Georgia, Moldova, Romania, Russia, Turkey, Spain, the Netherlands, Italy, the United Kingdom, and the United States. Most participants responded in writing, replying to our main research tool, a survey based on an extensive questionnaire.<sup>9</sup> Some interviewees preferred to give an oral interview, the contents of which were recorded and duly incorporated into the research.

Thus our study is predominantly based on our analysis of the responses provided by participants in the questionnaire, oral interviews and discussions we held during

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<sup>8</sup> A list of the participants in our research is presented in Annex A, at the end of the study. However, due to the politically sensitive nature of the topic for many of the participants, we have kept the identities of some interviewees anonymous. This was done at their request. Since the bulk of the remainder of the study was based on our interviews, we have not been able to provide a source for each interviewed comment, although we have tried to provide attribution to “EGF interview” where possible.

<sup>9</sup> A full list of the questions asked in the questionnaire is presented in Annex B.

international roundtables during the second half of 2011 and in the first half of 2012 (as well as on the sidelines of such meetings). We have not set out to rely predominantly on other published sources, although we have, of course, gathered information from some previously written material in order to provide further background and argumentation to the work. The ensuing pages (of this study) provide an edited account of the responses which the experts gave to the questions posed above and, in essence, the study represents a summary of our key findings based on extensive interviews. We hope that our endeavours will provide the reader with an adequate “testing of the water” of the economic incentives argument as a means of contributing towards breaking the current stalemate in conflict resolution processes over Nagorno-Karabakh.



## Economic Incentives and the Nagorno-Karabakh Conflict Resolution Process

We have attempted to justify above the reasons why we felt that it is worthwhile posing the question of the economic incentives argument in the Nagorno-Karabakh conflict resolution process. However, we concede that we are not “pioneers” when it comes to the question of economic incentives in the Karabakh context. In 1995, an article in the New York Times stated that a diplomat spoke of a “peace pipeline”, because such a project [i.e. a pipeline bringing Caspian Sea oil to consumers in the West having its best route through Armenia] would require peace between Azerbaijan and Armenia over Nagorno-Karabakh.<sup>10</sup> The article referred to a formal proposal made by the U.S., Turkey and Azerbaijan to Armenia entitled “Armenian withdrawal from the occupied territories and recognition of Azerbaijani sovereignty over Nagorno-Karabakh in exchange for the passage of the Baku-to-Ceyhan pipeline through Armenia”.<sup>11</sup> The proposal was not adopted, however, and the pipeline was subsequently built from Baku to Tbilisi in Georgia and onto Ceyhan in Turkey, circumventing Armenia.

Something similar happened around a decade later when the “peaceful resolution of Nagorno-Karabakh as a condition for Armenia's participation in the EU-backed NABUCCO gas pipeline” was reportedly raised in the context of a meeting of (NABUCCO consortium) delegates from Turkey, Azerbaijan and Armenia in New York in the autumn of 2007.<sup>12</sup> An accompanying statement from Turkish president, Abdullah Gul, in September 2007, was thought to be further underscoring this view when he suggested that the liberation of the occupied territories of Azerbaijan “would encourage very efficient economic cooperation in the region. Pipelines and transport communications would cover the entirety of the Caucasus”.<sup>13</sup> Not a lot followed in terms of regional economic cooperation following Gul’s statements, which experts seemed to attribute to the lack of political will to make Caucasus-wide cooperation happen. Thus when we started to pose the question of whether the “cart can come before the horse” on Karabakh, and whether economic questions could start to complement political ones, the main findings of our research can be summarised as follows:

**Economic incentives, particularly those which may facilitate access to regional (energy and infrastructure) projects cannot, on their own, substitute a political settlement to the conflict, including its territorial dimensions. However, economic incentives have the potential to contribute towards conflict**

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<sup>10</sup> “Could a Pipeline Bring peace?” from <http://www.nytimes.com/1995/02/15/business/could-a-pipeline-bring-peace.html>

<sup>11</sup> Galib Mammadov, “The Nagorno-Karabakh Conflict: Armenia's Victory or Nightmare?”, extracted from [www.foreignpolicyjournal.com/2011/10/13/nagorno-karabakh-conflict-armenia](http://www.foreignpolicyjournal.com/2011/10/13/nagorno-karabakh-conflict-armenia).

<sup>12</sup> From <http://www.asianews.it/news-en/Peace-in-Nagorno-Karabakh-a-condition-for-Armenia.html>

<sup>13</sup> Ibid

**resolution as an element of a broader deal between the parties. They could play a key role in confidence building by creating an atmosphere of tolerance and enabling mutual trust which could eventually move the sides towards political compromise.<sup>14</sup>**

Evidence supporting this position, by way of expert responses to our questionnaire, included comments suggesting that economic incentives:

- Could break the current economic isolation of Nagorno-Karabakh and Armenia. They would create openings for shared economic benefits stemming from trilateral cooperation (Georgia-Armenia-Azerbaijan) which might forge trust and strengthen regional identity throughout the South Caucasus. One expert highlighted the current Armenian weakness by wondering: "what will happen to Armenian external trade if geopolitical instability would negatively affect Georgia or Iran, which are currently the only trade corridors connecting Armenia with the outside world?";
- Could also provide economic benefits for Azerbaijan by opening a more direct and therefore more economically efficient set of transport routes for Azerbaijani oil and gas bound for European markets, while further diversifying Azerbaijan's energy export routes;
- Would offer the Nagorno-Karabakh enclave a broader range of economic options and opportunities, which could help diminish the current "we are under siege" mentality of the Nagorno-Karabakh authorities and population;
- Would forge interdependencies in the field of energy and infrastructure among conflicting parties and local stakeholders, which would make economic interests of all parties resonate, and would soften their current state of intransigence. In principle, economic incentives may help create common economic interests in joint infrastructure projects, which could serve as 'mutual security guarantees' within the framework of the peace process;
- Would create a stronger basis for the economic and humanitarian rehabilitation of the seven occupied districts around Nagorno-Karabakh;
- Could, from a psychological angle, turn the "zero-sum game" thinking on the Nagorno-Karabakh conflict resolution process currently exhibited by the parties into compromise-oriented, "win-win" solutions.

