Azerbaijan in a Reconnecting Eurasia

Foreign Economic and Security Interests

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The South Caucasus in a Reconnecting Eurasia

A REPORT OF THE
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43  About the Authors
In January 2014, the CSIS Russia and Eurasia Program launched its Eurasia Initiative. The vast Eurasian landmass, stretching from China in the east to Europe in the west and from the Arctic Ocean in the north to the Indian Ocean in the south, includes some of the world’s most powerful and dynamic states, as well as some of the world’s most intractable challenges. Scholars and analysts are accustomed to focusing on Eurasia’s various regions—Europe, the former Soviet Union, East Asia, South Asia, and Southeast Asia—rather than on the interactions between them. The goal of this initiative is to focus on these interactions, while analyzing and understanding Eurasia in a comprehensive way.

Today, more than any time since the collapse of the Silk Road five centuries ago, understanding these individual regions is impossible without also understanding the interactions among them. Over the past two decades, Eurasia has begun to slowly reconnect, with the emergence of new trade relationships and transit infrastructures, as well as the integration of Russia, China, and India into the global economy. Even as this reconnection is under way, the center of economic dynamism in Eurasia, and in the world as a whole, continues shifting to the East. The impact of these shifts is potentially enormous, but they remain poorly understood because of intellectual and bureaucratic stove-piping in government and the broader analytic community.

The report you are holding in your hands is one of the fruits of the Eurasia Initiative. Following the production of six reports as part of our 2015 series on Central Asia in a Reconnecting Eurasia, the CSIS Russia and Eurasia Program is now proud to announce the release of the next installment: The South Caucasus in a Reconnecting Eurasia. This four-report series includes detailed analytic reports on the foreign economic and security interests of Armenia, Azerbaijan, and Georgia, as well as a summary report laying out the challenges and opportunities for U.S. policy in the region. Long an important transit corridor between the western and eastern parts of Eurasia, the South Caucasus continues to face a range of geopolitical challenges, exacerbated by tectonic shifts taking place around the region’s borders: the crisis in Ukraine, growing confrontation between Russia and Turkey, turmoil in the Middle East, and reduced appetite for engagement in both the European Union and the United States.
To better understand the geopolitical and geoeconomic environment confronting the South Caucasus states, starting in 2014, members of the CSIS Russia and Eurasia Program traveled to the region and conducted interviews with a wide range of government officials, experts, private-sector actors, and representatives of international organizations to understand how elites in Armenia, Azerbaijan, and Georgia perceive the economic and security environment changing around them.

This report and the others in the series reflect what we gleaned from these interviews, along with analysis of published data and secondary literature, to provide a broad overview of how the world looks from the perspective of the South Caucasus. As in our earlier report series on Central Asia, the emphasis in these reports is the foreign economic and security policies of the three states. While we are cognizant of the complex situation surrounding domestic politics and human rights in some of these countries, the focus of this particular project is the strategic implications of a reconnecting Eurasia—in other words, how the states of the South Caucasus interact with each other and with the outside world. We address domestic issues, including human rights, corruption, and authoritarian practices, to the extent that they affect the interactions between Armenia, Azerbaijan, and Georgia, on the one hand, and the rest of the world, on the other.

The South Caucasus has throughout history been a political and civilizational fault zone between Europe, Turkey, Russia, and Persia. Since the Soviet collapse, the South Caucasus states have themselves acquired agency in international politics, even as they remain buffeted by the larger forces swirling around them. For the United States and other Western governments, effective policymaking in the South Caucasus requires a nuanced understanding of the interests, objectives, worries, and levers of influence available to the South Caucasus states. *The South Caucasus in a Reconnecting Eurasia* report series is designed to give a regional perspective to foreign officials, activists, investors, and others to help them better navigate the complex environment of the South Caucasus.
We would like to take this opportunity to express our gratitude to the many institutions and individuals who made this report and the others in the series possible. The project would not have been possible without the generous financial support of the Smith Richardson Foundation, the Ministry of Foreign Affairs of the Republic of Kazakhstan, and Carlos Bulgheroni. We are also extremely grateful for program support provided by the Carnegie Corporation of New York to the CSIS Russia and Eurasia Program. Additionally, we are grateful to the many government officials, experts, NGO staff, and private-sector actors who shared their insights with us during research trips to the region and in Washington, DC. Thanks are due as well to the embassies of Armenia, Azerbaijan, and Georgia in Washington, whose staff helped facilitate our travel to their respective countries, and in particular to Ambassadors Tigran Sargsyan (Armenia), Elin Suleymanov (Azerbaijan), and Archil Gegishidze (Georgia). The assistance of Hrachia Tashchian at the Embassy of Armenia, Mammad Talibov at the Embassy of Azerbaijan, and Tinatin Mikiashvili and Giorgi Khelashvili at the Embassy of Georgia is also worthy of special thanks.

We also owe a debt of gratitude to the reviewers who read and provided feedback on drafts of the reports in this series. These include Ambassador William Courtney, Rosemarie Forsythe, Richard Giragosian, Ambassador Batu Kutelia, Ambassador Richard Morningstar, Wayne Merry, and Sufian Zhemukhov. Finally, we would also like to extend our thanks to the many current and former members of the CSIS Russia and Eurasia Program who contributed to the project in various ways: Program Coordinator Sung In Marshall, as well as interns Fuad Abdul, Yulia Danilina, Jacob Gladysz, Yana Gololobova, Eric Griffith, Kendra Harkins, Vlad Kondratiuk, Peter Krivicich, Allen Maggard, Brina Malachowski, Daniel Mark, Kirill Prudnikov, Dylan Royce, Narek Sevacheryan, Jason Siler, and Nic Wondra.

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The View from Baku

Map 1.1. Azerbaijan

With its substantial oil and gas reserves, rapidly growing military capabilities, and long-standing commitment to balancing between East and West, Azerbaijan plays a pivotal role in the South Caucasus. For much of its post-Soviet history, Azerbaijan has used its energy reserves to pursue economic integration with the West, in part as a means of maximizing its room for maneuver with Russia, but without embracing Western-style liberalization. As upheaval and revolution have roiled its wider neighborhood in the past few years, Baku has clamped down at home and hedged its courtship of the West, even as it seeks international support for the recovery of territory occupied by neighboring, Russian-allied Armenia. By 2016, dramatically lower oil prices were adding a new element of uncertainty, placing significant pressure on Azerbaijan’s economy as well as its geopolitical ambitions.

Azerbaijan’s emphasis on ensuring its sovereignty as well as its wariness about Russia stem largely from the disastrous experience of the Nagorno-Karabakh conflict of the early 1990s. While the Soviet/Russian military on the ground fragmented and supported both sides at different times during the conflict, Russian troops’ support contributed substantially to Armenia’s victory. The 1994 cease-fire ending the conflict left Nagorno-Karabakh proper, as well as seven surrounding districts that in total comprised around a fifth of prewar Azerbaijan’s territory occupied by Armenian forces backed by Moscow.1

Azerbaijan consequently made the recovery of Karabakh and the surrounding territories a lodestar of its foreign policy, with Russia as a major obstacle given Moscow’s continued support for Yerevan, including the stationing of more than 5,000 troops on Armenian territory. Russia’s role in the Karabakh conflict and subsequent support for Yerevan led Baku from the mid-1990s to tilt its foreign economic and security policy toward the West, even as it continued to emphasize maintaining strategic autonomy and at least cordial ties with Moscow. Heydar Aliyev, Azerbaijan’s long-time president, understood that Azerbaijan’s oil and gas reserves would be an alluring prize for European states seeking to diversify their suppliers, and for international energy companies looking to tap the riches of the Caspian Sea following the Soviet collapse. Western energy majors soon concluded a raft of deals, leading to the construction of new pipeline infrastructure tying Azerbaijan to neighboring Georgia (which also faced Russian-backed separatists in Abkhazia and South Ossetia), Turkey, and ultimately to consumers in Europe. These pipelines ensured that the West as well as Turkey retained a stake in Azerbaijan’s continued sovereignty and independence, and also in continued stability along the line of contact in Nagorno-Karabakh. They also became the backbone for an increasingly important transportation corridor from the Caspian to Europe that has now expanded to include railways, roads, electricity grids, and other infrastructure. Participation in this east-west transit corridor has allowed Azerbaijan to raise its profile and become a more significant player in the region, though limited economic reform remains an impediment to foreign investment outside the energy sector.

Even as it sought to tie its security and economic fortune increasingly to the West, Azerbaijan resisted adopting Western-style liberalization. The absence of political and economic reform always rendered Azerbaijan’s Western orientation somewhat fickle, and in recent years events such

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1. These districts include all of Kalbajar, Lachin, Kubalti, Jabrayil, Zangilan, as well as parts of Agdam and Fizuli (see Map 1.1).
as the Euromaidan revolution in Ukraine have led Baku to greater authoritarianism at home, which has in turn created difficulties in relations with the European Union (EU) and the United States. Baku has partially in response sought to repair its relations with Moscow, though stopping short for now of accepting membership in the Eurasian Economic Union (EEU).

Nagorno-Karabakh, where the situation on the ground continues to worsen, remains a key wild card. Several of our interlocutors in Baku suggested that Azerbaijan could reconsider its opposition to joining the EEU should Moscow prove willing and able to engineer a favorable solution to the conflict, or look the other way if Azerbaijan were to use force to recover the occupied territories outside of Nagorno-Karabakh proper. Continued low oil prices and sanctions on Russia have made the prospect of EEU membership less alluring, but ultimately the decision is likely to be one driven more by politics and the regional balance of power than by purely economic considerations.

