

INTERNATIONAL ALERT

FROM WAR ECONOMIES TO PEACE ECONOMIES IN THE SOUTH CAUCASUS



ECONOMY AND CONFLICT RESEARCH GROUP
OF THE SOUTH CAUCASUS

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Note from the editors

The responsibility for the analysis or opinions contained in this publication rests with the authors of individual chapters.

Most of the papers were originally written in Russian. The translators have tried as far as possible to remain faithful to the original texts, but inevitably there will be some deviation.

This collection of papers reflects the sensitivities around the political status of certain territories of the South Caucasus. A map of the region is shown on page 15. The editors' policy on contested place names has been to keep the spellings used by the local authors themselves.

The English language distinguishes between *Azeri* and *Azerbaijani*. In the English edition of this book, *Azeri* is used to refer to the ethnic group which speaks the Azeri language (whether from Azerbaijan, Iran, Russia, Turkey or elsewhere). *Azerbaijani* is used to refer to the citizens of Azerbaijan (whether ethnic Azeris or not).

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INTERNATIONAL ALERT

International Alert is an independent non-governmental organisation that works to help build just and lasting peace in areas of violent conflict. It seeks to identify and address root causes of conflict and contribute to the creation of sustainable peace through work with partner organisations in the Great Lakes region of Africa, West Africa, Asia and the South Caucasus.

To complement its field work, International Alert undertakes research and advocacy to influence policies and practices that impact on conflict at the national, regional and international levels. International Alert seeks to act as a catalyst for change by bringing the voices and perspectives of those affected by conflict to the international arena and creating spaces for dialogue.

As part of its work, International Alert has a Business and Conflict programme, whose mission is to contribute to conflict prevention and transformation through engaging with economic actors and issues.

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Acronyms

ADR	Azerbaijani Democratic Republic
AIOC	Azerbaijan International Operating Company
BBC	British Broadcasting Corporation
bcm	billion cubic metres
BTC	Baku-Tbilisi-Ceyhan
CCR	Caucasus-Caspian Region
CIS	Commonwealth of Independent States
CRS	Catholic Relief Services
CS	Civil Society
ECRG	Economy and Conflict Research Group of the South Caucasus
EU	European Union
GCPP	Global Conflict Prevention Pool
GDP	Gross Domestic Product
GIOC	Georgia International Oil Corporation
GSM	Global System for Mobile Communications
GUUAM	Georgia, Ukraine, Uzbekistan, Azerbaijan and Moldova
ICRC	International Committee of the Red Cross
ICSRD	Institute for Civil Society and Regional Development
IDP	Internally Displaced Person
IMF	International Monetary Fund
kwh	kilowatt hours
mwh	megawatt hours
MSF	Médecins Sans Frontières
NATO	North Atlantic Treaty Organisation
NGO	Non-governmental organisation
NK	Nagorno-Karabakh
OSCE	Organization for Security and Co-operation in Europe
RAO-EEC	Russian Joint Stock Company 'Unified Energy System of Russia'
SIS	State Institute of Statistics (Turkey)
SME	Small or medium-sized enterprise
SSR	Soviet Socialist Republic
TABDC	Turkish-Armenian Business Development Council
TRACECA	Transport Corridor Europe Caucasus Asia
TÜSIAB	Association of Turkish Industrialists and Businessmen of Azerbaijan
UAE	United Arab Emirates
UK	United Kingdom
UMBA	Union of Manufacturers and Businessmen of Armenia
UN	United Nations
UNESCAP	United Nations Economic and Social Commission for Asia and the Pacific
UNHCR	United Nations High Commissioner for Refugees
UNICEF	United Nations Children's Fund
UNOMIG	United Nations Observer Mission in Georgia
UNTAES	United Nations Transitional Authority in Eastern Slavonia
USSR	Union of Soviet Socialist Republics
WTO	World Trade Organization

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Map of the South Caucasus*



ADAPTED FROM: MATVEEVA, A. & D. HISCOCK (eds) (2003) *THE CAUCASUS: ARMED AND DIVIDED* (LONDON, UK: SAFERWORLD)

* The geographic boundaries in the South Caucasus are contested. International Alert does not endorse any one view, but has included this general map to assist the reader.