The research also demonstrated, however, that there were also several interviewed experts who were more cautious about the economic incentives argument, suggesting that by virtue:

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<sup>14</sup> Author comment

- Economic incentives would not lessen Armenia’s position in calling on the international community to recognise the independence of Nagorno-Karabakh, since economic gains would offer too little against major security losses;
- Armenian ‘hard liners’ would never accept a territorial compromise as they would see any attempt at doing so as no less than "national treason", or as selling out the Armenian national interest/security to ‘business interests’ cultivated within (Caucasus) regional and international circles;
- "Lowland-Karabakh" (which is the term reportedly used within Armenians to describe the seven occupied districts around Nagorno-Karabakh), is the only place where the 400,000 Armenian refugees from the territory of the former Soviet Azerbaijan could settle safely;<sup>15</sup>
- We have “missed the bus” on cross border oil and gas pipeline projects which may have run across Armenian (and Karabakh) territory, transporting Caspian oil and gas to European markets. This idea may have worked in the 1990s and early 2000s, when oil and gas pipeline projects such as the Baku-Tbilisi-Ceyhan (BTC) oil pipeline and the Baku-Tbilisi-Erzurum (BTE) gas pipeline projects were being conceived and developed. Now that this high cost, cross border energy infrastructure is in place, any new projects (running across Armenia) would simply be duplicates which would not arouse investor interest. They would simply not be justifiable from a financial perspective in the current supply-demand environment for hydrocarbons. Investors, not governments, would have to provide much of the capital outlay to fund new projects and it would be very difficult to convince investors of the merits of “duplicate projects”. Further, new projects could be tacitly opposed by Tbilisi, given that Georgia currently serves as a transit hub for Westbound Caspian oil and gas, and would face new competition for the energy transit services it provides Caspian oil and gas producers;
- Russia would also tacitly oppose such economic incentives, as Moscow would perceive them as being against its regional economic and political interests, particularly in relation to its gas deliveries to Armenia, which could be

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<sup>15</sup> In much of the literature on the conflict between Armenian and Azerbaijan, the concept of land, or occupied land, includes a distinction between Nagorno-Karabakh and the seven occupied districts. In Armenia this distinction is not always made in this way. Rather, the distinction is between two types of Karabakh territory: Nagorno (Mountainous or Hilly) and Niziniy (Lowland), both of which are claimed by Armenia. Some of our interview respondents suggested that neither Mountainous nor Lowland Karabakh can be referred to as “land” in the context of negotiations to resolve the dispute between Armenia and Azerbaijan, as both types of Karabakh territory are our “motherland” – a hard line position which makes compromise extremely difficult.

supplanted by less expensive Azeri gas in the event of improved relations between Yerevan and Baku.

Although fewer of the experts who we interviewed displayed a sanguine position towards economic incentives, we found the contributions cited immediately above to be quite compelling. In fact the five bullet points immediately above provide no small counter argument to the view that there is usefulness for economic incentives in the Karabakh conflict resolution context. Furthermore, some experts debated as to whether our research question should be extended to include the Nagorno-Karabakh enclave itself, as well as the seven occupied districts, which led to further division of opinion about the usefulness of the economic incentives concept. Many interviewees thought that the Nagorno-Karabakh enclave should not be taken into account in the context of any major economic incentives package, since this would purport to undermine Minsk Group principles and negotiations framework, which – despite its incapacity to derive a peaceful resolution to the conflict during some two decades – is presently the only “game in town”.

Others thought that while the EU has sought to forge closer links with Karabakh, Brussels would likely seek to continue to project itself as a neutral, albeit active, stakeholder in the conflict. Other interviewees thought that an economic incentives package would only make sense for Baku in case that the entirety of Azerbaijan’s occupied territory (including the Nagorno-Karabakh enclave) would be considered for repatriation, even if the parties would set a schedule for the return of these territories which would take years to complete. Finally, one respondent thought that there was simply no way that any part of the Armenian-controlled territories (including both Mountainous and Lowland Karabakh) could be returned to Azerbaijan and that (he hoped that) such proposals would never be considered. The expert, representing a rather uncompromising position, added that “this is our Motherland” and opted to end the discussion.

We also asked experts as to whether there was any historical precedent where economic incentives have served as a facilitator in settling long-standing political disputes, or having been a factor in peace negotiations. Some experts mentioned the Camp David Accords underlying the peace treaty between Egypt and Israel in 1979, which contained references to economic incentives as a factor in the Israeli withdrawal from the Sinai Peninsula, which was returned to Egypt in 1982. Specific economic incentives mentioned in those accords were granting the right of free passage to Israeli ships through the Suez Canal, and the construction of a highway between the Sinai and Jordan. The obvious example of the establishment of the European Coal and Steel Community in the 1950s as a means to ensure long term peace between France and Germany following the Second World War was also mentioned. So too were the cases of the Aceh region of Indonesia, and the Island of Mindenau in the Philippines, both of which benefitted from economic incentives granted by Jakarta and Manila respectively in as part of those regions’ agreement to remain within the political jurisdiction of the two grander states.

The relevance of these examples (where economic factors have been engaged as instruments in peace building) may be somewhat questionable in terms of their application for the Karabakh case. However, it is worth noting that the inclusion of the economic incentives within the Camp David Accords has played a positive role in the development of Egyptian-Israeli economic and good neighbourly relations over the last 30 years. The realisation of the Arish-Ashkelon gas pipeline project is possibly the high point of those relations. But it is also significant to note that it took almost 25 years from the signature of the Camp David Accords until Egypt and Israel eventually reached an agreement on the gas pipeline initiatives. Further, it should be noted that while the Egyptian government under former-president Hosni Mubarak favoured better (economic and political) relations with Israel, the same could not be said about the mainstream Egyptian population, which continues to mistrust Israel and resent its alleged mistreatment of the Palestinians.

## Impact of the Conflict on Economic Development

It is often assumed that the unresolved conflict between Armenia and Azerbaijan over Nagorno-Karabakh has had dire consequences on the economic development of much of the South Caucasus. It has also affected the South Caucasus region more broadly, due to the opportunity costs of unrealized trade and investment, as well as non-engagement of the most efficient trans-regional lines of transport and communications. This may, indeed, be the case. What is more debatable, however, is the relative economic impact that non-resolution of the conflict is having on each of the parties independent of the other, as well as of the South Caucasus region as a whole. Azerbaijani sources often depict the scenario that "Armenia is a dying nation" and that the Karabakh enclave is "dying a slow economic death" under the current regional environment of non-resolution of the conflict. Indeed, senior Armenian diplomats confirm that their country would benefit substantially in economic terms if the borders with Turkey and with Azerbaijan would re-open.<sup>16</sup>

Research conducted by the World Bank has estimated that opening the closed borders between the Armenia, Turkey and Azerbaijan would increase Armenian exports to \$US269-342 million, increase GDP by 30-38%, and result in trade volumes exceeding \$US300 million.<sup>17</sup> Other forms of economic impact on Armenia relate to demography: emigration from Armenia to Russia and the West has arguably halved the country's population. Substantial investment and economic activity in Nagorno-Karabakh has been very low, while in the occupied districts it is practically frozen.<sup>18</sup> Both Armenia and Azerbaijan have shifted large volumes of their state budgets to defence requirements, away from investment into economic development and welfare programs. Azerbaijan, in spite of its rapid economic development and the rise of its hydrocarbons economy, has likewise had to spend a great portion of its national wealth on the needs of Azerbaijanis displaced by the Karabakh war. Azerbaijan spent \$US910 on each internally displaced person (IDP) in 2011.<sup>19</sup> This figure represents a nearly ten-fold increase year-on-year over the last decade.<sup>20</sup>

Interviews with experts, however, revealed that the economic impact of non-resolution of the Karabakh conflict may not be as dire as often perceived. Nor is the situation with the Armenian or Nagorno-Karabakh economy as desperate as Baku might like to think.