Azerbaijan continues selling oil to the West and buying arms from Russia. It is also a strategic partner with Turkey, and has even begun to repair relations with longtime rival Iran. Compared to neighboring Armenia and Georgia, Azerbaijan maintains significant strategic flexibility, though Baku’s authoritarian political model constrains its ability to cooperate with the West over the longer term. The principal challenges for Azerbaijan lies in navigating the increasingly polarized standoff between Moscow and the West, maintaining its efforts to recover Nagorno-Karabakh without provoking a major crisis, and ensuring domestic stability in an increasingly difficult economic environment.
Azerbaijan’s principal security objective is to guarantee its political and territorial cohesion, including the recovery of Nagorno-Karabakh and the seven neighboring regions. This concern is reflected in the 2007 national security concept, which identifies “attempts against the independence, sovereignty, territorial integrity and constitutional order” as the principal threats facing the Republic of Azerbaijan.1 Wedged between regional powers Russia, Iran, and Turkey, Azerbaijan is subject to a spectrum of external pressures. Azerbaijan recognizes the value of its pivotal location, astride the only viable corridor for Caspian oil and natural gas for to reach Western markets without crossing Russia or Iran. Baku also understands that it is well positioned to play its regional and international partners off one another while pursuing its own interests. Azerbaijan’s national security concept consequently lists a “multidimensional and balanced foreign policy”2 among its priorities.

Recovering Nagorno-Karabakh and the other territories lost to in the early 1990s is in many ways the core objective of Azerbaijan’s foreign policy.3 The Karabakh issue also shapes Baku’s strategic orientation. On the one hand, Russian support for Armenia during and since the war in Karabakh pushed Baku to tilt toward the West beginning in the mid-1990s; yet as some of our interlocutors in Baku noted, Russian support is necessary for any negotiated solution to the Karabakh conflict, pointing out that Baku never sought to challenge Russia openly in the manner of neighboring Georgia. Since the 2008 Russo-Georgian war, Baku has come to recognize that Western powers and Euro-Atlantic structures like the North Atlantic Treaty Organization (NATO) would not come to

2. Ibid.
Azerbaijan’s aid in the event of a similar confrontation with Russia. More recently, Azerbaijani elites came to fear that Western democracy promotion efforts were imperiling stability, concerns reinforced by the fall of Ukrainian president Viktor Yanukovich in early 2014 and Ukraine’s subsequent political and economic uncertainty. In response, Azerbaijan has in recent years sought greater strategic and tactical flexibility in its relations with both Russia and the West.

Energy is Azerbaijan’s most important foreign policy tool, even though total production from Azerbaijan is comparatively modest. As President Ilham Aliyev noted in a July 2009 speech, “[o]ne cannot separate the situation in the energy market from the general political development in the region.”

Baku seeks to leverage its importance as an energy producer to attract foreign investment in its energy sector, develop east-west energy transit infrastructure that insulates it from inherited dependence on Russia, and ensures Armenia’s economic isolation as long as the Karabakh issue remains unresolved.

Revenues from oil and natural gas production have also enabled Azerbaijan to construct the most modern and robust military in the South Caucasus, overcoming many of the deficiencies that contributed to its loss of Nagorno-Karabakh in the 1990s. Energy has been critical to Azerbaijan’s efforts to deepen its ties with Turkey and Europe but, as the 2008 Russo-Georgian war demonstrated, also a potential vulnerability.

Energy has proven a vulnerability in another way as well. With energy exports accounting for around three-fourths of state revenue, the dramatic decline in global oil prices since 2014 has wreaked havoc with Azerbaijan’s economy, sparking budget cuts, inflation, currency devaluations, and requests to international financial institutions for support—as well as violent protests in a number of towns across the country. This economic downturn and social unrest have injected new uncertainty into regional geopolitics, in particular the Nagorno-Karabakh conflict, where cross-border tensions have spiked even as Baku’s domestic challenges mount. Some analysts worry that Azerbaijan’s domestic challenges were a factor in the renewed fighting that shook Nagorno-Karabakh in the spring of 2016.

THE SOUTH CAUCASUS

With its energy reserves and location on the Caspian littoral, Azerbaijan in many ways serves as the gateway to the South Caucasus. Indeed, one expert whom we met painted Azerbaijan as an “anchor for wealth of the whole Caucasus,” thanks to its oil and gas resources. However, whereas Azerbaijan’s foreign economic policy is mainly concentrated on the West, its national security

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Strategy remains almost entirely focused on its immediate neighborhood. The war with Armenia over Nagorno-Karabakh drove a deep wedge between the two countries, severing diplomatic, commercial, and infrastructural ties and creating a fault line that drives regional geopolitics to this day. Conversely, Azerbaijan continues to enjoy close relations with Georgia, with which it cooperates on a wide range of energy, transportation, and security issues.

The centrality of the Karabakh issue to Azerbaijan’s strategic thinking cannot be overemphasized. Although often referred to as a “frozen” conflict, the standoff between Baku and Yerevan over Nagorno-Karabakh and the surrounding territories continues simmering, with frequent incidents along the line of contact and fears on both sides of escalation. In April 2016, the region appeared on the verge of renewed war, as cross-border incidents precipitated an Azerbaijani offensive that led to the retaking of several strategic heights across the line of contact and the death of dozens both sides.7


Map 2.1. The South Caucasus

Azerbaijan’s national security concept gives top priority to the “restoration of territorial integrity,” and asserts in no uncertain terms that Azerbaijan is prepared to take Karabakh by force in the absence of a political settlement. Despite a cease-fire agreement signed in May 1994 that has succeeded in halting major military operations, both sides accuse the other of egregious cease-fire violations on an almost weekly basis, and the past year has seen the employment of heavier weaponry and higher casualties on both sides—culminating in the spring 2016 Azerbaijani offensive.8 Azerbaijan, unlike Armenia, does not support the expansion of international monitoring mechanism overseen by the Organization for Security and Co-operation in Europe (OSCE).9 As part of its efforts to restore control over Nagorno-Karabakh, Baku has pushed to modernize the armed forces. Azerbaijan’s defense budget has risen from US$1.9 billion in 2013 to US$2.1 billion in

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2014. The expansion of Azerbaijan’s defense budget, however, has been matched by Armenian efforts to procure long-range, precision weapon systems, leading some outside observers to see an arms race breaking out, fueled in no small part by Moscow, which sells weapons to both sides. Baku’s increased firepower, not to mention the lack of arms control provisions in the 1994 cease-fire regime, contributes to the Azerbaijani military’s increased willingness in recent years to engage frontline Armenian forces—as does Baku’s frustration with the failure of the diplomatic track to bring about a restoration of Azerbaijan’s territorial integrity.

Even so, a number of the independent analysts we spoke with doubted that Baku possessed the wherewithal to retake Karabakh militarily, as the mountainous terrain favors the defending side, and because the Armenian military remains not only better trained and organized, but also enjoys Russian backing bilaterally and through the Collective Security Treaty Organization (CSTO). In response to the renewed fighting in April 2016, Moscow joined the other Minsk Group co-chairs in calling for a cease-fire but did not threaten direct intervention. Some of our interlocutors in Baku suggested that the Russian and CSTO guarantees could be interpreted to apply only to Armenia proper—but not to Karabakh or the seven occupied neighboring districts—and that Moscow could conceivably even greenlight Azerbaijani efforts to retake at least some of the occupied territories in exchange for Azerbaijan curtailing its energy cooperation with the West or possibly joining the EEU.

A campaign to reconquer Karabakh would in any case be extremely risky to Azerbaijan’s economy given the vulnerability of its energy transit infrastructure. Several sections of the Baku-Tbilisi-Ceyhan (BTC) oil pipeline pass within 100 kilometers of the line of contact, presenting an easy target for Armenian artillery and ground attack aircraft. Conversely, some observers noted that Azerbaijan’s persistent economic difficulties in the face of lower oil prices could have encouraged Baku to take a harder line on Karabakh.

14. As some of our interlocutors noted however, Russia has not officially recognized Armenia’s annexation of Nagorno-Karabakh, leaving open the question of whether an Azerbaijani attack on the region would activate the Russian or CSTO security guarantees.
But Baku has also demonstrated a willingness to use carrots as well as sticks to recover Karabakh. In 2013, Rovnag Abdullayev, president of the State Oil Company of the Azerbaijan Republic (SOCAR), announced that his company would be willing to supply Armenia with oil and natural gas provided that Yerevan first pulls back from the occupied territories around Nagorno-Karabakh.\(^\text{17}\)

Some Azerbaijani experts have also called for political, humanitarian, and general security assurances to Yerevan as part of a search for a settlement.\(^\text{18}\)

Azerbaijan’s relations with Georgia since independence have, in contrast, been consistently congenial. Georgia sits along Azerbaijan’s principal transit route to the west, and the two countries have cooperated since the mid-1990s on creating a corridor to Turkey that has grown to encompass a wide range of infrastructure projects as well as growing bilateral and trilateral (Azerbaijan-Georgia-Turkey) security cooperation. According to the International Monetary Fund (IMF), total trade turnover between Azerbaijan and Georgia grew from $542.2 million in 2008 to $1.182 billion in 2013, before declining back to $544.5 million in 2015 as a result of a sharp fall in the volume of auto re-exports.\(^\text{19}\) Azerbaijan is particularly important as an energy provider. In 2014, Azerbaijani oil and natural gas comprised 84.61 percent of Georgia’s total import volume.\(^\text{20}\)

Azerbaijani hydrocarbons reach Georgia (and beyond) through a series of pipelines and other infrastructure projects that both draw Azerbaijan and Georgia closer together and bind their futures—albeit tentatively—to the Euro-Atlantic bloc.\(^\text{21}\) SOCAR also provides Georgia a steep discount for oil and gas. These infrastructure ties have created a foundation for growing security cooperation with Tbilisi and Ankara, which focused initially on protection of critical infrastructure, but has since expanded.\(^\text{22}\)

In 2012, Azerbaijan, Georgia, and Turkey agreed to a kind of entente which, among other provisions, commits to upholding “respect for sovereignty and territorial integrity.”\(^\text{23}\) Both Azerbaijan

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Andrew C. Kuchins, Jeffrey Mankoff, and Oliver Backes
and Georgia stress that this security partnership is concentrated primarily on guaranteeing the security of transnational energy infrastructure, and are quick to play down any larger geopolitical subtexts.24 During the 2008 Russo-Georgian war, Baku voiced support for Tbilisi’s actions, and argued that by seeking “to restore its territorial integrity,” Georgia had acted well within its rights under international law.25