Foreword

Violent conflict is possible wherever there is an unresolved issue between two or more antagonists who have the means with which to fight, but what brings the conflict to the point of violence is one or more of a wide variety of different factors. Each conflict has its own dynamic, its unique history and actors. Yet within this picture of complexity there are some common issues. No conflict is exactly like any other, yet no conflict is wholly unique.

The link between economic factors and conflict is one such issue. In recent years, the difficulties of securing a stable peace if economic performance does not recover and if the business sector is weak has come under increasing scrutiny, as have the ways in which other economic drivers can sustain conflict. Yet economic factors have received relatively little attention from those involved in trying to resolve the conflicts of the South Caucasus region. Furthermore, the perspectives of those living with and affected by these conflicts are seldom heard.

This volume is welcome because it seeks to redress both these gaps. Its chapters are written by researchers from, Abkhazia, Armenia, Azerbaijan, Georgia, Nagorno-Karabakh, South Ossetia and Turkey. They form the Economy and Conflict Research Group of the South Caucasus (ECRG), originally convened by International Alert as part of a broader programme of work aimed at promoting a positive relationship between business and peacebuilding. The voices in this volume are from the region, and explore the ways in which economics and conflict are interlinked. The overriding message from the authors is that understanding these links is essential if there is to be a successful process of long-term peacebuilding in the region, moving beyond the current stasis of frozen conflicts. This is a message that is equally important to politicians, policymakers, businesspeople and NGO workers.

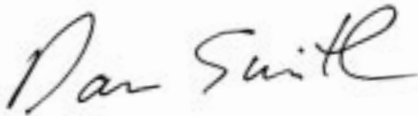
Events that have unfolded since the chapters that make up this book were written illustrate the fluid nature of conflict and the difficulties facing researchers working in a conflict environment. The recent change of administration in

Adjara and the closure of the Ergneti market in South Ossetia occurred after the completion of this book. These developments reflect the dynamic nature of the administration that came to power in Georgia under President Saakashvili in the wake of the 'Rose Revolution' in November 2003. This dynamism is a new factor in regional politics, causing people in the region and international observers alike to ask whether a similar approach will be taken to end the secessionism of South Ossetia and Abkhazia. Similarly, the newly emerging Neighbourhood Policy of the EU could have an important impact on the South Caucasus, having the potential over time to increase EU influence in the region.

As the context changes, so the analysis of conflict and its likely trajectory has to be modified, especially when the change is dramatic and major new factors enter the regional political equation. Underlying these changes and the uncertainties they induce, however, there are some long-lasting features.

Whatever happens in the short term, we can be sure that the nature of the links between the economy of the region and its conflicts will be an important determining factor. There cannot be a sustainable peace without economic opportunity for the region's people, and that requires a sustainable strategy for economic development that involves a thriving business sector operating within a legal framework that meets international norms and results from democratic decision-making. Both local and foreign businesses have a role to play, and both have an interest in doing so. These findings are not subject to alteration by the impact of recent events.

This volume of papers by local researchers offers important insights into the interlinkages between business and the economy on the one hand, and the prospects for peace or conflict escalation on the other. It is an important read for anyone interested in finding solutions to the protracted conflicts that continue to impoverish the people of the South Caucasus.



Dan Smith
Secretary General
International Alert

Introduction

PHIL CHAMPAIN

At the time of writing, Ilham Aliyev is in his tenth month as president of Azerbaijan following the death of his father, Heidar Aliyev. Mikhail Saakashvili is in his seventh month as president of Georgia following the bloodless 'Rose Revolution' that ousted Eduard Shevardnadze from 30 years of rule. Of the leaders of the three countries that constitute the South Caucasus region, only President Robert Kocharian of Armenia can boast experience of high office. Winds of change are blowing, though it is not yet clear if they will thaw the frozen conflicts that have plagued the region for the last decade, or, alternatively, cool the diplomatic climate by another degree or two.