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<sup>16</sup> "Security in the South Caucasus", Wilton Park Round Table, op.cit;

<sup>17</sup> Aghavni Karakhanian and Artush Mkrtchian, "The Role of Economic Cooperation in the Settlement of Conflicts in the South Caucasus", *From War Economies to Peace Economies*, International Alert, 2004, pp.70-88, extracted from [http://www.international-alert.org/sites/default/files/publications/from\\_war\\_economies001-copy.pdf](http://www.international-alert.org/sites/default/files/publications/from_war_economies001-copy.pdf)

<sup>18</sup> Phil Champain, "The Cost of Stalemate – Economic Aspects of the Nagorno-Karabakh Conflict", in *Conciliation Resources, Accord*, 2005.

<sup>19</sup> Crisis Group interviews, State Committee of the Republic of Azerbaijan for Refugees and IDPs, Baku, December 2011.

<sup>20</sup> "Self-Reliance: Livelihoods of Internally Displaced Persons", World Bank, October 2011.

In fact one expert deemed that the respective economic narrative cultivated by both sides is one reason why we are unlikely to see a resolution to the conflict at any time soon:

Both sides hope that the economic status quo is not sustainable for the other, producing an “information war” and little progress towards peace. Since both sides build their policies to the conflict on these premises, the odds for reaching a political solution are very low. Azerbaijan hopes that Armenia and the Nagorno-Karabakh enclave will collapse economically sooner rather than later. Armenia is waiting for Azerbaijan’s energy driven economic growth to plummet, so that it is able to re-balance its economic status and defence budget to greater parity with that of their adversaries, and decrease economic pressure mounted against the country externally.<sup>21</sup>

On Armenia’s “grim economic outlook”, a number of respondents indicated that the country has shifted its external trade through Georgia (between 70-80%) and via Iran (20-30%), thereby circumventing the Azerbaijani and Turkish blockades. To further release from the pressure of the blockades on its economic development, Armenia has had little choice but to increase its reliance on both Russia (in terms of external loans and foreign investments, but also for security and defence purposes), and the Armenian Diaspora, which is also one of the main pillars of the economy and public budget of the Nagorno-Karabakh enclave.

The main message that we received here was that since the mid-1990s Armenia has found effective ways to adapt itself to, and tackle the consequences of the blockades imposed by Azerbaijan and Turkey, and therefore it is very unlikely that its economy will collapse at any time soon. The irony of this rather positive message for the Armenian side is that Yerevan is unlikely to budge on its position on Karabakh, further reducing scope for a settlement and elevating the risk that Azerbaijan may be forced to take desperate measures in order to retake its territories. Similarly, there is no sign that global demand for oil and gas is set to decline at any time soon, further propping up Azerbaijan’s position and deflating any form of Armenian wishful thinking that Baku’s energy incomes are set for a drastic decline.

Indeed, our research suggests that the main challenge for the economy of Armenia (as well as the Nagorno-Karabakh enclave) is not so much the threat of economic collapse, but rather “building-up a sound framework for economic governance”.<sup>22</sup> Indeed, as explained by one respondent to our questionnaire, the only way that the Nagorno-Karabakh enclave can hope to revive its economy was to achieve higher standards of economic governance and to pave the way for the private sector. This would help the enclave overcome its current inward-oriented economy, driven by an “under siege” mentality and heavy reliance on Armenia and on the Armenian Diaspora. While the

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<sup>21</sup> EGF Interview.

<sup>22</sup> Ibid

Nagorno-Karabakh economy remains in a precarious (albeit not critical) condition at the time of writing, worse off still are the 14,000 or so persons apparently living in the in the seven occupied districts. Recent field trips to the area conducted by international observers appear to uphold this view.<sup>23</sup>

Taking into account the less than dire levels of economic impact on the main stakeholders to the conflict, we questioned experts on whether they thought that the present economic status quo (in the region as well as in the cases of each of the key parties individually) was sustainable. Most respondents suggested that the status quo was definitely sustainable into the medium term, and possibly in the longer term as well, even though the situation was sub-optimal. The main arguments supporting this assessment were related to the way Armenia has adapted its economy to survive the Azerbaijani-Turkish blockade, and to the shared interest of both Russia and the West (especially the EU) to support Armenia's economic stability. That being said experts also expressed their concern as to the long term sustainability of the economic status quo, offering the following reasons:

- The lack of regional integration and its impact on the integration of the South Caucasus in the global economy;
- The lack of resources available for ensuring vibrant and sustainable economic growth (particularly in the case of Armenia);
- Weak governance standards set against the backdrop of persistent and high levels of corruption;
- Uncertainty about future economic growth and prosperity of the “big neighbours” of the South Caucasus region: Europe and Russia;
- The fact that the “military option” for the resolution of the Karabakh conflict remains on the cards, which might reverse economic gains made during the past 20 years.

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<sup>23</sup> Executive Summary of the "Report of the OSCE Minsk Group Co-Chairs' Field Assessment Mission to the Occupied Territories of Azerbaijan surrounding Nagorno-Karabakh" from <http://www.osce.org/mg/76209>.



## Scope for Armenian Participation in Regional Energy and Infrastructure Projects

Our interviews showed that there is an interest from the Armenian side to engage in regional energy and infrastructure projects in the South Caucasus, including those with the participation of Azerbaijan. This was alluded to by Armenian and other respondents to our questionnaire. The research also showed, however, that while such an interest exists (from the Armenian side), Armenia remains nevertheless strongly reluctant to factor in any sense of participation in such projects if this were to be based on the conditionality of either returning land (to Azerbaijan) or any other form of compromise which would endanger Armenian and Nagorno-Karabakh security. Further, Azerbaijani and several international participants in the research also made it clear that without having a strong agreement on peaceful resolution to the conflict in place, it is highly unlikely that Baku would ever consent to the inclusion of Armenia into any regional projects in which Azerbaijan participated.

These rather blatant positions suggest how difficult it will be to move towards a settlement on Karabakh, despite the fact that all sides show a penchant for business development (ie, economic incentives). Political and security questions remain dominant in relation to Karabakh, and it will not be a simple task to see these supplanted by economic ones. However, the research has also highlighted that a number of experts support the idea of using economic incentives in the shape of Armenian participation in regional (energy and infrastructure) pilot projects as a confidence building measure, which should be well synchronized with – and thus mutually reinforcing – the current negotiations ongoing in the Minsk Group framework.

For example, one expert suggested the establishment of a Regional Development Agency (RDA), which should be in charge of preparing and implementing such regional projects, including the reconstruction and development of energy and transport infrastructure, as well as telecommunications networks. The RDA could focus, as a first priority, on developing integrated regional transport corridor projects, including railways and highways covering Turkey, Azerbaijan, Armenia and Russia. The RDA could also involve, as appropriate, countries from beyond the region, as well as international organizations. It is worth noting that this innovative proposal is coherent with (and could actually offer an institutional framework for) the proposals of two Armenian experts who in 2004 proposed "the realisation of regional cooperation programmes entitled "energy resources and communication routes in the South Caucasus".<sup>24</sup>

Such programmes were seen as an integral part of a strategy for economic integration in the South Caucasus which would create conditions for sustainable development for the entire region, stimulating regional trade and investment. An RDA-based strategy would also compliment the aspirations of Azerbaijan to become "a hub for regional

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<sup>24</sup> Aghavni Karakhanian and Artush Mkrтчian, Op.cit.

transportation networks and a locomotive of regional economic development" given its energy-driven surplus investment capacity and the need to diversify its economy beyond the energy sector.<sup>25</sup> For the moment, the Karabakh conflict is the penultimate obstacle preventing the fulfilment of Azerbaijani aspirations in this regard.