Georgia is also home to around 321,000 ethnic Azeris, who are the country’s largest ethnic minority group.26 Most live along Georgia’s southeastern border with Azerbaijan, and this proximity to their homeland, coupled with high levels of unemployment and perceptions of relative socioeconomic privilege among the Georgian majority, has contributed to intermittent tensions, though Baku has shown no interest in manipulating this discontent for its own ends.27 SOCAR’s Georgian subsidiary, SOCAR Energy Georgia, has reportedly made efforts to employ ethnic Azeris, providing them a degree of socioeconomic enfranchisement.28

THE CASPIAN SEA, TURKMENISTAN, AND IRAN

Azerbaijan has an interest in maintaining stability in the Caspian region because of its extensive offshore energy extraction. The demarcation of maritime borders accordingly represents a serious concern, especially with respect to the strategic ambitions of littoral neighbors Iran and Turkmenistan. Azerbaijan signed a trilateral demarcation agreement with Kazakhstan and Russia in May 2003,29 but Turkmenistan and Iran have refused to sign demarcation agreements.30

Baku has augmented its Caspian naval flotilla to match the capabilities of its regional rivals while hardening critical offshore extractive infrastructure.31 Azerbaijan’s navy comprises about 2,200

30. Although the Azerbaijani Ministry of Foreign Affairs recognizes the Caspian as “the largest salt-water lake on the planet,” it nevertheless argues that the Caspian’s relative size and “hydrological characteristics” make it a sea. See Republic of Azerbaijan Ministry of Foreign Affairs, http://www.mfa.gov.az/en/content/9 (accessed May 28, 2016).
31. Anar Valiyev, “Azerbaijan’s Military Exercises in the Caspian: Who Is the Target?,” Eurasia Daily Monitor 9, no. 94 (May 17, 2012), http://www.jamestown.org/single/?no_cache=1&tx_ttnews%5Btt_news%5D=39385&tx_ttnews%5BbackPid%5D=7&cHash=64e5e79b88ef193fa4b11c4c86434c2#.VQchJo7F-.So.
Map 2.3. The Caspian Sea


sailors manning eight coastal patrol vessels, one frigate, four minesweepers, and six landing craft.32

Azerbaijan has seen limited success in its various attempts to settle the maritime border issue with Iran and Turkmenistan. Disputes over ownership of the waterways have led Azerbaijan and Turkmenistan to resort to displays of force at times, such as in 2012 when Azerbaijani border guards

32. IISS, "Chapter 5: Russia and Eurasia," 176.
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seized a Turkmen vessel near the disputed Kapaz (Serdar) oil fields, or earlier efforts by Azerbaijani naval vessels to intercept foreign drilling rigs working for Turkmenistan.33

A proposed Trans-Caspian Gas Pipeline (TCGP) holds out the possibility of encouraging a rapprochement between Ashgabat and Baku, though it continues to face long odds. Baku officially supports TCGP, which, if built, would dramatically expand the volume of Caspian gas available in Europe.34 However, especially in a low energy price environment, the economics of TCGP (and the concomitant expansion of the Southern Gas Corridor) are questionable at best. Whether or not Azerbaijani officials believe TCGP will ever be built, supporting it in public bolsters Baku’s strategic value to Europe.

Relations between Baku and Tehran are plagued by similar disagreements over maritime borders and claims to natural resources, as well as by ideological enmity and competing geopolitical affiliations. Iran’s clerical regime sees Shi’a majority but secular, traditionally pro-Western Azerbaijani as representing an alternative social model that could prove attractive to ordinary Iranian Shi’as. At the same time, Iran itself is home to a large ethnic Azeri population (more Azeris live in northern Iran than in Azerbaijan), and Tehran fears the potential for irendentism. Incautious rhetoric from some Azerbaijani nationalist figures exacerbates these fears, though support for separatism among Iranian Azeris appears low. Azerbaijan’s close partnership with Israel, in part a response to Iranian hostility, has also contributed to worsening relations with Tehran.

Especially at moments of heightened tension, Iran has taken steps to openly subvert the Azerbaijani state and regime. It has funded Islamist political parties and, allegedly, instigated terrorist attacks on targets inside Azerbaijan.35 In 2012, Baku arrested 22 Azerbaijani citizens who purportedly had been trained in Iran to carry out an attack on the Israeli and American embassies. In 2007, Azerbaijan arrested another 15 individuals for involvement in an Iranian-linked spy network.36


Iran has proven itself to be uncompromising on the subject of maritime demarcation in the Caspian, arguing in favor of treating the Caspian Sea either as a commons or, alternatively, by dividing the physical seabed equally into exclusive economic zones.\textsuperscript{37} Iran has attempted to strengthen its leverage by investing in the modernization of its Caspian naval fleet, including the development of a “rapid reaction Caspian squadron” to handle the defense of offshore infrastructure and to other, more offensive operations.\textsuperscript{38} The expansion of Iran’s military presence in the Caspian has encouraged Baku to overhaul its own naval capabilities while downplaying the impact on Iranian interests.\textsuperscript{39}

The tentative settlement reached between the five permanent members of the UN Security Council plus Germany (P5+1) and Iran with regard to the latter’s nuclear program in July 2015 holds the potential to drastically reshape relations between Baku and Tehran. The gradual removal of Iran’s pariah status would reduce the chances of a military confrontation that could drag in Azerbaijan, as well as Iranian suspicions that Azerbaijan could act as a launch pad for Western or Israeli hostilities. A final deal would also afford the Aliyev government free reign to develop commercial ties with the Islamic Republic of Iran, which could open up a new route for Azerbaijan’s hydrocarbons to reach global markets, potentially reducing not only dependence on Russia, but also the importance of the vulnerable Southern Corridor to Europe.\textsuperscript{40} At the same time, normalization of diplomatic relations with Iran could reduce Azerbaijan’s strategic value to the West, diminishing still further the need for Western powers to downplay concerns about Azerbaijan’s domestic situation.\textsuperscript{41}

**TURKEY**

Azerbaijan’s relations with Turkey are quite close; former president Heydar Aliyev described the Turkish-Azerbaijani bond as “one nation, two states.”\textsuperscript{42} Turkey was the first country to establish diplomatic ties with the Republic of Azerbaijan following its independence from the Soviet


\textsuperscript{42} Joint press statements of presidents of Azerbaijan and Turkey, Official Website of the President of Azerbaijan Republic, September 15, 2010, http://en.president.az/articles/736/print. Azeris and Anatolian Turks are both descended from the Oğuz branch of the Turkic peoples and speak mutually intelligible languages, although most Turks are Sunni Muslims while most Azeris, whose territory was long in the Persian sphere of influence, are Shi’a.
Union, and today is arguably Baku’s closest strategic partner. Azerbaijan offers Turkey a corridor to Caspian energy and, potentially, to the various Turkic peoples of Central Asia. Baku has mostly viewed its partnership with Ankara as a route into Euro-Atlantic political structures, not to mention as a balance against the Armenian-Russian alliance. Turkey also provides diplomatic support for Azerbaijan’s quest to retake Nagorno-Karabakh and restore its territorial integrity.

Turkey is a significant contributor to Azerbaijan’s security. A 2010 agreement established a mutual security guarantee between the two countries, pledging them to deploy “all possible means” to assist each other should either one come under outside military attack. Turkey also engages in various forms of military cooperation with Azerbaijan, including sales of weaponry and joint weapons production. Some of this cooperation is also trilateral, with Georgia participating as well in initiatives to secure critical infrastructure, as well as consultations among senior officials from the three states.

Turkey closed its border with Armenia in 1993 in response to Armenian forces’ advance beyond the frontiers of Soviet-era Nagorno-Karabakh into Azerbaijan proper. To this day, Turkey maintains an economic blockade of Armenia designed to pressure Yerevan into returning Karabakh and the surrounding districts to Azerbaijani control. Turkish officials are outspoken that Karabakh remains Azerbaijani territory. Nevertheless, according to a senior analyst we interviewed, Ankara understands its limits, especially at a time when Turkish-Russian relations are poor. During the heavy fighting that broke out in spring 2016, Turkey strongly supported Azerbaijan. Turkish president Recep Tayyip Erdoğan declared that “Turkey has always been on the side of Azerbaijan in the Karabakh question, and will continue to provide assistance. . . . We feel in our hearts the pain from the occupation of Karabakh. . . . I want to say that one day, Nagorno-Karabakh will absolutely belong [again] to Azerbaijan.”

Turkey is a member of the OSCE’s Minsk Group, charged with managing and ultimately resolving the Karabakh conflict. However, compared to cochairs the United States, Russia, and France, Turkey plays a somewhat secondary role. Turkish leaders have also at times criticized the Minsk Group as being weak and ineffective at helping Azerbaijan recover its lost territory.

Erdoğan’s attempt to normalize relations with Armenia in 2009–2010 ultimately foundered over Baku’s opposition, with Azerbaijani officials demanding progress on the return of Karabakh prior to

any steps toward Turkish-Armenian normalization. Baku saw the Turkish blockade as its strongest piece of leverage for regaining Karabakh, and was incensed that Erdoğan was considering weakening the blockade without obtaining any concessions on Karabakh. Aliyev threatened to “reconsider” Azerbaijan’s energy agreements with Turkey over the Turkish-Armenian protocols, which he termed a “historical mistake.” Ankara withdrew the protocols from parliamentary consideration in April 2010, largely because of Baku’s objections to the de-linking of normalization from the return of Karabakh.

Azerbaijan and Turkey are also economically interdependent, with Azerbaijan sending the bulk of its oil and gas to Turkey and investing heavily in Turkish energy transit infrastructure. The State Oil Company of the Republic of Azerbaijan (SOCAR) owns 58 percent of the shares in the Trans- Anatolian Pipeline (TANAP), while Turkish pipeline operator BOTAŞ holds 30 percent. Azerbaijan is also the largest source of foreign investment in Turkey, much of it originating with SOCAR. Investment from Azerbaijan is also a critical element in Turkey’s strategy of positioning itself as an energy hub for the wider region. Bilateral trade turnover was approximately $1.79 billion in 2014, and Turkey was the second largest source of Azerbaijan’s imports (after Russia).