It has been more than a decade since the collapse of the Soviet Union and the transition process it triggered in the South Caucasus. People in the region have suffered war and/or civil war for nearly half this short period of independence, patronage politics is still on the rise, and poverty is all-pervasive, particularly outside the urban centres. Despite high expectations of the continuing investment in oil and gas, the region is struggling to attract foreign investment and take its place as a serious player in the global economy.

But there are signs of change too. A new generation of Georgian leadership has asserted its commitment to fight corruption. Oil threatens stability in Azerbaijan through possible negative 'petro-state' impacts, but it can also be a resource to support development if its influence is considered in the context of the overall political economy of the region.¹ The Baku-Tbilisi-Ceyhan (BTC) oil pipeline is half constructed and, with careful management, could be a lever for confidence building in the region. Talks continue between Armenia and Turkey about opening the border between Kars and Gyumri, promising a significant step towards warmer relations between the two countries and a more integrated economic system in the South Caucasus region that cuts across traditional geopolitical fault lines.

This research project set out to explore the dynamic between economy and conflict in the South Caucasus. It was framed positively, that is, to see

how a better understanding of the region's current economic dynamics might contribute to the resolution of its conflicts. The researchers themselves noted that the project had 'come at a good time', when new ideas are needed and when, after more than a decade of 'no peace', there are signs that new approaches could gain traction.

In late 2002, the UK-based conflict transformation NGO International Alert launched a process of facilitating a group of researchers from across the region as part of its broader programme of work on promoting a more positive relationship between business and conflict. The group convened by this project included representatives from Armenia, Azerbaijan, Georgia and Turkey, including Abkhazia, Nagorno-Karabakh (NK) and South Ossetia, and calls itself the Economy and Conflict Research Group of the South Caucasus (ECRG).

The working relationships between ECRG members fostered by the project were an important component of the project since they all hail from different sides of different conflict divides. In this sense, the process of the work is more than the papers contained in this volume. It is sometimes easy to forget the people responsible for the words on the printed page, yet this project is also about these people. It is about their ideas, meetings, exchange of stories and experiences, and their critiques of one another's work. They do not all agree. Indeed, the project did not set out to achieve consensus between these different individuals on the links between economics and conflict, and what those links imply about possible solutions. The picture is too complex for such an ambition. Researchers were invited to identify dynamics on this theme that they felt were important – but some common threads did emerge that tell us something about the task ahead if economic and business levers are to be used effectively to help unlock conflict. Some common lessons have also been learned, particularly about the content of the research. This volume is a step in a process. To date there have been several meetings in the region between the researchers, including a conference in Moscow in March 2004 that brought together a wider group of stakeholders, as well as independent research activities and the drafting of papers. The project aims to develop ongoing transformative activities based on the analysis conducted to date over a two-year period up to 2006.

A number of questions guided the design of the project. Some related to content and the broader study of war economies. To what extent is conflict determined by inequalities in wealth distribution? Who determines how economic benefits are distributed? Does trade reduce, or fuel, conflict? Which economic sectors are most vulnerable to conflict and which are most resistant? What role does the private sector play? If economic issues are to be brought further up the conflict transformation agenda, what alliances will be required? These questions and others (generated by the researchers, but also drawn from other studies on war economies) frame the subject matter of the papers that follow.²

There was another set of guiding questions that related to the ways the researchers worked (and continue to work) as a group in exploring questions of content. Who should be included in the group of researchers? How many from each region? Which regions? Should we include Russia, Turkey and Iran? Should we work individually or meet as a group? If we meet, then where, for how long and how often? What role will International Alert play?

These two sets of questions – one content-related, one process-related – are necessarily interlinked since the process operated within the context of the political economy of the South Caucasus. Since the researchers are all from the region, they are, in a sense, part of ‘the problem’. They are certainly part of ‘the solution’: their contributions to this volume are testimony to that. The point is that the process cannot be divorced from the context. The context has already shaped the process of this project. Hopefully, the process will help in some way to reshape the context.