The research has also highlighted a number of energy and communications infrastructure projects originating in, or transiting through Azerbaijan which could potentially become open to Armenian participation. We list the main examples of such projects below, all of which were identified by respondents to our questionnaire:

- The Baku-Nakhichevan-Yerevan-Gyumry-Kars and The Baku-Ijevan-Yerevan-Nakhichevan railways;
- The former-Soviet railway route: Baku-Armenia-Nakhichevan-Turkey;
- The Moscow-Baku-Yerevan railway;
- The Aghdam-Karabakh-Sisian (Armenia)-Nakhichevan-Turkey highway;
- The transport ring around the Black Sea;
- Trans-Caspian transport infrastructure;
- North-South and East-West South Caucasus transport corridors.
- The regional electricity grid covering Armenia-NK-Azerbaijan-Turkey;
- The Aghdam - Khankendi(Stepanakert) – Shusha – Lachin – Goris – Sisian – Nakhichevan - Turkey gas pipeline.

Armenian participation in such projects would create tangible benefits for both Armenia and Nagorno-Karabakh including:

- Direct economic and social benefits from the development and implementation of such projects;
- Revenue from the transit of goods through their territories;
- Opportunities for improving the investment climate and for generating trust among foreign investors;
- New opportunities for employment and provision of services;
- Increased border trade with Azerbaijan and Turkey;
- Lower natural gas prices and the loosening of GAZPROM's current monopoly for gas supply to Armenia;
- Cheaper travel and trade opportunities with Turkey and Europe via new road and rail links.

In time, these potential economic and social benefits might turn into strategic benefits for the Armenian side entailing:

- Better opportunities for economic growth through regional integration;
- Reversing the deepening dependence on Russian and Iranian energy supplies;

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<sup>25</sup> BTI 2010, Azerbaijan Country Report, published by the Bertelsmann Foundation

- Diversifying the source of energy supply from the above mentioned countries ;
- Increasing mutual trust in relations with Azerbaijan and Turkey.

One interviewee argued that (in the long run) Armenia "can neither afford nor obtain consistent energy supplies while being excluded from regional energy development".<sup>26</sup> It was added in this context that Armenia has already been exposed to energy supply disruptions in the initial stages of the Azerbaijani-Turkish blockade (during the 1990s), demonstrating Yerevan's vulnerability. In more recent years, Armenia has become increasingly energy dependant on Russia, the seeds of which were sown when Moscow gained control over Yerevan's strategic energy sector assets in the framework of the "assets-for-debts" agreements which the two parties signed about 10 years ago.

Interviewees also identified what we could refer to as a number of obstacles hindering possible Armenian participation in regional projects, which included:

- The existence of minefields and unexploded ammunitions along the line of contact separating the parties;
- The unknown technical state of rail and road infrastructures, which have not been in service for many years;
- The absence of common technical standards and of appropriate frameworks for dialogue between technical experts;
- Domestic politics in Yerevan: most notably the influence of nationalist circles on president Serzh Sargsyan, pushing him to avoid making any concessions to Azerbaijan and taking risks prior to the 2013 presidential elections in Armenia;
- The influence which oligarchs-cum-politicians currently exercise over the Armenian economy;
- The influence of the Armenian Diaspora which, on the one hand, might be interested to invest in such projects, whilst on the other, might view them as a negative factor and one capable of undermining "the Armenian cause";
- Russia's geopolitical interests in the region. Moscow may have a vested interest to preserve the present-day status quo over Nagorno-Karabakh as a means of maintaining its leverage over both Armenia and Azerbaijan;
- Baku's perception of Armenia as little more than "a continuation of the Russian political and economic sphere (of influence) in the South Caucasus".

We asked experts as to which would potentially be the most feasible pilot initiatives under the rubric of economic incentives as a means of accessing regional (energy and infrastructure) projects. The two most prominent such pilot initiatives cited by respondents were the restoration of the former-Soviet period rail connection between Baku and Nakhichevan (which crossed through Armenia) and the inter-connection of the electricity grids expanding across Armenian, Azerbaijani and Turkish territories, which would enable regional electricity trade. Restoration of the Soviet era railway project, which would require major study testing project feasibility, would play a key

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<sup>26</sup> EGF interview

role in reducing transportation costs in regional trade. Substantial investment could be required to rehabilitate and further realise the project, which would also call on Armenia, Azerbaijan and Turkey to move to a level of economic integration which, while may be desirable, is highly unlikely in the current security environment.

On the other hand, the inter-connection of the electricity grids would enable Armenian electricity exports to Nakhichevan and potentially to the Eastern parts of Turkey without requiring major investments. Just like Azerbaijan's desire to become the focal point of oil and gas activity in the South Caucasus, this initiative could help realise Armenia's potential to become the main base of electricity production and distribution in the region. Regional electricity trade could also open the way for Azerbaijani natural gas exports to Armenia and, perhaps further down the line – suggested one expert – a network of Azerbaijani petrol stations in Armenia as well as across the region. The above mentioned RDA could initially serve as an international guarantor for the implementation of regional infrastructure projects involving both Armenia and Azerbaijan, as without doubt some level of international supervision would be needed in order to oversee the early phase of economic integration.

While all of this might be starting to sound between foolishly optimistic and utopian, experts continued to remind us that nothing would happen in terms of regional economic integration unless there would be “significant movement” in the Minsk Group-led peace process. Yet even if a breakthrough would start to loom somewhere on the horizon, it also became clear from the research that there would be a need for tight synchronization between running such pilot projects and advancing the peace process on Karabakh. Otherwise, some respondents felt, a major concession potentially granted by Azerbaijan (ie; terminating the economic blockade against Armenia and opening the road for economic cooperation) would risk not being followed by appropriate progress on settling the territorial aspects of the conflict. (i.e., return of land to Azerbaijan).

Thus we come back to the “chicken or the egg” question posed in the initial sections of this study: how do we get there? What comes first: economic incentives or return of occupied territories? Yet one expert made these questions seem even more redundant by suggesting that Russia has invested heavily in Armenia over the past decade and has major interests in the country. Armenia has become Moscow's economic and political hub in the South Caucasus, the argument goes. Would GAZPROM want to give up its energy assets and gas supply monopoly over Armenia any more than it would over the European gas market?