RUSSIA

Relations between Russia and Azerbaijan have oscillated dramatically over the past 20 years. Russia’s support for Armenia during the Nagorno-Karabakh war inclined Azerbaijan to seek an alignment with the West. Azerbaijan nonetheless continues to share deep social and economic ties with Russia (including the presence of several hundred thousand migrants). In recent years, relations with Russia have grown closer still, as Baku has come to see the West, with its calls for political reform and human rights, as a force for instability.

Though it is Armenia’s primary ally and the guarantor of Yerevan’s security, Moscow has long cultivated Baku as well, using a mixture of carrots and sticks. Russia portrays the presence of its military in Armenia as a hedge against Turkey rather than a threat to Azerbaijan, and many observers question whether the security guarantees Russia has extended to Armenia cover Nagorno-Karabakh. Despite its long-standing support for Armenia, Russia is also the principal supplier of arms to Azerbaijan’s military. Unlike Yerevan, Baku can afford to buy Russian-manufactured weapons at market prices, and therefore has access to the most up-to-date Russian military technology. Russian-manufactured weapons account for roughly 85 percent of Azerbaijan’s foreign arms


acquisitions, whatever relative advantages Azerbaijan may gain from these weapon systems, however, is likely to be offset by Armenia’s discounted access to surplus Russian military stockpiles, along with Russian training.

The memory of historical trauma wrought by Russia continues to loom over the bilateral relationship. Some of our interlocutors pointed to these legacies in expressing skepticism toward Russian-led integration projects like the Eurasian Economic Union, though a few suggested that Russia bringing about a favorable resolution of the Nagorno-Karabakh conflict, or giving Azerbaijan a free hand to settle scores with Armenia, could lead Baku to reconsider. Russia, along with France and the United States, is a cochair of the OSCE Minsk Group; Moscow has also at times acted as a direct mediator. Former Russian president Dmitry Medvedev brought the leaders of Armenia and Azerbaijan together for a much-heralded meeting in Kazan in June 2011, while current Russian president Vladimir Putin met with both Aliyev and Armenian president Serzh Sargsyan in August 2014 in Sochi following renewed incidents along the line of contact.

Until 2012, Russia’s military operated an early warning radar at Gabala, which Moscow at one time offered use of to NATO as part of an effort to construct a joint European missile defense system. Unable to secure an extension of the lease, Moscow handed the Gabala radar back to the Azerbaijani government in 2013.

Azerbaijan’s commercial relations with Russia have deepened, with their total trade volume expanding from just over $1 billion in 2005 to more than $1.95 billion in 2014, a compound annual growth rate of 7.7 percent. Azerbaijan’s principal export to Russia is gas, which accounts for around 48 percent of the total, followed by vegetable products, and passenger and cargo ships. From Russia Azerbaijan imports metals and mineral products, processed foodstuffs, wood products, and vegetable products (mainly wheat).

In freeing itself from dependence on Russia’s energy transit network through the construction of pipelines to Georgia and Turkey, Azerbaijan emerged as a competitor to Russia in European energy markets. Russia responded by attempting to impede the construction of new pipelines from Azerbaijan and by closing down extant transit routes passing through Russia such as the Baku-Novorossiysk pipeline (since reopened but now at scaled-down volume). In 2011, it also offered to buy up Azerbaijani gas that would otherwise be sold to Europe through the planned Southern Gas Corridor.

Indeed, Moscow frowns upon Azerbaijani plans for new pipeline routes that bypass Russian territory, especially the TCGP. While Russia generally opposes the Southern Corridor concept, its response to the announcement of the TANAP pipeline has been rather muted, reflecting in part the fact that TANAP’s limited volume (16 billion cubic meters a year) does not threaten Russia’s position in European gas markets. Russian officials have even suggested that Gazprom could eventually participate in the TANAP project.

Another source of leverage available to Moscow is the presence of large numbers of Azerbaijani migrant workers in Russia. Konstantin Romodanovsky, head of the Russian Federal Migration Service, estimates that there are over 550,000 Azerbaijani migrants living Russia, while the World Bank gives a figure of more than 743,000. As the Russian economy continues to deteriorate, Moscow is toughening its migration policy, especially for states like Azerbaijan that are not members of the Eurasian Economic Union. According to IMF data, Azerbaijan received more than $1.84 billion in remittances in 2014. While this figure accounted for just 2.4 percent of the gross domestic product (GDP), emigration represents an important safety valve at a time of mounting political tensions and slowing growth at home.


65. World Bank, “Migration and Remittances Data.”

Andrew C. Kuchins, Jeffrey Mankoff, and Oliver Backes
Azerbaijan has remained cautious in responding to the conflict in Ukraine, which many Azerbaijanis believe has implications for Russia’s potential actions in Nagorno-Karabakh. While supporting Ukraine’s territorial integrity, Baku has little sympathy for the post-revolutionary government in Kyiv. Azerbaijan voted in favor of the March 2014 UN General Assembly resolution reaffirming support for Ukraine’s territorial integrity and rejecting the legitimacy of Crimea’s referendum to join Russia. Yet as one foreign diplomat we spoke with noted, Baku was probably more concerned about the potential for a Maidan-type scenario at home than about the possibility of Russian intervention.

EUROPEAN UNION

Baku and Brussels have long seen each other as important partners, especially in the sphere of energy security. Azerbaijan’s national security concept assigns great weight to Baku’s relationship with Europe, and lists “integration in European and Euro-Atlantic structures” second only to the “restoration of territorial integrity” as a strategic priority. Europe seeks Azerbaijani gas as part of its strategy for reducing dependence on Russia, while Azerbaijan looks to Europe as its most promising energy market. Despite extensive cooperation in the energy sphere, relations have deteriorated in recent years over concerns about Azerbaijan’s domestic political environment.

Though Azerbaijan provides only a little more than 4 percent of the European Union’s total oil imports—about 417.3 million barrels per day (bbl/d)—and minimal gas, the connection is significant because of the long-standing focus on Azerbaijan as a source of diversification, allowing Europe to reduce its dependence on oil and gas from Russia. The pivotal moment in securing Azerbaijan’s tie to Europe was the signing of so-called Contract of the Century in 1994, which awarded extraction contracts to several European (and other) energy firms and laid the foundation for Azerbaijani oil to go west. European patronage looks set to continue with the development of the Trans Anatolian Pipeline (TANAP) and the connected Trans Adriatic Pipeline (TAP), which will bring Azerbaijan’s offshore gas across Turkey and the Adriatic Sea to Italy.

According to the International Monetary Fund, trade between the European Union and Azerbaijan increased from $3.68 billion in 2005 to $14.96 billion in 2013, declining slightly to $14.35 billion in 2015.

Another defining event came in 2006 with Azerbaijan’s entry into the European Neighborhood Plan (ENP). Between 2007 and 2010, the European Union allocated €88 million to Azerbaijan for

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the implementation of the ENP.70 Although the ENP expired on December 31, 2011, both sides agreed on an informal extension until the ratification of an association agreement.

Azerbaijan had previously asserted that any association agreement between it and the European Union would need to proceed from the principle of “mutual respect and equality of rights of [both] parties.”71 Baku in this sense understands its engagement with Brussels as a strictly “interest-based” relationship, paying lip service to the notion of complying on normative standards while hesitating to align itself firmly to European norms.72

Particularly in the aftermath of the Ukraine crisis, Azerbaijan has begun to have cold feet about a full-fledged association agreement with the European Union. In November 2014, Novruz Mammadov, deputy head of the presidential administration, confirmed that his government had opted not to pursue an association agreement, but reiterated Baku’s commitment to an independent foreign policy that would allow it to engage with individual EU member states on a bilateral basis, while President Aliyev argued the following month that “Today there’s no necessity for our country to choose between cooperation with EU and Customs Union.”73 This approach seems to have wide support among the Azerbaijani elite. As one of our pro-Western interlocutors in Baku noted, “Azerbaijan should strive to become a civilized country, not necessarily a European one.”

UNITED STATES AND NATO

Although the United States does not match the European Union in terms of trade, total trade turnover grew by 24.37 percent compound annual growth from $184.4 million in 2005 to $1.31 billion in 2014.74 Washington maintains a vested interest in Azerbaijan’s energy industry, especially as a counterweight to Russia’s dominant position in European energy markets. Indeed it was Washington more than Brussels that lobbied and cajoled to get the BTC pipeline built in the 1990s,

and remains a strong advocate of the Southern Corridor.75 In August 2007, the U.S. Trade Development Administration provided US$1.7 million in grant money to Baku for a program to assess the feasibility of constructing the TCGP.76

Baku has long objected to Section 907 of the 1992 U.S. FREEDOM Support Act. Drafted under the influence of the Armenian-American lobby in response to Baku’s closing of the Azerbaijan-Armenia border during the Nagorno-Karabakh war, Section 907 effectively bars the United States from supplying humanitarian and military aid to Azerbaijan.77 Baku argues that this legislation ultimately works against Washington’s geostrategic interests, and has expended considerable effort in recent years to highlight its strategic importance to the United States in part as a means to encourage the repeal of Section 907. The Bush administration obtained from Congress the right to waive Section 907 on a temporary, year-by-year basis in exchange for Baku’s continued support in U.S.-led overseas contingency operations in Afghanistan and, later, Iraq, where Baku has provided important logistical support.78 Although Azerbaijan has received an annual waiver of Section 907 every year since 2001, Baku still regards the provision as discriminatory and counter-productive, and seeks its full repeal.

