



STRATEGIC FILE

No. 2 (65), January 2015 © PISM

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Azerbaijan and the EU: Prospects for Partnership Beyond Energy

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Azerbaijan, which until recently has been a key EU partner in the Caucasus, now adopts increasingly anti-Western rhetoric in line with Russia's criticism of the West. The government in Baku may calculate that getting closer to resurgent Russia is a way to enhance its regional security and even to resolve the Nagorno-Karabakh conflict. However, Russia cannot replace the EU as Azerbaijan's main economic partner, and the alternative to cooperation with the West would be self-isolation. Development of EU-Azerbaijan cooperation is a must for Baku and a regional priority for Brussels, no matter how tough their current relations are. However, the launch of the EU's strategic partnership for modernisation with Azerbaijan must be dependent upon ceasing repression of civil society by authorities in Baku and the start of serious reforms.

Fewer Western Values, More Russian-Style “Sovereign Democracy”

Azerbaijan's presidency of the Council of Europe from April to November 2014 coincided with a new wave of arrests of representatives of civil society.¹ In total, a dozen people were arrested, based on politically motivated charges.¹ Repression against human rights defenders continued later, as evidenced by the arrest of Hatice Ismailova, a known activist, on 5 December.

The arrests of activists could have been aimed at preventing them from carrying out an information campaign on human rights violations in Azerbaijan during the presidency. However, it appears that the effect intended by the authorities in Baku has not been achieved. On the contrary, the question of the repression of civil society is becoming more problematic in relations between the EU and Azerbaijan.

The government in Baku already has many more problems in its relations with the United States, which is much more vocal in criticism of human rights violations than the EU. So far the Azerbaijani authorities' response to this critique has been not only aggressive rhetoric towards the United States, but also further authoritarian actions such as a police raid on the U.S.-funded Radio Free Europe/Radio Liberty bureau in Baku on 26 December. Twelve of its journalists were arrested during the following two days. The highest ranking officials such as the head of the presidential administration, Ramiz Mehtiyev, explicitly called all the institutions linked to the U.S. a “fifth column” established with the sole aim of organising a “colourful revolution”. This kind of rhetoric is accurately copying the Kremlin's wordings used in propaganda

¹ Among those arrested based on politically motivated charges were renowned human rights defenders Intigam Aliyev, Rasul Cafarov, Leyla and Arif Yunus and the editor of the Russian language newspaper Rauf Mirkadirov. The last three mentioned persons were engaged in a dialogue with the representatives of Armenian civil society for the settlement of the conflict over Nagorno-Karabakh. This fact has been used by the authorities to charge them with alleged espionage in favour of Armenia.

statements against NGOs in Russia and Ukraine. Thus, for the Azerbaijani government the attractiveness of the Russian model of “sovereign democracy” is growing.

EU-Azerbaijan: A Strategic Partnership for Modernisation

Baku’s relations with the European countries have not so far reached as low a level they have with the U.S. Moreover, the EU will remain a key economic partner for Azerbaijan, no matter how the political affairs between the two develop. The EU, with its energy-hungry, lucrative markets is a priority customer for energy-rich Azerbaijan. However, there was also a chance for deepening the EU-Azerbaijan political partnership, which may now soon be lost.

In 2009, Azerbaijan became a member of the Eastern Partnership (EaP) launched by the European Union. Participation in the EaP meant that the country began to be seen, like other countries of the region, as part of Eastern Europe, the closest neighbourhood of the EU. In 2010, the EU launched talks on signing association agreements with all three countries of the South Caucasus. The necessary condition for any country to conclude such an agreement, including its economic component (the creation of the comprehensive free trade area) is the country's prior accession to the WTO. Azerbaijan's adaptation to the WTO's requirements continues, but it is a slow process with no prospects for a successful conclusion in the near future.²