## Impact of the Economic Incentives on the Minsk Group Negotiation Process

It is unclear to what degree economic incentives, of one sort or another, are presently incorporated into the negotiations between Armenia and Azerbaijan in the context of the OSCE-driven Minsk Group conflict resolution process. The Minsk Group, established back in 1992 and co-chaired by the U.S, France and Russia, is the main framework within which Baku and Yerevan conduct dialogue towards peace-building. Stepanakert, as well as the community of Azerbaijani IDPs, currently have no formal voice in the process. Since 2007, negotiations in the Minsk Group have focused on having Baku and Yerevan accept (and work towards) the so called "Basic Principles", or "Madrid Principles", which include, inter alia the following points:<sup>27</sup>

1. Return of the territories surrounding Nagorno-Karabakh to Azerbaijani control
2. An interim status for Nagorno-Karabakh providing guarantees for security and self-governance
3. A corridor linking Armenia to Nagorno-Karabakh
4. Future determination of the final legal status of Nagorno-Karabakh through a legally binding expression of will
5. The right of all internally displaced persons and refugees to return to their former places of residence
6. International security guarantees that would include a peacekeeping operation

Acceptance of the Madrid Principles by both sides would subsequently allow, in the next phase of peace building, the drafting of a comprehensive conflict settlement agreement which would encompass detailed (and presumably binding) measures which both parties would implement in order to ensure peace, stability and prosperity.

Negotiations conducted in the Minsk Group framework are generally considered to be rather secretive and information released thus far by the Group co-chairs (such as the July 2009 press release) did not refer to either the restoration of infrastructure, the resumption of trade, or to confidence building measures (ie, which could have been implied to mean economic incentives). One could assume, however, that these issues have been somehow addressed in the classified draft agreement text proposed by the co-chairs for adoption by the parties. In fact experts (who we did not interview but who are reportedly close to the negotiators, have affirmed that:

**the restoration of social and transport infrastructures, the resumption of trade and other confidence building measures are dealt with by the Basic Principles,**

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<sup>27</sup> Mark Dietzen, "A New Look at Old Principles: Making the Madrid Document Work", Journal of Conflict Transformation: Caucasus Edition, April 1, 2011, extracted from: <http://caucasusedition.net/analysis/why-nagorno-karabakh%E2%80%99s-status-must-be-addressed-first/>

**but all of these actions would start after the sides agree on the mechanism for the determination of the final status of Nagorno-Karabakh.<sup>28</sup>**

This last point brings us back to a recurring theme identified by this research: that economic incentives could be “put on the table”, either in the Minsk Group framework, or other format (hypothetically speaking), but only after a wider-settlement on Karabakh is in sight – including, presumably, a mechanism for determining the final legal status of the enclave. This position was reflected by many of our interview respondents, while further interviewees admitted that economic incentives may succeed only as an element of a broader resolution package between the parties. Experts suggested that economic incentives should play a key role in building mutual trust among the parties, but most avoided stating as to whether they should be pursued before or after agreement on the Madrid Principles was reached.

Further, our research implies that the underlying lack of trust between Armenia and Azerbaijan puts the whole concept of economic incentives under question, primarily from the perspective of their practical implementation. On the one hand, such projects could be a key driver to building much needed trust between the parties, fostering confidence on the basis of seeking to generate wealth, prosperity and putting the past behind them. On the other, it is this very lack of trust which is the most flagrant obstacle standing in the way of pursuing economic incentives, including the type of scoping pilot initiatives we discussed in the previous section of the study.

On a more positive note, one of our interview respondents suggested that fostering an environment where expert-level exchanges of information about the possibility of “exploring economic incentives” could take place between Armenians and Azerbaijanis, would itself be useful (and could even serve to compliment the Minsk Group formal negotiations) since this could have the effect of de-escalating the rather strident political discourse which currently dominates the narrative of the Karabakh conflict. In fact Thomas de Waal, the author of the “Caucasus pragmatism” thesis which we mentioned earlier in this study, likewise noted that “the challenge in the Karabakh dispute is not about reconciling ordinary people, but about reconciling political narratives”.<sup>29</sup> Commencing expert-level discussions on economic incentives – including regional energy and infrastructure projects of the type we have identified earlier – could help reconcile hard-line political narratives which both Armenia and Azerbaijan are using at present, by bringing a different dimension into the picture.

Further, one of our respondents argued – in contrast to the majority of our interviewees – that sufficient confidence already exists in order for exchanges between Armenian and Azerbaijani experts to take place. It was mentioned that it would be useful for select groups of (Armenian and Azerbaijani) experts to exchange information and experience

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<sup>28</sup> Fariz Ismailzade, "The Nagorno-Karabakh Conflict: Current Trends and Future Scenarios", IAI Working Papers 1129, November 2011.

<sup>29</sup> Thomas De Waal, op.cit;

related to projects arising from would-be economic incentives. The expert admitted, however, that while expert exchanges were one matter, moving “from discussion to actual implementation of such projects would require substantially more time, as well as careful preparation of public opinion in the two countries”. This respondent, as well as other interviewees, suggested that economic incentives (of the type being discussed in this study) could merge into economic confidence building measures, as part of wider means of promoting people-to-people contact and developing post-conflict scenarios for the Nagorno-Karabakh enclave and the seven occupied districts.

Worthy of note, these suggestions are consistent with an EU Council decision adopted earlier this year, which expressed:

**EU readiness "to provide enhanced support for confidence building measures, in support of and in full complementarity with the Minsk Group" and which invites the High Representative and the (European) Commission "to develop, in close consultation with the OSCE, post-conflict scenarios for Nagorno-Karabakh as a basis for future EU engagement".<sup>30</sup>**

Could this imply a window of opportunity to incorporate economic incentives into the Minsk Group format? Are such incentives already being discussed in high level consultations between Armenia and Azerbaijan? Possibly. What seems more evident, however, is the fact that a greater number of “weighty” international stakeholders will have to increase their exposure to the Karabakh peace building process – a position further reflected in our research, with respondents calling for expert level discussions to commence with the inclusion of participants from all stakeholders in the conflict – both local and international. Clearly, there is much newfound influence which international stakeholders could bring to the process – providing new frameworks for dialogue, guaranteeing security and political aspects of economic pilot projects and associated confidence building measures, and compelling both sides to take a more flexible and constructive approach towards the conflict. The EU, in particular, our experts felt, can bring the powerful message of “focusing creative energies on fostering regional economic cooperation, rather than striving to maintain an unacceptable status quo or threatening the use of force”.

Bringing in experience of “conflict dis-incentivisation” and fostering economic cooperation from the previously war-torn Balkans, particularly ex-Yugoslavia, where the EU continues to play a quintessential role, would also not go astray. Either way, it would help bring some life into the current stalemate over the conflict and within the peace building process in the Minsk Group framework, which Azerbaijan in particular feels is biased towards maintaining the status quo and thus favouring Armenia’s current advantage with respect to land gains made in the 1990s. In fact one expert who we interviewed (needless to mention nationality) asserted that the Minsk Group “supports

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<sup>30</sup> Conclusions of the Council of the European Union on the South Caucasus, 27 February 2012, from <http://register.consilium.europa.eu/pdf/en/12/st06/st06932.en12.pdf>

Armenian aggression against Azerbaijan because of the pro-Armenian policies of its Russian and European/American co-chairs".<sup>31</sup> It is in everyone's interests to redress the perception of such bias within the Minsk Group framework, which will be difficult until there is some movement in the peace building process, which, we feel, will be unlikely without opening up the process to greater levels of international involvement.