The deal waiving application of Section 907 in exchange for Azerbaijan’s support of U.S. operations in Afghanistan and Iraq appeared a coup for the United States, which obtained a Muslim state’s support for its military operations in the Muslim world—albeit one with a secular government and a majority Shi’a population. Many in the Azerbaijani elite were dissatisfied with the deal, however, because Washington remained noncommittal on Nagorno-Karabakh. Though the United States, along with France and Russia, is a cochair of the OSCE’s Minsk Group, it has made little progress. Several of our interlocutors complained that it had now become a tool for managing the conflict rather than resolving it. Azerbaijani officials are unhappy that the United States regards Nagorno-Karabakh as disputed—rather than occupied—territory.79 In a February 2015 interview with Financial Times, presidential spokesman Ali Hasanov pointed out that while the United States and Western Europe have been swift to label members of the pro-Russian movement in Ukraine as “separatists,” they have yet to do so with Karabakh Armenians.80

Domestic developments in Azerbaijan, coupled with reduced U.S. dependence on Azerbaijan as a transit country to Afghanistan, have contributed to a deterioration in U.S.-Azerbaijan relations in the past few years. Though tensions had been building for some time, Washington’s overt support for the popular uprisings of the Arab Spring as well as the Euromaidan revolution in Ukraine deeply unsettled Baku, and played a role in Azerbaijan’s efforts to improve relations with Russia. In December 2014, Ramil Mehdiyev, head of the presidential administration and one of the most prominent critics of the United States in the Azerbaijani government, accused the United States of deploying rights NGOs to destabilize foreign governments like Azerbaijan’s for political and economic gain. At the same time, many officials in Baku resent how fiercely the United States berates it on its human rights record, arguing that Baku’s strategic importance means the United States should be willing to overlook its domestic record. For U.S. officials in both the executive branch and Congress, conversely, the closing of political space and Azerbaijan’s worsening human rights record are major issues that limit opportunities for engagement. The release of several high-profile political prisoners in early 2016, including Khadija Ismayilova, a journalist who exposed corruption within Azerbaijan’s ruling elite, were likely designed in part to ease U.S. pressure on human rights issues.

Azerbaijan also maintains a strong tie to NATO. Integration with (though not membership in) NATO is listed as a priority in Azerbaijan’s foreign policy concept. Like most of its post-Soviet neighbors, Azerbaijan joined NATO’s Partnership for Peace in 1994. It subsequently signed an individual partnership action plan (IPAP), which lays out a tailored program for cooperation focusing on security sector reform and democratic institution building. Azerbaijan has also committed troops to NATO’s out of area missions in Kosovo and Afghanistan. Around 95 Azerbaijani service members are serving (as part of a Turkish contingent) in the NATO-led International Security Assistance Force in Afghanistan. Additionally, NATO is helping Baku carry out security sector reform designed to improve interoperability between Azerbaijan and NATO forces. Each summer, Azerbaijan and NATO cosponsor the NATO International School in Azerbaijan (NISA), which provides training on a range of security issues to personnel from throughout the region. As with the other South Caucasus states, Azerbaijan uses cooperation with NATO to ensure strategic flexibility and limit dependence on Moscow for its security needs, while recognizing that formal membership is unlikely.

86. Ibid.
Azerbaijan in a Reconnecting Eurasia

Baku and Beijing have enjoyed warm bilateral relations since the dissolution of the Soviet Union. The People’s Republic of China sees great economic potential in the South Caucasus, as the region serves as a vital link between Europe and Asia along China’s planned Silk Road Economic Belt. Beijing also considers the wider Caucasus to be closely connected to Central Asia, and therefore important to its efforts to secure its own western frontiers.\(^{87}\)

Azerbaijan has long considered economic engagement with China to be integral to its strategy of diversifying its economy away from its reliance on energy exports.\(^{88}\) Between 1995 and 2011, Chinese companies invested $598 million in Azerbaijani oil and gas, while committing just $102.5 million to other industries.\(^{89}\) Although Beijing has been relatively late in penetrating the Azerbaijani energy industry,\(^{90}\) several Chinese oil companies have been given permits to work in the country. These firms have, however, only been given access to aging onshore fields that require significant modernization.\(^{91}\)

In 2014, China accounted for 7.59 percent and 0.29 percent of Azerbaijan’s total import and export volume, respectively.\(^{92}\) According to IMF statistics, bilateral trade grew at a compound annual rate of approximately 12.06 percent from $273 million in 2005 to $760.9 million in 2014.\(^{93}\)

While China has officially remained neutral on the Nagorno-Karabakh conflict, Chinese officials have rhetorically supported Azerbaijan’s sovereignty and territorial integrity.\(^{94}\) In 2014, during the Conference on Interaction and Confidence Building Measures in Asia (CICA), President Aliyev praised China for respecting “other countries’ development paths,” and pledged support for China’s own efforts to combat ethnic separatism.\(^{95}\) Furthermore, Baku has shown some interest in joining the Shanghai Cooperation Organization (SCO) as an observer state, which holds out the

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93. World Bank; IMF DOTS; author calculations.
prospect of new economic opportunities in Asia. Nevertheless, some Azerbaijani elites worry that affiliation with the SCO will compromise Azerbaijan's autonomy (for similar reasons, Baku has avoided formally affiliating with either NATO or the Russian-backed CSTO).

While Chinese investment is broadly welcomed, the potential for it to come with strings attached is likewise a source of concern. One of our pro-Western interlocutors in Azerbaijan warned that “China is even worse [than Russia] for the soul.”

ISRAEL

Azerbaijan arguably represents Israel’s strongest ally in the Muslim world today. Since independence, the Azerbaijani government has cultivated an “improbable” relationship with Israel. Especially following Turkey’s diplomatic break with Israel over the latter’s controversial 2010 raid on the Gaza ‘Freedom Flotilla,’ the bond between Baku and Jerusalem has expanded to one of intense strategic partnership. To a significant extent, this partnership is based around a shared antagonism toward Iran, though it increasingly facilitates economic ties as well. It is also a way for Azerbaijan to build ties with major Jewish groups in the United States, which in turn helps Baku offset the Armenian diaspora’s influence in Washington.

Since 2000, Israel has grown from Azerbaijan’s 10th largest trade partner to its 5th largest with exports to Israel—virtually all of it petroleum—comprising 8.12 percent of Azerbaijan’s total export volume in 2014. Azerbaijan currently supplies around 30 to 40 percent of Israel’s oil, and SOCAR has regularly assisted Israel in its efforts to develop its own offshore oil and gas industry. In turn, Israeli investments have contributed to the modernization of Azerbaijan’s agricultural and information technology sectors, and its medical and sanitation infrastructure.

100. World Bank; IMF DOTS; author calculations.
More significant though are the growing security ties. In 2012, Israel agreed to supply Azerbaijan with US$1.6 billion in sophisticated arms technology, ranging from unmanned aerial drones to antiaircraft and missile defense systems.104

Tehran has repeatedly accused the Aliyev government of allowing Israeli Mossad agents to operate out of Azerbaijan,105 even going so far as to summon the Azerbaijani ambassador in order to protest Baku’s alleged complicity in Israel’s targeted assassination of Iranian nuclear scientists.106 In August 2014, the Iranian military announced that it had shot down an Israeli-manufactured drone and claimed that the device had been operated out of a “former Soviet republic to the north.”107

A 2012 press report claimed that Baku had even offered the Israeli Defense Forces use of its bases in the event of a conflict between Israel and Iran.108 While these reports were denied by both sides and are almost certainly false, their existence speaks to the growing cooperation between the two states. Israel for its part has affirmed that it recognizes Azerbaijan’s territorial integrity, favors a peaceful solution to the Karabakh conflict and supports the OSCE Minsk Group format.109

The possibility of a rapprochement between Baku and Tehran following the withdrawal of sanctions on Iran’s nuclear program could affect Azerbaijan’s relations with Israel as well. One foreign diplomat we spoke with suggested that Jerusalem would be extremely wary of any such efforts, which it fears could lead Azerbaijan to downgrade its existing level of cooperation with Israel.


Azerbaijan in a Reconnecting Eurasia

Energy and geography dictate the contours of Azerbaijan’s foreign economic policy. Located astride critical east-west and north-south transit corridors, and blessed with substantial oil and gas reserves, Azerbaijan seeks to establish itself as a regional transit hub. Its ability to export energy from the Caspian littoral to Turkey and Europe has boosted Azerbaijan’s prosperity as well as its strategic independence. Yet these assets also pose vulnerabilities that Azerbaijan’s larger neighbors have at times sought to exploit, and have left Azerbaijan vulnerable in the face of oil prices that have fallen from over $110 per barrel in the summer of 2014 to around $30 per barrel at the start of 2016.

Given this complex regional environment, few of our interlocutors showed enthusiasm at the prospect of either European or Russian-backed integration. The general consensus among our interlocutors was that Baku views integration as a zero-sum game, which might benefit Azerbaijan’s economy, but would inevitably undermine its sovereignty. Baku has thus pursued a policy of selective participation in regional trade and transit development projects, favoring engagement with neutral third parties such as the United Nations Development Program (UNDP) in order to avoid possible entanglement in what one of our academic contacts termed any “competing political-military blocs.”

Between 2005 and 2013, Azerbaijan’s total trade turnover increased from $8.55 billion to $34 billion, for an annualized growth rate of roughly 16.58 percent. Trade, however, dropped to $30.9 billion in 2014 on the back of lower oil prices.1 Throughout this same period, Baku experienced annualized trade growth in excess of 10 percent with its most important trading partners. Azerbaijan meanwhile conducts little intraregional trade due to the closure of its border with Armenia; it has meanwhile seen only minute gains (less than 1 percent) in its commercial ties with Georgia.

While hydrocarbon production and export have facilitated rapid economic growth, they have left Azerbaijan vulnerable to fluctuations in energy prices and demand. Nonetheless, most of our interlocutors in Azerbaijan favored increasing oil and gas production. A few did note the

1. International Monetary Fund (IMF) Direction of Trade Statistics (DOTS) database; author calculations.
Table 3.1. Annualized Growth in Azerbaijan’s Global Trade Ties, 2005–2014

<table>
<thead>
<tr>
<th>Partner Country/Group</th>
<th>Growth Rate (%)</th>
<th>Value (2005), US$ million</th>
<th>Value (2014), US$ million</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>15.35</td>
<td>8,558</td>
<td>30,930</td>
</tr>
<tr>
<td>European Union</td>
<td>16.31</td>
<td>3,684</td>
<td>14,347</td>
</tr>
<tr>
<td>United States</td>
<td>24.36</td>
<td>184</td>
<td>1,309</td>
</tr>
<tr>
<td>Israel</td>
<td>27.22</td>
<td>205</td>
<td>1,790</td>
</tr>
<tr>
<td>Ukraine, Moldova, and Belarus</td>
<td>6.08</td>
<td>284</td>
<td>483</td>
</tr>
<tr>
<td>Turkey</td>
<td>13.16</td>
<td>588</td>
<td>1,789</td>
</tr>
<tr>
<td>Russia</td>
<td>10.27</td>
<td>1,002</td>
<td>1,954</td>
</tr>
<tr>
<td>China</td>
<td>12.05</td>
<td>273</td>
<td>760</td>
</tr>
<tr>
<td>Iran</td>
<td>−2.88</td>
<td>242</td>
<td>186</td>
</tr>
<tr>
<td>South Caucasus</td>
<td>10.53</td>
<td>253</td>
<td>623</td>
</tr>
<tr>
<td>Central Asia</td>
<td>−7.77</td>
<td>814</td>
<td>393</td>
</tr>
</tbody>
</table>

Source: IMF Direction of Trade Statistics (DOTS) database; author calculations.