Although the government in Baku does not reject the possibility of deepening cooperation with the EU, integration with the EU, in contrast to neighbouring Georgia, is not a political goal. Baku’s ruling elite seeks to create its own economic and political model, excluding democratic solutions adopted in the EU. It seems that this attitude and lack of prospects for a quick signing of an association agreement has led the EU and Azerbaijan to a new concept, launched in 2013, to sign a document on strategic partnership for modernisation. This concept is reminiscent of the EU-Russia Partnership for Modernisation project from 2010, which ultimately didn’t lead to a sustained improvement in EU relations with this country. The weakest point of this initiative was that the EU ignored the growing authoritarian trends in the Kremlin. In case of Azerbaijan, there is no doubt that the issue of democracy and human rights will not disappear from the agenda of the Azerbaijani – EU relations.

On the other hand, the EU will not limit its relations with Baku to criticism concerning the repressions. From the Brussels point of view, Azerbaijan, which observes international law, still remains a more reliable state than Russia, which occupies parts of Georgia and Ukraine. Moreover, the EU still values energy cooperation with Baku as a way to diversify European sources of hydrocarbons.

EU-Azerbaijan Energy Cooperation

In fact the only progress in the rapprochement between the EU and Azerbaijan is seen in energy sphere. However, this is an area in which cooperation between the EU, searching for new sources of energy, and Azerbaijan, an oil and gas producer, would develop independently of the EU's policies. Furthermore, it now resembles more a realisation of Azerbaijan's energy policy goals than the coordinated efforts of Baku and Brussels.

Over the years, the European Commission’s hopes were pinned on Azerbaijan as the most reliable supplier of gas to the EU's Southern Gas Corridor and its main planned route, the Nabucco pipeline. It was planned to deliver about 20 billion cubic metres of gas per year to Central Europe, which would significantly reduce the dependence of some countries of this region on supplies from Russia. In addition to Azerbaijani gas, it was planned to transport Central Asian, Iranian and Middle Eastern gas. After years of stagnation of the project, Azerbaijan declared in 2011 its intention to build a gas pipeline (the Trans-Anatolian, TANAP) with Turkey, designed to transport gas to the border with the EU. Then the Nabucco consortium proposed limiting its project to a shorter version of the pipeline (Nabucco West), which would be an extension of

² Last year the WTO noted the progress in the negotiations and defined the areas in which Azerbaijan should carry out legislative changes on tax exemptions, investment incentives, operation of foreign-owned enterprises, privatisations, technical barriers to trade, subsidies, transit and intellectual property. *Azerbaijan accession negotiations gain momentum*, 21 February 2014, wto.org/english/news_e/news14_e/acc_aze_21feb14_e.htm.

TANAP and run through Bulgaria, Romania and Hungary to Austria. Nabucco West would deliver about 10 billion cubic metres of gas per year by the second half of this decade.

However, in 2013 the TANAP consortium decided that its gas exports to Greece, Albania, and Italy would go through the planned Trans-Adriatic pipeline (TAP) with the possible construction of an interconnector between Greece and Bulgaria. This meant giving up the Nabucco West project, and thus the fall of the concept of diversification of gas supplies to the Central European countries. Currently TANAP can increase energy security of only two of the EU Member States, Greece and Bulgaria.³

The construction of the second line of the Baku–Tbilisi–Erzurum gas pipeline, linking Azerbaijan with TANAP, started in September 2014. Previously, European companies TOTAL and Statoil had withdrawn from participation in the TANAP consortium. Most of the investment costs will be covered by the Azerbaijani state oil company SOCAR. The TANAP gas pipeline is thus a financial challenge for Azerbaijan. The project also demonstrates the determination of the authorities in Baku to start gas exports to the EU countries. However, from Brussels' point of view, energy cooperation with Azerbaijan will not have the strategic importance that the original plan for Nabucco would have had.

Negative Consequences of an Oil Dependent Economy

The current period of prosperity, primarily due to exports of oil, not gas, followed the opening of the Baku–Tbilisi–Ceyhan oil pipeline in 2005. The long-term challenge is how to continue modernisation of the state in a situation where oil production in Azerbaijan has been gradually declining since 2010. The main issue that will determine the success or failure of the economic transformation of Azerbaijan is the ability to translate the income from oil exports to sustainable development and diversification of the economy.