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<sup>31</sup> EGF interview



## Strategic Relevance of the Seven Occupied Districts

The seven districts of Azerbaijan which Armenian forces seized during the Karabakh war remain under Armenian control at the present time, although they are still widely seen as part of Azerbaijan. The strategic value of these territories for Armenia in its negotiations with Azerbaijan is well understood in geopolitical circles: the districts are a key bargaining chip for Yerevan in the negotiation process with Baku over Nagorno-Karabakh. The occupied land is also a vital security belt for Armenia, offering some level of strategic depth needed to defend Nagorno-Karabakh against possible attack from Azerbaijan. Two of these territories, namely Lachin and Kalbajar, also have a critical logistic function, since their control guarantees open communication lines between Nagorno-Karabakh and Republic of Armenia. Worth adding also is the economic value this land has for Yerevan, with one of our interview respondents speaking its capacity "to provide up to 120,000 tons of grain and up to 8,000 tons of meat and other foodstuffs for resource poor Armenia, as well as potential of developing the mining sector, which could provide precious and rare metals".<sup>32</sup> There is also a sense of psychological value of controlling this land for the Armenian side – a feat which should not be underestimated for a recently established nation-state looking to reinforce its sense of national identity in the international arena.

While the strategic value of the seven occupied districts for Armenia is widely understood, our research begins to elaborate on the sense of ideological value which these territories may likewise have for the country in the context of its wider nationhood. We have already mentioned the distinction between Mountainous (Nagorno-) Karabakh and (Niziniy-) Lowland Karabakh earlier in this study. Karabakh, itself, is a Turkic word meaning "black garden". In the Armenian language, the word for Karabakh is Artsakh. While most persons familiar with Armenia specifically and with the South Caucasus more broadly appreciate that it is only natural for Armenians to refer to Karabakh as Artsakh when speaking their mother tongue, what is worthy of note in terms of our research is that Armenians likewise refer to the seven occupied districts as Artsakh or Lowland Karabakh. From our perspective this implies that for Armenians these territories may not simply be a security belt or bargaining chip as is widely assumed, but that they may also be part of a vision which some Armenians may have in relation to the dream of restoring a historically significant, once grand Armenian Kingdom.

Azerbaijani sources claim that Armenians within Nagorno-Karabakh have been changing the names of villages and towns in the occupied districts from Azerbaijani to Armenian, while in some Armenian circles the lands are referred to as "liberated territories".<sup>33</sup> Were such reports to be confirmed by independent sources, they would feed into Azerbaijani concerns that Yerevan not only does not plan to return these lands to Baku

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<sup>32</sup> EGF Interview.

<sup>33</sup> From <http://www.caspianinfo.com/2012/02/icg-calls-for-urgent-international-efforts-to-end-Karabakh-crisis>

despite requirement to do so upon adoption of the Minsk Group's Madrid Principles, but that it is turning a blind-eye to Stepanakert's active efforts of incorporating the districts into the unrecognised Republic of Nagorno-Karabakh. Further, it reinforces Azerbaijan's position that the outcomes of the Minsk Group negotiations process, unable to foster a breakthrough on peace building nor prevent moves to incorporate the districts into Nagorno-Karabakh proper, may de facto be biased towards Armenia by indirectly aiding the status quo over Karabakh. However, we have not been able to confirm these reports through independent sources within the context of our research.

It is clear – from our research and other written sources – that Azerbaijan is quite frustrated with the inability of the Minsk Group process to deliver some form of result over the Karabakh conflict. Furthermore, given the possible “dualist” approach which Armenia exercises towards the occupied districts, it is not difficult to see why Azerbaijani experts argue that it would be difficult for any confidence building measures by way of economic incentives to be initiated, since for Baku these would appear as little more than “a manifestation of weakness and a concession to the aggressor”.<sup>34</sup> This view also supports that position of some analysts who suggest that Baku's patience may be running somewhat thin over Karabakh and that much of the Armenian population does not support its government's position over the Madrid Principles, which would require Yerevan to return the seven districts to Azerbaijan.<sup>35</sup> However, it may be worthwhile asking the question that if the Madrid Principles would require Armenia to surrender this land to Azerbaijan, what prompted Baku's (reported) reluctance to sign up to the agreement on the Madrid Principles at last year's Kazan Summit in Russia ? This is a matter for a separate piece of research, however.

We also asked experts as to whether they thought Azerbaijan has any concrete plans for the rehabilitation and reintegration of the seven occupied districts in the event that they were returned to Baku as implied in the Madrid Principles. There was no clear answer to this question arising from our interviews. Some respondents thought that such plans not only already exist but also include plans for the rehabilitation of the Nagorno-Karabakh enclave itself (assuming that it too would be returned at some future point). Others doubted the existence of any concrete plans from Baku. It is worth noting, however, that in 2010 an Azerbaijani business group funded a research project entitled "Basic Principles for the Rehabilitation of Azerbaijan's Post-Conflict Territories".<sup>36</sup> This extensive although somewhat hypothetical study offered some tentative conclusions regarding the direction and cost of reconstruction (of the territories) and of the potential role of the private sector in the work as a whole.

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<sup>34</sup> Gulshan Pashayeva, “The Nagorno-Karabakh Conflict in the Aftermath of the Russian-Georgian War”, Turkish Policy Quarterly, Vol.8 (4), 2009, pp.55-69.

<sup>35</sup> EGF interview/author conversations with Armenian “civil society” in Brussels, spring 2012.

<sup>36</sup> Nazim Muzaffarli, and Eldar Ismailov; "Basic Principles for the Rehabilitation of Azerbaijan's Post-Conflict Territories", Institute of Strategic Studies of the Caucasus, CA&CC Press AB, Stockholm, 2010.

While this project evidently had a most laudable starting point, since it helped clarify from a technical standpoint how substantial an undertaking reconstruction of the territories would be, its main drawback, from our perspective, is that it omitted participation of Armenian researchers. Although in its own right a highly creative initiative due to the fact that the work forced stakeholders to consider the prospect that there are “some post-conflict scenarios” on the table for Karabakh, genuine economic incentives and confidence building measures will only succeed if they include both sides. In future scenarios, we hope that one might be able to imagine Armenian and Azerbaijani experts working on such complex and highly demanding projects together, irrespective of the final legal status of Karabakh or adoption of the Minsk Group Madrid Principles.

Threat perceptions would begin to change on both sides if joint working groups, Armenian and Azerbaijani, would begin to tackle such studies together, albeit it would be most likely that they would have to meet under wider international supervision. As one respondent to our interviews put it:

**if Azerbaijan ever takes these territories back, it will want to showcase them as examples of its success and will invest large sums of money into them. They will however, remain distant border regions, so unless the whole region is opened up in a way that these regions can benefit from trade and new transport routes, they will remain of limited economic value.<sup>37</sup>**

Would such a joint endeavour be possible, where Armenia and Azerbaijan would work together in rehabilitating these territories and oversee their integration into the wider-regional economy of the South Caucasus? Who would take charge of implementing the work and under which auspices would it be developed? Perhaps a Regional Development Agency as mentioned earlier in this study, working to create relevant institutions for a “South Caucasus Confederation of States and Entities” – an economically integrated region governed by free trade and open borders.<sup>38</sup> This topic, however, will be the subject of further independent research.