Figure 3.1. Breakdown of Azerbaijan’s Global Trade Ties, 2005–2013

Sources: IMF DOTS; author calculations.
importance of diversifying the economy by attracting additional foreign direct investment (FDI) in non-energy sectors, but seemed to have limited understanding of the obstacles Azerbaijan faces.

In a 2012 interview, President Aliyev asserted that development of non-oil industries would “let us completely eliminate dependence on the oil sector” by 2020.² Efforts to attract FDI to non-energy sectors nonetheless face a series of bureaucratic and regulatory obstacles, as well as corruption.³ Additionally, the control of important sectors such as tourism and agriculture by politically powerful oligarchs discourages outside investors. Non-oil and gas FDI in Azerbaijan has risen steadily in the past decade, growing 6.6 percent from $529 million in 2005 to $1.107 billion in 2013. Yet, during this same period, inward FDI for the energy sector was three times as large. Due to this high dependence on hydrocarbons, Azerbaijan suffered from so-called Dutch disease, with a comparatively strong currency that makes its non-energy exports less competitive.⁴

With the collapse of oil prices since early 2014, Azerbaijan confronts a new set of challenges. The Central Bank spent close to half its foreign reserves propping up the manat, before allowing the currency to float in December 2015. While the resulting devaluation stopped the hemorrhage of foreign currency, it sparked significant inflation, with consumer prices rising 4.4 percent just in December 2015, and increased the pressure on banks with dollar-denominated loans in their portfolios.⁵ Protests, some violent, followed. Baku was also forced to cut back on defense spending, even as violence in and around Nagorno-Karabakh increased.⁶ By early 2016, Azerbaijan was in talks with the International Monetary Fund and other international lenders for assistance.

Even before the collapse of oil prices, Baku had taken some concrete steps to reduce dependence on hydrocarbons. Its policy of economic diversification was outlined in the “Long-Term Strategy on the Management of Oil and Gas Revenues” document that was signed into law by President Aliyev in 2004.⁷ While discussing allocation of the oil revenues within the economy, the document prioritizes development of the non-energy sectors as a path toward gradually reducing dependence on hydrocarbons. Baku has been gradually channeling oil and gas revenues into non-energy industries like telecommunications, construction, and tourism. In 2013, non-energy sectors’ share of GDP reached 56.5 percent.⁸

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Baku has also sought to reform its bureaucratic procedures, expedite commercial transactions, revitalize financial institutions, and nurture a new generation of skilled cadres. A number of our local contacts pointed to the newly implemented asan xidmet (easy service) initiative, which streamlines the process of obtaining permits, licenses, and other documents as an example of the government’s commitment to liberalization. Another concrete step was the establishment of the Azerbaijani Standards Institute in 2007 for the development of national standardization and certification practices.9

The government has also moved to make Azerbaijan a more attractive destination for foreign investment. Baku reduced corporate taxes by 20 percent and recently established the Azerbaijan Investment Company (AIC), which aims to attract foreign investments into the non-oil sector through postindustrial reclamation projects.10 Baku also reformed the banking industry with banks now providing better interest rates and relaxing collateral requirements.11

In addition to boosting non-energy FDI, Baku hopes to leverage its location to become a hub for east-west as well as north-south transit. Yet our local contacts suggested corruption was limiting Azerbaijan’s ability to achieve its aspirations of becoming a major hub. An independent analyst we spoke with in Baku hypothesized that 60 percent of cargo from Central Asia that could be passing through the South Caucasus ends up instead crossing Russia, where corruption is “better

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organized.” High tariffs are another impediment to trade and transit through Azerbaijan. Azerbaijan has an average tariff rate of 4.5 percent compared to Armenia’s 2.3 percent and Georgia’s 0.7 percent.12

An even bigger obstacle may be the geopolitical fragmentation of the Caucasus. The unresolved Nagorno-Karabakh conflict has kept Azerbaijan’s border with Armenia closed for more than two decades (the Armenian-Turkish border is also closed), requiring east-west transit from Azerbaijan to take the less direct route through Georgia, which faces its own security challenges and frozen conflicts in Abkhazia and South Ossetia. North-south transit, meanwhile, is inhibited by both Azerbaijan’s sometimes difficult relationship with Iran as well as instability across the border in the Russian North Caucasus.

OIL

Azerbaijan has been an important oil producer since the very first days of the global energy industry in the mid-19th century.13 The rapid development of the oil industry was further facilitated by the discovery of the Azeri-Chirag-Guneshli (ACG) field in the Caspian Sea in the early 1980s. With an estimated capacity of 4.67 billion barrels, the ACG is the largest oil field in the country.14 It has already produced over 2.5 billion barrels of crude and 23 billion cubic meters (bcm) of associated gas since 1997.15

Today, Azeri oil is distributed through three pipelines: Baku-Novorossiysk, Baku-Supsa, and Baku-Tbilisi-Ceyhan (BTC). Built in 1997, Baku-Novorossiysk has a capacity of 36.65 million barrels of oil per year, but does not operate at full capacity. In 2012, Baku-Novorossiysk transported just over 15 million barrels, which declined to 12.83 million barrels in 2013 and just 9.3 million barrels in 2014.16

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15. SOCAR, “Upstream,” accessed through SOCAR Group, July 28, 2015, http://www.socartrading.com/socar_group/upstream. As part of the deal, 11 original companies (BP, Amoco, Unocal, Lukoil, Statoil, Exxon, TPAO, Pennzoil, McDermott, Ramco, Delta Nimir) agreed to jointly develop the ACG field and the Azerbaijan International Operating Company was founded to oversee and coordinate all operations. The contract also stipulated a $60 billion investment into Azerbaijan’s growing energy industry. See “Azerbaijani Oil,” Economics, accessed through Azerbaijan.az, August 1, 2015, http://www.azerbaijan.az/_Economy/_OilStrategy/_oilStrategy_e.html. Today, the ACG field is operated by BP (35.78 percent), SOCAR (11.65 percent), Chevron (11.27 percent), INPEX (10.96 percent), Statoil (8.56 percent), ExxonMobil (8.00 percent), TPAO (6.75 percent), Itochu (4.3 percent), and ONGC (2.72 percent). It is worth noting, however, that the ACG field production has been steadily declining in recent years. In 2014, only 233 million barrels were extracted from the field compared to 239 million barrels in 2013.

Possible reasons for Baku-Novorossiysk’s declining volumes include the fact that Baku has been losing money on shipments because high-quality Azeri oil is blended with lower-grade crude from Russia and sold at a lower price. Pipeline tariffs, set by Russian operator Transneft, represent another impediment. SOCAR can now transport oil for $6 per barrel via BTC, compared to $15.65 per barrel via Baku-Novorossiysk. In 2014, Transneft announced that it would like to increase the tariff on Baku-Novorossiysk an additional 30 percent, even though Azerbaijani officials stated that Baku-Novorossiysk was already not profitable. SOCAR stopped shipments through Baku-Novorossiysk in November 2015 because of Russian sanctions.

<table>
<thead>
<tr>
<th>Rank</th>
<th>Country</th>
<th>Crude Oil Production in Barrels per Day</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Russia</td>
<td>10,840,000</td>
</tr>
<tr>
<td>2</td>
<td>Saudi Arabia</td>
<td>9,735,000</td>
</tr>
<tr>
<td>3</td>
<td>United States</td>
<td>8,653,000</td>
</tr>
<tr>
<td>4</td>
<td>China</td>
<td>4,189,000</td>
</tr>
<tr>
<td>5</td>
<td>Iran</td>
<td>3,614,000</td>
</tr>
<tr>
<td>6</td>
<td>Canada</td>
<td>3,603,000</td>
</tr>
<tr>
<td>7</td>
<td>Iraq</td>
<td>3,368,000</td>
</tr>
<tr>
<td>8</td>
<td>United Arab Emirates</td>
<td>2,820,000</td>
</tr>
<tr>
<td>9</td>
<td>Kuwait</td>
<td>2,629,000</td>
</tr>
<tr>
<td>10</td>
<td>Venezuela</td>
<td>2,500,000</td>
</tr>
<tr>
<td>22</td>
<td>Azerbaijan</td>
<td>845,900</td>
</tr>
</tbody>
</table>


Note: Russian sanctions, not sanctions against Ukraine, prevented shipments through Baku-Novorossiysk in November 2015.
Map 3.1. Caspian Oil Pipelines


technical limitations, but company officials have indicated they would like to resume shipments in 2016.19

In contrast, Baku-Supsa is widely regarded as a success story. The first post-Soviet pipeline built by an international consortium, the construction of Baku-Supsa in the mid-1990s instilled confidence among foreign investors, helping foment an influx of FDI into Azerbaijan.20

In recent years, Baku-Supsa has drawn even greater international interest with the exploration of the Kashagan oil field in the Caspian Sea off Kazakhstan. Although repeatedly delayed by environmental and technical challenges, Kashagan remains one of the largest oil fields discovered anywhere in recent decades, and its eventual development could raise the question, mooted earlier this century, of expanding Baku-Supsa to accommodate increased production. If expanded, the pipeline could enable Kazakh crude to reach ports in Romania or the Ukrainian city of Odessa via the Odessa-Brody pipeline.