Already in 2000, by decree of late president, Heydar Aliyev, the State Oil Fund of Azerbaijan had been created. It was to be modelled, among others, on the experience of the Norwegian State Oil Fund, and its purpose was to be the rational use of wealth derived from oil: avoiding the threat of overheating the economy and saving part of the income for future generations. However, the Azerbaijani oil fund played quite a different role when the global economic crisis started in 2008. Oil prices fell to \$30 per barrel and Azerbaijan tax revenues decreased in 2009 by 35%. Then the government increased the transfer from the Fund from \$4.8 billion to \$6.3 billion to cover the fiscal deficit.

Due to the recent fall of oil prices the government will probably have to resort to similar action in 2015. The estimates of 2.5% GDP growth in 2014 were made before the decline of oil prices in second half of the last year, which will surely affect the growth of the Azerbaijani economy. It is likely that government will have to limit its investment plans, mainly in the construction sector. If the authorities stop many of these projects, it will have a serious impact on the growth of unemployment.⁴

Threats to the economy will grow if the government in Baku does not opt for reforms recommended by the International Monetary Fund (IMF) and the WTO. One of the major pitfalls for the countries producing hydrocarbons is so-called Dutch disease, the negative impact of the excessively rapid growth of the mining sector on other sectors of the economy. In case of Azerbaijan there are visible signs of this phenomenon, such as the decline in the production of non-oil tradable goods and the development of the sector of non-tradeable goods.⁵ In the opinion of the IMF, the concern is the dominant role of public expenditure in the creation of growth in industries outside the energy sector.⁶ At the same time, the development of the non-oil sector of the economy, especially the private sector's diversification, is hampered by monopolies, and by administrative and bureaucratic barriers.⁷

All these factors contribute to the phenomenon of corruption. The introduction of reforms in line with the recommendations of the IMF or WTO would limit the ability for corruption resulting from the lack of a

³ Bulgaria and to a lesser extent Greece are dependent on gas supplies from Russia. Italy is a country with a diversified structure of gas supplies, including Algerian, Libyan, Russian, Dutch and Norwegian supplies.

⁴ *Azerbaijan: How Will Baku Handle the Oil Price Slide?*, 22 December 2014, eurasianet.org/node/71451.

⁵ F. Hasanov, "Dutch disease and the Azerbaijan economy," *Communist and Post-Communist Studies*, vol. 46, Issue 4, December 2013, pp. 463–480.

⁶ *Republic of Azerbaijan: Selected Issues*, January 2012, IMF country report No. 12/6 imf.org/external/pubs/ft/scr/2012/cr1206.pdf.

⁷ V. Bayramov, "Spotlight on Azerbaijani Economy," in A. Hug (ed.), *Spotlight on Azerbaijan*, Foreign Policy Centre, London 2012, p. 58.

clear separation between the sphere of government and business. Transformation of the system is a sine qua non condition for Azerbaijan to achieve sustainable economic development. Without changes, a sudden end of the prosperity era based on oil exports may lead to a deterioration of living conditions of Azerbaijanis. In such a case, tensions and social protests cannot be ruled out.

Is Nagorno-Karabakh Worth the Eurasian Union?

A possible internal crisis combined with deteriorated relations with the West and a desire to break the deadlock in the conflict with Armenia over the Nagorno-Karabakh region may persuade the government in Baku to cooperate more closely with Russia, or even to enter the Kremlin-led Eurasian Economic Union (EEU). Azerbaijan may also be tempted to join this organisation to counterbalance its arch-rival Armenia, which is already in the EEU. This would be a huge propaganda success for Russia. Nevertheless, even if it happens, it would probably result only in Baku's superficial integration with the EEU.