BLOCKADES

The difficulties that International Alert faced in simply getting the ECRG members together as a group mirrors the problems facing those engaged in economic activity in the South Caucasus. For example, without officially recognised passports, the Abkhaz were restricted in their freedom to travel. The fact that they could travel to Moscow said something of the ‘marriage of convenience’ between Abkhazia and Russia (the latter seeking to maintain influence in the region following the collapse of the Soviet Union, the former seeking support to counter its own isolation). Furthermore, despite their 325km-long border, regular flights between Istanbul and Yerevan are the only direct connection between Turkey and Armenia. Direct land communications were severed in 1993 when Turkey, in support of Azerbaijan’s territorial integrity, closed its border with Armenia. This barrier to human and business interactions has become the frontline of conflicting interests and prevented these two populations from bridging the century-old gap dividing them. With contact so difficult, it is easy to see how ‘images of the enemy’ are sustained, and how grievances and ongoing issues remain unresolved. Trade is inevitably driven underground when the borders between Armenia and Azerbaijan, Georgia and Russia, and Armenia and Turkey are, if not closed, then at best ‘semi-porous’.

It is clear from evidence around the world that blockaded communities can and do develop a particular entrepreneurial spirit. In Jaffna, northern Sri Lanka, 20 years of isolation have led to a strong sense of self-sufficiency and independence that makes the Tamil people wary of outside influences now that links between the north and south are opening up again. During a four-year economic blockade by central government, the island of Bougainville in Papua New Guinea developed new methods of powering engines, using palm

oil instead of petrol. There are numerous other examples – a survivalist mentality and the spirit of innovation almost invariably emerge under the conditions created by blockades and embargoes – and similar kinds of resilience and independence of spirit are apparent in Abkhazia, South Ossetia and NK.

The physical, cultural and economic blockades brought about by conflict in the South Caucasus have led to a particular pattern of trading in the region, a pattern sustained by entrepreneurial energy, and the need to trade to survive and to exploit the limited opportunities that remain. Armenian brandy can be found in Azerbaijan, Azerbaijani caviar in Armenia – most likely transported via Georgia. A wide range of goods is similarly exchanged at border markets such as Sadakhlo (located at a crossroads between Azerbaijan, Georgia and Armenia) and Ergneti (between Georgia and South Ossetia). One individual spoken to in Yerevan during the research commented that business people are natural conflict resolution practitioners because of their very ability to do business in spite of conflict blockades. A throwaway remark, perhaps, but it says something about the need and ability of people to trade, no matter what the political situation. It also underlines the importance of unregulated, informal economic relations as coping mechanisms for those caught up in conflict zones.

However, there is a more sinister dimension to this image of individuals working within a ‘war economy’, namely the ways in which some people, or groups of people, seek to control it, or become its ‘gatekeepers’. While recognising the significance of informal economies as coping mechanisms for people in the Caucasus, it is clear that unregulated trading patterns also provide space for those seeking to exploit the context to make huge profits. An unregulated economic system tends to generate revenue (including ‘taxes’ in the form of bribes) for the pockets of the few. If these ‘few’ also hold political power, then the paradox emerges that ‘the deeper the (unregulated) economic and business relations between the conflicting sides, the less interest there is in a political solution to the conflicts’.³ This is one of the main obstacles to peace in the region.

Despite the strong entrepreneurial energy apparent across the region’s economies, this end point of political control creates a sense of being blockaded, denied opportunity and of suffering both psychologically *and* economically from the hardship born of conflict. This is a mindset that pervades the region – a sense of isolation and suspicion that is the reverse side of resilience and creative survivalism in conflict contexts, and which it will be necessary to overcome in the task of conflict transformation. It is as much a feature in Armenia, suffering from a dwindling population and an economic decline, as in Abkhazia, which has received little or no development assistance over the past decade due to its ‘unrecognised status’; or in Georgia, held to ransom by Russian control of its power supplies; and

South Ossetia, where the unregulated Ergneti market is such an important source of revenue, and few economic alternatives exist. The nexus of economic stagnation, entrepreneurial coping mechanisms, competition and control represents both a challenge and an opportunity for conflict transformation in the region. As such, and in view of the excellent groundwork laid to date by the research, it will be the subject of continuing focus from the International Alert/ECRG project, with the recent Moscow meeting of researchers prioritising the deeper mapping of informal economic actors and mechanisms for their future engagement in regional initiatives.