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<sup>37</sup> EGF Interview

<sup>38</sup> One interviewed expert described our economic incentives approach as a key element of a new vision for peace in the South Caucasus reinforced by comprehensive, integrated and sustainable cooperation, which would ultimately enable free movement of people, goods, services and capital at the regional level, lead to economic integration and the opening of all closed borders

## Conclusion: Pragmatism or “Warrior Nationalism” Over Karabakh?

In this research, we have attempted to take a more pragmatic approach towards the conflict resolution process between Armenia and Azerbaijan over Nagorno-Karabakh, which remains in a dangerous state of stalemate at the time of writing. More specifically, we wanted to ask whether economic incentives could help break the current deadlock. As a means of answering this question, we posed a series of our own questions to a notable range of international experts familiar with the conflict, asking them whether an approach towards conflict resolution where Armenia would return some land to Azerbaijan in return for the latter providing access to regional energy and infrastructure projects could contribute towards breaking the current stalemate. The “return of land”, in the context of our research, referred primarily to the seven districts of Azerbaijan which Armenia has occupied as an outcome of the Karabakh war of the 1990s and which remains under Armenian control to this day.

At the outset of our research, we were optimistic that the “economic incentives” approach could offer a fresh dimension to peace building in relation to the current stalemate over Nagorno-Karabakh. We felt that all parties could exercise a degree of “Caucasus pragmatism” if the right arguments were appropriately used in order to persuade governments and the public, bearing in mind the widespread desire to see the region “take off” economically. Despite our initial optimism, however, the results of our research are somewhat less convincing than we had hoped. Some of the key note findings we identified, implying that economic incentives are likely to play mainly a secondary – rather than leading – role in any future efforts to resolve the Nagorno-Karabakh conflict, include the following:

- Although economic incentives were seen as a laudable concept by most of our interviewees, all interviewed experts agreed that any sense of a “land for (access to regional energy and infrastructure) projects” formula could not break the deadlock on its own. It could only serve as an element in a wider-“Grand Bargain”, which would include political, economic, security, humanitarian, and democracy building aspects.
- From an Armenian viewpoint, economic incentives could not serve as a bargaining chip in any process which would be deemed as weakening the security of Nagorno-Karabakh. Such schemes could only work upon prior resolution of the status of Karabakh. Furthermore, there appears to be notable reluctance from within Armenia to withdraw from the occupied districts around Nagorno-Karabakh until such resolution of status of the latter is reached, further hardening the standoff. One Armenian participant in the research preferred to “rule out such discussions altogether since we do not engage in discussions about our Motherland”.

- While acknowledging the inability of the Minsk Group to forge a breakthrough on Karabakh, most participants in the research did not show enthusiasm for taking the peace building process out of the hands of the OSCE. The economic incentives argument was to some extent discarded altogether, since experts felt that such measures could not be adopted in any significant manner prior to adoption of the Minsk Group Madrid Principles.

We support a situation where the withdrawal of Armenian forces from the territories of Azerbaijan surrounding Nagorno-Karabakh would open the road for the effective implementation of the economic incentives approach, thereby reducing the current levels of tensions and pessimism surrounding the conflict resolution process at the present time. However, our research also shows that even in the non-withdrawal of Armenian forces from Azerbaijan's occupied districts, it cannot be said that there is no place for such approaches in future efforts to forge a resolution on Karabakh. Most experts whom we interviewed acknowledged that "discussions around economic issues" should take place and only two experts – both reflecting hard line national views towards the conflict – ruled this approach out of the picture altogether. The research brought out the view that starting a comprehensive dialogue among interested businesses and experts from the conflicting parties (together with international actors) on post-conflict scenarios involving joint regional energy and infrastructure projects would be a step in the right direction. The role of such dialogue in the context of broader Karabakh conflict resolution process should not be underestimated, we feel. Most significantly, such measures could force a "shift of gears" in the prevailing political narrative over Karabakh at both government governmental and non-governmental levels, which is full of bellicose language and only serves to heighten tensions.

Our interviews revealed that possible topics for the agenda of such dialogue could include joint Armenian and Azerbaijani rehabilitation of war-weary infrastructure in both Nagorno-Karabakh and the occupied districts. A technical basis for such discussions already exists in terms of the private study produced by Azerbaijani and international experts as already mentioned earlier in this work.<sup>39</sup> Armenian participation by way of commentary on this study could be invited in possible working group format and would constitute a substantial confidence building measure helping build trust between the parties. Another topic for discussion could address issues such as priorities, joint management, sources of funding, inter-operability of technical standards and other challenges (not directly related to the Nagorno-Karabakh conflict) to planning and implementing such regional infrastructure projects.

A third topic for discussion might address how to make best use of such regional infrastructure projects to help the process of resettlement of IDPs and refugee communities of both Armenian and Azerbaijani ethnicity, bearing in mind the need to respond to their legitimate need for compensation for lost and/or destroyed property. We feel – as did no shortage of interviewed experts – that the commencement of such

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<sup>39</sup> Nazim Muzaffarli, and Eldar Ismailov op.cit

dialogue should not, necessarily, be dependent on adoption of the Minsk Group Madrid Principles. Indeed, such initiatives could form a useful, additional instrument capable of complementing Minsk Group endeavours. Developing additional tools where post-conflict scenarios could effectively be modelled would itself provide a framework within which 'conflict transformation approaches' could take place. Such frameworks could possibly even help Minsk Group negotiators and Co-chairs find a "light at the end of the tunnel". That, in itself, would be no small achievement. The road ahead for Karabakh – pragmatism or "warrior nationalism"?

## Annex A

### List of Contributors to the Research<sup>40</sup>

No.	Name	Organization/Position	Nature of Contribution
1.	Anonymous	NGO Armenia	Questionnaire
2.	Anonymous	NGO Armenia	Questionnaire
3.	Anonymous	Noravank Foundation Armenia	Questionnaire
4.	Igor Muraydyan	EGF Affiliated Expert Armenia	Questionnaire
5.	Richard Giragosian	Regional Studies Centre, Armenia	Questionnaire
6.	Rahim Rahimov	Independent Scientist, Azerbaijan	Questionnaire
7.	Anonymous	NGO Azerbaijan	Questionnaire
8.	Anonymous	NGO Azerbaijan	Questionnaire
9.	Azer M. Safarov, PhD	Advisor to the Chairman of the Board, International Bank of Azerbaijan-Moscow, Member of the International Association of Authors and Publicists	Questionnaire
10.	Nika Chitadze, PhD	Head, International and Security Research Centre, Georgia	Questionnaire
11.	Oktay Tanrisever	Associate Professor, Middle East Technical University, Turkey	Questionnaire
12.	Steffen Elgersma	Officer, NATO IS	Interview
13.	Anonymous	European External Action Service	Interview
14.	Jos Boonstra	Senior Researcher FRIDE, Head EUCAM Program	Interview
15.	Natalia Mirimanova, PhD	Senior Adviser to the Eurasia Program of International Alert, Brussels	Interview
16.	Anonymous	Academic Researcher, Romania	Questionnaire
17.	Denis Sammut	LINKS, UK	Questionnaire
18.	Anonymous	Diplomat, Turkey	Questionnaire
19.	Nana Gegelashvili	Centre for Regional Studies, Institute of US and Canada Studies, Russian Academy of Sciences	Questionnaire
20.	Aleksey Vlasov	Executive Director of the Center for	Questionnaire

<sup>40</sup> The authors gratefully acknowledge the contributions of all participants in this research who have provided substantial portions of their valuable time and without which this work would not have been possible. We appreciate all of your contributions, both anonymous and declared, and express our gratitude to you for showing interest in our work as well as the prospect of a peaceful South Caucasus, which we hope to see one day in our life time.