A more important aspect of Azerbaijani–Russian relations is the military one. Paradoxically, Russian aggressive actions in the Post-Soviet region may contribute to a strengthening of Baku's relations with Moscow. Azerbaijan fears destabilisation of some of its regions inhabited by minorities, similar to the Ukrainian scenario. The annexation of Crimea and Russian intervention in eastern Ukraine is also observed with concern in Azerbaijan. For Baku it may be a dangerous precedent, as the case of Crimea is compared by Armenia (although still not by Russia) to the problem of Nagorno-Karabakh.

On the other hand, a group of Russia-oriented politicians in Baku may see Crimea's annexation as a promising precedent, showing that the "restoration of justice" may be achieved through military means. The Azerbaijani officials already use belligerent rhetoric and the risk of the resumption of full-scale war in Karabakh in 2014 was at its highest since 1994. Baku may also hope for a more favourable Moscow position on the issue of the Karabakh conflict in return for Azerbaijan's neutrality or tacit support in the Russian-Ukrainian conflict.

So far the government in Baku has maintained a rather cautious and ambiguous attitude. After the occupation of Crimea by Russia, Azerbaijan expressed only general support for the idea of territorial integrity of states, not directly condemning Russia's actions towards Ukraine. On 27 March, however, Azerbaijan voted for the UN General Assembly resolution declaring the referendum on the independence of the Crimean peninsula illegal.

This was condemned by Kremlin ideologist Alexander Dugin, a member of the board of experts under the speaker of the State Duma Sergei Naryshkin. Dugin threatened the government in Baku that further cooperation with Western countries would result in the final loss of any chance to recover Karabakh, as well as the "self-destruction" of Azerbaijan. Such threats cannot be ignored since the chauvinist ideas of the Kremlin's main ideologue are increasingly becoming the official rhetoric of Russian authorities.

Apart from such threats, Moscow also offers Baku a positive agenda, such as proposal for a new format of military cooperation launched by Russian defence minister Sergei Shoigu during his visit to Baku in October 2014. Included in the concrete topic of such extended cooperation are further deliveries of Russian arms, navy exercises in the Caspian Sea in order to create a "common security system" there, and Azerbaijani officer training at Russian military schools.

Conditions of Further EU–Azerbaijan Cooperation

Despite the growing challenges in the EU's eastern policy, related primarily to the situation in Ukraine, Brussels should continue to seek ambitious goals in its policy towards Azerbaijan. The concept of a strategic partnership for modernisation should provide the EU with the necessary leverage, and Azerbaijan with a sufficient incentive to involve both players in more meaningful, multi-layered cooperation. Such a new offer by the European Union should contain a number of key issues for both parties.

For the government in Baku, a priority is to acquire new technologies, to develop industry, including both in the energy and non-energy sectors. The sector of the Azerbaijani economy that needs to be reformed, and which is already receiving support from the EU, is agriculture. The development of the rural areas is

covered by the EU aid programme. The EU could enhance its support in these areas, but it should also insist on Azerbaijan's progress in reforms in other even more crucial areas.

Brussels should therefore condition its strategic partnership offer on increasing government transparency, including progress in the anti-corruption efforts and reform of the public finance management system as well as reform of the judiciary. A prerequisite for any deepening of EU–Azerbaijan cooperation must be a retreat from the policy of repression against civil society. As a first symbolic gesture, the government should release of the activists arrested recently. In the longer term, the EU should put pressure on the authorities in Baku to include the representatives of civil society organisations in the debate on the reforms.

Possible further cooling of the relations between Brussels and Baku is likely to result in warming of the latter's relations with Moscow. The Azerbaijani government expects that, in exchange for some political moves friendly towards the Kremlin, Russia may decide to become more supportive of Azerbaijan in the Karabakh conflict with Armenia. Even if Russian-led Eurasian integration is not an economic alternative to cooperation with the EU for Baku, further political rapprochement with Moscow can lead to petrification of negative phenomena in Azerbaijan, such as corruption and restriction of civil liberties, which are an integral part of Russian model of "sovereign democracy".