SOME CHALLENGES

The next section of this introductory chapter groups some of the common findings of the individual research papers into specific challenges that need to be addressed:

- 1) How can legal frameworks be established for trade while the political status of unrecognised entities remains unresolved? Although the Georgian researchers conclude that strengthening unregulated economic links between Georgia and South Ossetia merely serves to sustain those who benefit from the frozen context and thereby prevents the resolution of the conflict, the South Ossetian researchers point out that Ergneti market is the main source of revenue for their economy and should therefore be strengthened. Without Ergneti market, they argue, South Ossetia would suffer financially, and conflict would be more likely to re-ignite. The main proposal from the South Ossetian research is to stimulate local business development, thereby lessening dependence on the unregulated Russian goods that currently dominate Ergneti market and opening up possibilities for market reform. But the dilemma persists of how Ergneti market can be legitimised while South Ossetia's legitimacy as a recognised entity is still contested.
- 2) How can the 'internal' development needs of the people in non-recognised entities be addressed without alienating the recognised states? The NK researchers present some interesting ideas about the links between international aid and business development in NK, proposing that in the current context international aid should be redirected from large infrastructure projects towards the development of small or medium-sized enterprises (SMEs). Their research suggests that those with secure jobs have attitudes more aligned to peaceful approaches to conflict resolution. However, although this may be true in NK, business development there may have an opposite effect on the attitudes of Azerbaijanis towards a resolution of the conflict since they view their own economic problems as

inextricably linked with the loss of the region. The research on Abkhazia explores the potential for restoring agricultural production in the east of the region. There is a growing internal market for agricultural products that could be supplied by Abkhaz farmers, given the necessary assistance. But the same dilemma emerges: what would Georgia's reaction be to such assistance and development? How can economic development in non-recognised entities be fostered without antagonising the 'other side'?

- 3) How can an economic dynamic based on competition and cooperation be compatible with a political dynamic based on confrontation and domination? This dilemma is explored in the dual political (or security) and economic roles that Turkey plays in relation to Armenia and Azerbaijan. Turkey has in some ways sacrificed its economic (competition/cooperation) role for a political and security (confrontation/domination) role by supporting Azerbaijan over the NK dispute. The sealed Turkish-Armenian border contributes to the fragmentation of the region and has increased security concerns: its opening has the potential to foster economic integration in the South Caucasus and facilitate a restart to the deadlocked peace process. Recent lobbying for the border to be opened by the Turkish-Armenian Business Development Council (TABDC) is significant since it may well prove that the solution to this blockage actually lies with the private sector. Harnessing the influence of business to foster a culture of competition and cooperation is a feature highlighted by the ECRG researchers from both Turkey and Armenia, and is a challenge for all those involved in finding economic points of leverage to help resolve conflict in the South Caucasus.

- 4) How can the needs of small-scale traders be brought to the attention of those in positions to influence the political context within which they operate, often simply just to survive? This issue touches on arguments for more democratic political processes that can create the space for different needs to be heard and for the legitimisation of the informal economy. This dilemma is present in one way or another in several of the research papers, but is most clearly illustrated in the research from Azerbaijan. People come together to trade at Sadakhly market which 'has demonstrated that no matter how tense relations are, trade can bring warring nations closer together and enrich both sides'.⁴ The market has its own rules for maintaining cooperation, in spite of a potentially confrontational national and political context. The market ebbs and flows depending on this context, over which the market traders have little chance of influence. It may be the case that the market's unique socio-psychological atmosphere and the demonstrable pragmatism of its participants is worthy of serving

as a model of possible coexistence and deserving of further study. However, there remains the issue of how to connect such pragmatic people with those seeking a political solution to the conflict: space needs to be found to bring their influence to bear on those engaged in track one and track two negotiations.