		Political Science «North-South», Russia	
21.	Prof. Kamer Kasim PhD	Turkey	Questionnaire
22.	Prof. Emanuela Del Re	University "Niccolo Cusano" of Rome, University "La Sapienza" of Rome, International Mediating and Negotiating Operational Agency EPOS, Italy	Questionnaire
23.	Matthew Bryza	Former Senior US diplomat	Questionnaire



# Annex B

## Research Questionnaire

### **1. The role of economic incentives in Nagorno-Karabakh conflict resolution/management**

- What do you understand by the "land for access to regional energy and infrastructure projects" formula for the resolution/management of the Nagorno-Karabakh (N-K) conflict?
- What arguments would favour applying this formula in and around N-K?
- What other examples/case studies of "land for access to economic projects" or, more broadly, "lands for peace" might be relevant to the N-K conflict?
- Have they worked ? (f.i. the resolution of the Egypt-Israel conflict),

### **2. Impact of the N-K conflict on economic development**

- What is the impact/consequences of the conflict in N-K (i.e. closed borders; economic blockade; regional security deficit) on the economic development of Armenia ? of N-K ? of Azerbaijan (including its occupied territories) ? of the South Caucasus?
- Is the current economic development status quo sustainable in the medium and longer term?

### **3. Scope for regional energy and other infrastructure projects which might be open to Armenia**

- What energy and other infrastructure projects originating in, or transiting, Azerbaijan could potentially become open to Armenian participation?
- Would tangible benefits would Armenia see from participating in such projects?
- Are such benefits stronger than maintaining the current status quo on N-K ?
- What potential pilot projects could be developed in this respect?
- What resources would be needed to implement such pilot projects?
- What organizations might be interested to invest in such pilot projects?

**4. Anticipated impact of the "land for access to regional energy and infrastructure projects" formula on the OSCE's Minsk Group negotiation process**

- Could the "land for access to regional energy and infrastructure projects" formula fall within the N-K negotiations process?
- Is there sufficient trust between the parties to allow for economic incentives of this nature?
- Excluding issues directly relating to the N-K conflict itself, what are the primary obstacles which hinder Armenian participation in such projects? (ie, damaged or destroyed infrastructure, landmines, etc)
- How could the international community assist in this process?

**5. The strategic relevance of the "occupied territories of Azerbaijan" around N-K/ "the buffer zone of N-K"**

- What is the relevance of these territories for Armenia?
- Could incorporation of safeguarded economic incentives overwrite existing Armenian conditionality to return these territories to Azerbaijan?
- Considering post-conflict scenarios, does Azerbaijan have any concrete plans for reintegrating the territories into a wider economic framework?

**6. Recommendations**

- Would you generally support a "land for access to regional energy and infrastructure projects" formula in the context of the resolution/management of the N-K conflict? Why?

## About the Authors

### Marat Terterov

Dr Marat Terterov, who is originally from Odessa, USSR, is the founder and Principal Director of the European Geopolitical Forum. He received his education in Australia, the United States and the United Kingdom, and holds a D.Phil. (PhD) in political science from St. Antony's College, Oxford University. He has written widely on the countries of the former-USSR and Middle East from the perspective of their geopolitics, domestic security and international relations. He has worked as a consultant and adviser under the auspices of a number of government related and inter-state organisations, including the Department of Trade and Industry in London, USAID in Cairo, the Foreign Ministry of Egypt, the Energy Charter Secretariat in Brussels and a range of projects in the former-Soviet states. He is active in wider-Eurasian decision making advisory circles, as well as the corporate world, and is a visiting lecturer at the University of Kent in Brussels. He contributes actively to debates on numerous global issues through television, the print media and the internet, as well as numerous international speaker events. He speaks English, Russian and is conversant in Egyptian Arabic

### George Vlad Niculescu

Mr. George Vlad Niculescu is originally from Bucharest, Romania, and is currently acting as Head of Research at the European Geopolitical Forum. He holds a postgraduate diploma in European integration and international relations from the National School of Political Studies and Public Administration (NSPSPA) Bucharest, and has completed Advanced Studies at the College of Strategic Studies and Defence Economics of the George Marshall Centre in Garmisch- Partenkirchen, and the Royal College of Defence Studies in London. He has also completed training with Welcomeurope on how to prepare and manage European funded projects, as well as on how to manage the budget of a European project. Between 2004-2010, he worked as NATO staff officer focusing on partnerships and cooperation, mostly with the countries from the Greater Black Sea Area, in areas like: security sector reform, combating terrorism, and cyber defence. Prior to that, he held various positions with a focus on defence policy and international cooperation in the Ministry of Defence of Romania (1994-2004). He has also academic experience as assistant professor and/or visiting lecturer at the NSPSPA, "Dimitrie Cantemir" University, NATO Studies Centre, and the PFP Training Centre from Bucharest (1997-2004). He is also affiliated with the Centre for East European and Asian Studies, Bucharest (Romania), as Director of Programs in Brussels, for whom he published articles on <http://www.cseea.ro>, and has been involved in various international research projects, including CRISHOPE, that was funded by the Black Sea Trust for Regional Cooperation.

## About EGF

The European Geopolitical Forum (EGF) was established in Brussels, Belgium, in early 2010 by several independently minded practitioners of European geopolitics, who saw a certain vacuum in the information flow leading into the European geopolitical discussion. EGF is dedicated, therefore, towards the promotion of an objective pan-European geopolitical debate incorporating the views of wider-European opinion shapers rather than simply those from the mainstream European Union (EU) member states. EGF seeks to elaborate upon European decision makers' and other relevant stakeholders' appreciation of European geopolitics by encouraging and effectively expanding the information flow from east to west, from south to north.

In order to achieve these objectives, the European Geopolitical Forum was established as an independent internet-based resource, a web-portal which aims to serve as a knowledge hub on pan-European geopolitics. EGF's strength is in its unique ability to gather a wide range of Affiliated Experts, the majority of whom originate from the countries in the EU's external neighbourhood, to examine and debate core issues in the wider-European geopolitical context. Exchange of positions and interactivity between east and west, south and north, is at the heart of the EGF project. For more information about EGF, our Affiliated Experts and to view our numerous publications, please visit [www.gpf-europe.com](http://www.gpf-europe.com)