19. SOCAR, “SOCAR in talks with Transneft on Renewal.”
20. Italian Eni owns a 16.8 percent stake in the project, along with Royal Dutch Shell (16.81 percent), Total S.A. (16.81 percent), ExxonMobil (16.81 percent), KazMunayGas (16.81 percent), China National Petroleum Corporation (8.4 percent), and Inpex (7.56 percent). See Catherine Putz, “Kazakhstan’s Massive Oil Field Is Finally Getting Repaired,” Diplomat, April 17, 2015, http://thediplomat.com/2015/04/kazakhstans-massive-oil-field-is-finally-getting-repaired/.
Another option for moving Kashagan oil to Europe is to connect the BTC pipeline to the eastern shore of the Caspian by constructing a 700-kilometer underwater pipeline from the port of Atyrau in Kazakhstan to Baku, while raising the total throughput of the BTC to 1.7 million barrels per day.21 Of course, Moscow would strongly oppose such a pipeline as well.

The BTC pipeline itself was the product of a long campaign championed by the United States to bring Caspian oil to European markets as a means of reducing dependence on routes through Russia.

With a current total capacity of 1.2 million barrels per day, BTC transports oil pumped from the Azeri-Chirag-Guneshli (ACG) fields.22 BTC bypasses both Russian territory and the heavily trafficked Turkish Straits.23 Since it began operating in 2006, BTC has strengthened interdependence between participating states, while creating new jobs and stimulating economic growth. The pipeline earns roughly $50 million per year in transit revenues for Georgia24 and has furnished almost $12 billion for Turkey between 2006 and 2014.25 As the main exporter, Azerbaijan has been the main financial beneficiary of the project. The International Financial Corporation (IFC) estimates that between 2005 and 2024, Azerbaijan will gain $500 million from the BTC in transit-related revenues alone, mainly through the 27 percent tax levied on BTC companies.26

BTC demonstrated the viability of major international energy projects bypassing Russia, and strengthened Azerbaijan’s image as a reliable Western partner. It likewise created a community of common interests between Azerbaijan, Georgia, Turkey, and consuming states in Europe that has helped anchor the westward-facing foreign policy strategies of both Georgia and Azerbaijan. For this reason, BTC has also faced its share of security challenges. In the run-up to the 2008 Russo-Georgian war, an explosion along the BTC in Turkey disrupted supplies for a few days. Initially claimed by Kurdish rebel groups, the explosion was later found to be the result of a cyber-attack presumably originating in Russia. During the conflict, Russian warplanes dropped bombs on Georgian territory only meters from the pipeline, a step widely interpreted as a warning from Moscow to all three states along the BTC route.27

The biggest challenges facing BTC though may be declining production in Azerbaijan, coupled with the challenges of accessing oil from Kashagan. Already, the pipeline is operating at below capacity, and in late 2014, a source close to the government revealed that Azerbaijan’s oil output is expected to decline 2.5 percent year-on-year in 2015, down to 40.62 million tons from 43.15 million in 2011. Further estimates indicate this number will drop further to 39.32 million tons in 2018. Unless Azerbaijan can discover new oil fields, it may need to seek out Russian or Central Asian substitutes to meet its commitments to European customers. Since October 2013, BTC also pumps limited amounts of petroleum from Turkmenistan and Kazakhstan.

NATURAL GAS

While oil is Azerbaijan’s principal export commodity, Baku also has become a significant producer and exporter of natural gas since the discovery of the offshore Shah Deniz field in 1999. Azerbaijan holds an estimated 2.5 trillion cubic meters of natural gas and produced an estimated 16.9 bcm in 2014, of which 8.57 billion bcm was exported. A foreign diplomat we interviewed speculated that as Baku depletes its oil reserves, it will likely strive to boost gas production to offset the lost revenue, even though it would need to also invest large sums in building new export infrastructure.

Current gas exports to Europe are transited through the Baku-Tbilisi-Erzurum (BTE), also known as the South Caucasus, gas pipeline. BTE is the first piece of the planned Southern Corridor, which the European Union is promoting as a mechanism for boosting its access to Caspian gas and ameliorating its dependence on Russia. Completed in 2006, BTE pumps approximately 20 bcm of gas per annum from Shah Deniz field.

Baku aims to supplement BTE through the construction of additional transit capacity in the Southern Corridor. Construction is currently under way on the Trans-Anatolian Pipeline (TANAP), stretching from the Turkish-Georgian border to Turkey’s frontier with Greece and Bulgaria. The pipeline will be able to carry 16 bcm of gas from Shah Deniz’s second phase westward. SOCAR holds a 58 percent stake in TANAP, with 12 percent owned by BP and 30 percent by Turkish BOTAŞ. From Greece, Caspian gas could travel deeper into Europe through the planned Trans Adriatic Pipeline, which while serving as an extension of TANAP, can carry 10 bcm of gas via Albania and the Adriatic Sea to Italy.

Although both Azerbaijan and the European Union see the Southern Corridor as advancing their strategic objectives, its development continues to face a number of obstacles. Among the most significant is the limited volumes available from Azerbaijani sources. Since gas from Azerbaijan alone will never be sufficient to replace the volumes Europe currently buys from Russia, industry analysts question whether the marginal gains in diversification justify the Southern Corridor’s financial and political costs. Currently, Azerbaijan’s two largest oil fields are Shah Deniz and Umid.


Shah Deniz is the largest field in the country with an estimated reserve of 1 trillion cubic meters and an annual production capacity of 10 bcm.\(^\text{37}\) The second stage of the project, dubbed Shah Deniz II, is expected to be launched in 2019 once TANAP is online.\(^\text{38}\) It will add 16 bcm to the exiting gas volumes, of which 6 bcm will be delivered to Turkey while the remaining 10 bcm will reach Europe via TANAP and TAP.\(^\text{39}\)

Estimated reserves at the Umid field are around 200 bcm (possibly reaching 300 bcm with additional drilling), while the field’s daily capacity is about 1 million cubic meters.\(^\text{40}\) Between 2010 and 2014, SOCAR extracted 390 million cubic meters of gas from the field, but daily production plummeted to 630,000 cubic meters in 2014 from 638,000 cubic meters in 2013 and 1.5 million cubic meters in 2012 as a result of what the company called technical problems.\(^\text{41}\) In order to ameliorate the situation, SOCAR announced a tender to develop the field conjointly with other companies, with drilling finally resuming in mid-March 2016.\(^\text{42}\)

By 2030, Europe is estimated to require annual imports of natural gas totaling 400 bcm. On its own, Azerbaijan will never be able to produce such volumes, requiring additional countries to participate for the Southern Gas Corridor to emerge as a viable alternative to Russian gas.\(^\text{43}\)

Baku prioritizes exporting its own gas to Europe, but is also in theory open to transporting additional volumes, particularly from Turkmenistan via the planned TCGP. One senior official we spoke with assured us that Baku is willing to transit Turkmen gas because the European market is "plenty large." In addition to the economic hurdles facing the TCGP and the unresolved legal status of the Caspian Sea, Azerbaijan and Turkmenistan also have their share of disputes that appear to limit their appetite for energy cooperation. In addition to their disagreements over Caspian demarcation and ownership of the Kapaz/Serdar field, they remain at odds over who would pay for the construction of new infrastructure.\(^\text{44}\)

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37. South Caucasus Pipeline,” BP Azerbaijan.

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Russia has also expressed a range of concerns about the Southern Corridor concept, although its comments on TANAP have been relatively restrained so far (likely reflecting TANAP’s quite limited volume). Moscow sees the Southern Corridor as an effort to weaken its market power in Europe, and has voiced environmental concerns, criticized its erratic deadlines, and questioned the overall feasibility of the project given its technical complexity and size.\textsuperscript{45} Russia’s own pipeline projects, notably the now-defunct South Stream and Turkish Stream, appear designed to compete with the Southern Corridor. Moscow has also offered to buy all of Azerbaijan’s gas production for its own pipeline system, likely to demonstrate that Baku does not need the Southern Corridor.

**REGIONAL INTEGRATION**

While Azerbaijan remains strongly opposed to regional integration, the establishment of the Russian-backed Eurasian customs union and Eurasian Economic Union (EEU) has affected Baku’s economic and strategic calculations. Baku has come out strongly against membership in the EEU, which officials argue would undermine Azerbaijan’s strategic independence and likely damage the economy. Foreign Minister Elmar Mammadyarov stated in December 2014 that “Azerbaijan has not received official notification about joining [the EEU], and this question is not on the agenda for Azerbaijan,” which he characterized as a country that “in political, economic, and trade relations gives priority to the bilateral format.”\textsuperscript{46}

Given the importance of European markets for Azerbaijan’s energy exports, EEU membership would represent a significant reorientation of the economy. Opponents of membership fear joining would have calamitous implications for already feeble industries. One sector that would stand to lose the most is agriculture. Although the agrarian sector accounted for just around 6 percent of Azerbaijan’s GDP in 2014, it employs almost 40 percent of the country’s working population.\textsuperscript{47} The government imposes high tariffs on foreign agricultural goods, which membership in the EEU would require dismantling. Removing these barriers could “destroy Azerbaijan’s agricultural sector” in the long term with potentially serious consequences for political stability.\textsuperscript{48} Some analysts do suggest that signing up with EEU could ultimately help Azerbaijan to diversify its exports away from oil,\textsuperscript{49} while others argue that EEU’s provision for a common external tariff would hinder Baku’s ability to participate in regional economic integration projects such as the


Interstate Oil and Gas Transportation to Europe (INOGATE) energy cooperation regime and Transport Corridor Europe Caucasus Asia (TRACECA)50—not to mention deprive Baku of its ability to formulate its energy strategy independently of outside influence.51 EEU membership would also entail additional tariffs on trade with nonmember states, which would affect Baku’s trade with Turkey, its primary political ally, and the European Union, its largest trade partner. Nor would trade with the other EEU member states offset these losses, because energy-rich states like Russia and Kazakhstan have little need for Azerbaijan’s hydrocarbons. Still, most of our contacts agreed that the question of Baku’s relationship with the EEU is ultimately more political than economic.