- 5) How is it possible to engage the gatekeepers of the current economic system as stakeholders in future alternatives? This challenge is, perhaps, the most daunting since it recognises that any change in the status quo requires engagement with those holding economic power. In an unregulated economic system it is difficult both to identify exactly who holds this power, and to find openings for dialogue with them. There is the added dilemma of legitimising such actors through the process of engagement. However, if, as the research suggests, trade links across the conflict divides already exist, then there are opportunities on which to build. Business people can be at the forefront of such efforts, given their interest in stability and open markets. If the Georgian government and business community fears Abkhazia will be flooded by Russian and Turkish goods, for example, is that not an incentive for Georgian business to enter the market now?

LOOKING AHEAD

So where does this volume of papers leave us? The ECRG offers the following chapters as stimulus for further discussion and dialogue about the links between economy and conflict, and the potential for economics and business to play a positive role for peace. While international perspectives on the region tend to be dominated by a focus on oil exploitation, the ECRG research reveals that tapping the nexus between economic factors and conflict in the South Caucasus more broadly is a fertile line of enquiry from the conflict transformation perspective.⁵ Further discussion, dialogue and analysis are needed about these links, and the potential for economics and business to play a positive role for peace.

The researchers are also themselves agents for change. They have networks and connections within their own constituencies. The experience they have gained through the research process will find its way into their discussions and interactions ‘at home’. They are well placed to continue to play a role as ‘middle-range leaders’, helping to link, for example, elites with grassroots market traders.⁶ As the project moves forward, this part of the ECRG’s role will become increasingly more important as the ideas contained in these papers are translated into practical projects. It also represents the main ‘dialogue’ component of the project; dialogue between ECRG members themselves, between the ECRG and other stakeholder groups in the region,

and between ECRG members and their own constituencies. This dialogue will be the key mechanism for progressing ideas into actions.

In beginning to translate ideas into actions, the support of the private sector (both local and foreign) is needed, since it has an important role to play in promoting a more cooperative approach to engagement between the different peoples of the South Caucasus. Relevant economic actors need to be identified, though the process of engaging in the search for solutions to the challenges outlined above will take patience and further investigation. Foreign investors can contribute to economic development, job creation and the transfer of business standards, as long as they are sensitive to the interaction between their investments and the dynamics of local conflict. The geopolitical dimensions of major regional projects such as the BTC pipeline should not be underestimated, as borne out by the fact that the pipeline's route from Azerbaijan to Turkey avoids the territory of Armenia. As outlined above, local business actors have a huge potential to promote peaceful change as well.

Efforts can be made to develop geopolitical alliances that cut across the north/south and east/west axes that dominate confrontational politics. Turkey's role in developing economic relations with Armenia and Russia is important here. The donor community can also develop economic strategies that contribute more directly to conflict transformation through projects that help to integrate the region economically, and protect and promote livelihoods.

Development interventions have to be aware of the existing linkages between legal and shadow economies, and balance recognition of territorial integrity with the development needs of the non-recognised entities in the region. At the same time, they should take pre-existing structures, such as informal markets, into account and try to incorporate them into development efforts where they provide vital economic support to local populations. Otherwise the creation or consolidation of 'formal' structures like transport and infrastructure links may unwittingly undermine less visible survival economies. Ensuring that support to economic development and private sector growth is cognisant of, and sensitive to, these rich linkages with conflict is crucial. Again, ECRG's future work involves looking more closely at these dynamics.⁷

There is much before us as the ECRG launches this collection of papers on economy and conflict in the South Caucasus. As anyone with experience in the Caucasus or of conflict transformation will testify, the road to peace is long and there are no short cuts. But closer attention from a range of actors to the complex linkages between economic factors in seeking to unlock the region's conflict would appear, on the strength of research conducted as part of this project, to make a worthwhile contribution.