The biggest impediment to membership though may be the unresolved Karabakh conflict and the fact that Armenia is already in the EEU, rather than the potential economic impact. As Azerbaijan’s ambassador in Moscow noted, “we cannot be in the same league with the aggressor country and address any issues with this side.”52

LAND, AIR, SEA, TRANSIT

Azerbaijan’s strategic location and vast energy reserves are two of its most valuable assets, and Baku seeks to leverage them as part of its quest to become a major trade and transit hub for the wider Eurasian region. Azerbaijan is constructing and renovating a range of infrastructure and transportation projects that could, in the words of one senior official, help position Azerbaijan at the center of “processes that are happening in the world.” According to President Aliyev, realizing Azerbaijan’s potential as a convenient north-south, east-west transportation corridor “will increase [its] geopolitical importance” and attract FDI.53

Though Baku’s vision is wide-ranging, in practice the bulk of this new transit infrastructure leads to Europe, helping cement Baku’s economic and strategic ties to the West. One such initiative being undertaken by the state railway companies of Georgia, Turkey, and Azerbaijan is the Baku-Tbilisi-Kars (BTK) railway, also known as Kars-Akhalkalaki-Baku, which along with the Baku-Tbilisi-Ceyhan oil pipeline and the Southern Gas Corridor, were described by Elin Suleymanov, Azerbaijan’s ambassador to the United States, as the three “pivotal projects” in reviving the historic Silk Road.54 The project entails restoration of the 178-kilometer-long Marabda-Akhalkalaki railway, which will be connected to the newly constructed railway from Akhalkalaki to the Turkish border. At its peak,

BTK will be able to transport 20 million tons cargo and 3 million passengers per year.\textsuperscript{55} Completion of the railway has now been pushed back to 2019, at an estimated cost of more than $600 million.\textsuperscript{56}

In addition to bolstering trade in its immediate vicinity, Azerbaijan is interested in capturing a larger share of freight that travels between east and west as well as north and south. The BTK railway aims to expand the volume of goods moving between Turkey and Central Asia, while also opening new routes from Turkey to Russia.\textsuperscript{57} Kazakhstan, in particular, has been mulling the idea of connecting its own railway grid to BTK.\textsuperscript{58} Kazakhstan’s enthusiasm is echoed in Beijing, which sees BTK as an additional opportunity to expand its exports to Europe.\textsuperscript{59}

Another link between Azerbaijan and Europe is the Interstate Oil and Gas Transportation to Europe (INOGRATE) energy cooperation regime. INOGATE strives to “converge” European energy markets with various energy suppliers in Eastern Europe, the Caucasus, and Central Asia through a broad variety of EU-funded programs encouraging technical extension, standards harmonization, transit security, and sustainable development.\textsuperscript{60} Since 2011, INOGATE has reduced nontariff barriers to EU-Azerbaijan natural gas flows, helped Azerbaijan reduce losses in its natural gas and electrical distribution networks, and assisted Baku in formulating renewable energy strategies.\textsuperscript{61} As for future priorities, INOGATE is currently engaged in efforts to encourage the creation of a joint electricity market among Azerbaijan, Georgia, and Turkey.\textsuperscript{62}

Azerbaijan also participates in the EU Transport Corridor Europe Caucasus Asia (TRACECA), which has its headquarters in Baku. The project encompasses a network of railways, sea lanes, air routes, and roads shadowing the trail used by the caravans of the original Silk Road.\textsuperscript{63} TRACECA stretches from Bulgaria through Ukraine and Romania to the ports of Poti and Batumi on the Black Sea and on to the Caspian basin. From there, goods are shipped across the Caspian to the ports of Aktau (Kazakhstan) and Turkmenbashi (Turkmenistan), from where they are transited by rail across

\footnotesize{55. Ibid.  
Central Asia as far as the borders with Afghanistan and China. While the bulk of these transit initiatives run along an east-west axis, Azerbaijan has also kept one eye on the emergence of new north-south projects as well, even if these often entail political complications given Baku’s complex relations with Moscow, Tehran, and, especially, Yerevan. In particular, the International North-South Transport Corridor (INSTC) presents Azerbaijan with an opportunity to host critical transit lines that will connect the Persian Gulf, Indian Ocean, and Caspian Sea. Through this route, freight will be shipped from India to Iran and then travel through Azerbaijan and up the Volga River to destinations in Northern Europe. By evading a choke point in the Suez Canal, the INSTC aims to cut delivery time from 45–60 days to 25–30 days and slash transportation costs by 30 percent (or $2,500 per 15 tons of cargo). Interest in the INSTC is congruent with Baku’s desire to maintain its pivotal role and avoid being completely tied to any particular integration project or economic bloc.

With an annual capacity of 18 million tons, Baku International Sea Port (BISP) on the Caspian is a lynchpin of Azerbaijan’s maritime trade. A presidential decree issued in 2007 called for the demolition of the existing port and construction of the new BISP in Alyat, a settlement 65 kilometers south of Baku. With its upgraded capacity of 25 million tons per year, the new port will be situated on the crossroads of the east-west and north-south trade corridors, while a newly constructed rail ferry terminal will connect Baku with ports at Aktau and Turkmenbashi—a modification aimed at enhancing cooperation within the framework of the TRACECA project.

Azerbaijan is located within a 3.5-hour flight from 45 countries, making it an attractive stopping point for both cargo and passenger planes. For example, a Boeing 747-400 F flying from Shanghai to Frankfurt can save up to 21 tons of fuel if it chooses Baku as a stopover instead of Dubai. From 1996 to 2013, the number of international passengers and goods traversing through

72. Ziyadov, Azerbaijan as a Regional Hub in Central Eurasia, 134.
Azerbaijan’s airspace increased by 77.8 percent and 583.33 percent, respectively. Thanks to constant modifications and steady public investment, Heydar Aliyev International is the busiest airport in the South Caucasus, and one of the more technologically advanced in the entire post-Soviet region. The airport handles 2.857 million passengers a year on 22 separate carriers, including the national carrier Azerbaijan Airlines. The airline services 32 routes from Baku, stretching from New York to Beijing.

To handle the increasing volume of incoming freight, Baku Cargo Terminal was officially inaugurated in 2005 and Terminal 1 opened at Heydar Aliyev International in 2014.

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Conclusion

Azerbaijan’s energy resources and ability to balance its engagements with multiple partners have allowed Baku to preserve a high degree of strategic autonomy in a fragmented region. Recent developments, though, complicate this strategy, raising questions about Azerbaijan’s continued ability to maintain its precarious balancing act. The crisis in Ukraine, which has seen a corrupt post-Soviet government ousted by its own people, followed by Russian military intervention, is a source of concern in Baku as in other post-Soviet capitals. Azerbaijan’s efforts to ensure against a domestic Euromaidan through domestic crackdowns in turn complicated relations with the European Union and the United States at a time when both were in the process of reconsidering their engagement with Eurasia. Lower oil prices, the emergence of new supplies (including unconventional oil and gas as well as in the longer term likely from Iran), and declining production at Shah Deniz have also made Azerbaijani energy less critical to solving Europe’s dependence on Russia, while increasing Baku’s internal challenges. Azerbaijan continues to anchor the Southern Corridor, but Europe increasingly has other options, and like the United States is increasingly willing to criticize Azerbaijan’s treatment of its own citizens. In response, Azerbaijani officials point to the March 2016 amnesty of political prisoners (ahead of Ilham Aliyev’s visit to the United States) and the subsequent release of Khadija Ismayilova as indications that the post-Maidan crackdown was temporary.

While relations with the West have grown more difficult, Azerbaijan continues to guard against being pulled too far into the Russian orbit. Of course, many Azerbaijaniis blame Russia for enabling Armenia to maintain control of Nagorno-Karabakh and the surrounding districts, leaving little appetite in Baku for closer relations (much less membership in the EEU) absent a clear path to a favorable settlement on Karabakh. Nonetheless, Baku is sophisticated enough to understand that at a time of Western retrenchment and perceived domestic challenges, maintaining cooperation with Moscow is imperative, and could become more so if relations with the West worsen.

The biggest challenges facing Azerbaijan, however, lie closer to home. These include the need to maintain domestic order in more straightened economic times that have seen the emergence of
large-scale protests for the first time in many years, as well as the potential for renewed conflict around Nagorno-Karabakh. Azerbaijan’s military buildup feeds belligerent rhetoric from analysts and at least some officials about recovering Karabakh by force. Azerbaijani forces’ advance across the line of contact in the spring of 2016 threatened to create a precedent for using force to alter facts on the ground, and could lead to the unfreezing of the status quo that has more or less held since the 1994 cease-fire. Yet the difficulties of any campaign in that mountainous territory, coupled with the potential for Russian forces to tip the balance, make any offensive to seize the whole of Karabakh risky in the extreme. The one certainty surrounding any resumption of hostilities is that casualties would be high on all sides given the size and firepower of the arsenals belonging to Baku and Yerevan, as well as Stepanakert. Given the alignments tying the protagonists to larger outside powers like Russia and Turkey, renewed fighting along the line of contact could also escalate in unpredictable and dangerous ways.

Azerbaijan’s efforts to position itself as a regional transit hub offer a more hopeful picture for the future, but success is far from guaranteed. Infrastructure projects connecting Azerbaijan to Georgia and Turkey have become a crucial piece of Baku’s strategy for accessing global markets and giving outsiders a stake in its success. Extending these connections to Europe, for instance through the TANAP and TAP pipelines, would allow Baku to build on this success. Yet Azerbaijan needs to do more to convince foreign companies to invest, particularly outside the energy sector. Such investment is especially important given low oil prices and difficulties at Shah Deniz, which highlight the need for Azerbaijan to diversify its economy—a step that, in turn, requires confronting entrenched interests at home at a time when concerns about domestic stability are mounting.

In a difficult environment characterized by both regional and great power rivalry, Azerbaijan has long stood out for its ability to maintain its freedom of maneuver while leveraging its natural resources to become an important player in the wider region between the Caspian Sea and Europe. Baku’s challenge going forward will be to continue pursuing its ambitions during a period of shifting geopolitical priorities and uncertain energy price dynamics. Natural resources have long provided Azerbaijan a comparative advantage among the states of the South Caucasus. That advantage remains, but in the more complex regional environment it now faces, Azerbaijan needs to develop new tools as well, opening up politically and economically in order to maintain its long-standing strategic balance at the crossroads between Russia, the West, Turkey, Iran, and the still volatile South Caucasus.
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