Endnotes

- ¹ Karl, T. L. (1997) *The Paradox of Plenty: Oil Booms and Petro-states* (Berkeley, USA: University of California Press) and others have, through comparative research into petro-states, highlighted tendencies in such states for currency appreciation (making exports less competitive), increased levels of corruption through strengthening of elites, neglect of non-oil sectors of the economy due to lack of state dependence on taxes from them, and a general leaning towards 'predatory developmental trajectories'.
- ² Humphreys, M. (2003) 'Economics and Violent Conflict', Program on Humanitarian Policy and Conflict Research, Harvard University, February 2003, available at <http://www.preventconflict.org/portal/economics/Essay.pdf>; Ballentine, K. and J. Sherman (eds) (2003) *The Political Economy of Armed Conflict: Beyond Greed and Grievance* (Boulder, USA: Lynne Rienner Publishers); and Banfield, J., V. L. Haufler and D. L. Lilly (2003) *Transnational Corporations in Conflict Prone Zones: Public Policy Responses and a Framework for Action* (London, UK: International Alert).
- ³ See research on Georgia in Chapter 4.
- ⁴ Extracts from research on Azerbaijan Chapter 7, section 3.6.
- ⁵ The ECRG has not looked in depth at the BTC pipeline to date, although International Alert has a parallel strand of work engaging oil companies in the region in thinking differently about their relationship to conflict, especially around the BTC project.
- ⁶ According to Lederach's three levels of intervention. See Lederach, J.P. (1997) *Building Peace: Sustainable Reconciliation in Divided Societies* (Washington DC, USA: United States Institute of Peace Press).
- ⁷ Duffield, M. (2001) *Global Governance and the New Wars: The Merging of Development and Security* (London, UK: Zed Books).

SECTION ONE

REGIONAL PERSPECTIVES

CHAPTER ONE

Cross-border cooperation between Turkey and South Caucasus: prospects for sub-regional integration

BURCU GÜLTEKİN

1. INTRODUCTION

The break-up of the Soviet Union had far-reaching consequences for Turkey's close neighbourhood. Turkey discovered in her vicinity a new world that had been separated by an 'Oriental Iron Curtain' for 70 years. Turkey, along with Norway, was one of the two flanking states of NATO that shared a land border with the USSR. The Moscow Treaty of 1921, which established the Soviet-Turkish border, gave birth to 70 years of relative stability. A preliminary definition of the Turkish-Armenian frontier provided the setting for that treaty, as well as defining the boundaries between Turkey and the three Transcaucasian republics. The opening of Doğu Kapı/Akhourian, the first and only border gate between Turkey and the USSR, dates back to 1927. The gate is located a few kilometres from the Turkish city of Kars and the Armenian city of Gyumri.

In the early 1990s, the days of Turkey sharing a land border with the USSR ended and it discovered three new neighbours. The end of the bipolar order allowed Turkey to redefine her cross-border relations and regain access to the former southern underbelly of the USSR. The post-cold war context radically changed political data in the region and modified the scheme of Turkey's border exchanges. The closure of the border with Armenia and the opening of border crossings with Georgia and Nakhitchevan are the most significant events.

The involvement of the Turkish private sector in the region dates back to the early 1990s, the time of the South Caucasian republics' accession to independence. Turkish business activities range from purely commercial transactions to major infrastructure projects, but Turkish businesspeople can also be credited with bringing private entrepreneurship to the region. Willing to operate at high levels of risk, Turkish businesses sustained the flow of essential products and ensured logistics during the various conflicts in the South Caucasus. Turkish firms are

involved in every aspect of their economies and, distinct from other foreign companies, are not restricted to a particular sector protected by state guarantees. In addition to their core activities, some - especially in Azerbaijan – have invested in philanthropic activities, and are helping to foster dialogue on policy issues and the institution-building process.

Turkey is the premier foreign investor in the non-oil sector in Azerbaijan, and Turkish businesses have pioneered the services and distribution sectors. They have shaped the city of Baku and contributed to the abolition of the Soviet era by accelerating the transition to a market economy. New buildings, restaurants and shops, designed, financed, built and sometimes owned by Turkish companies, transformed Baku's appearance and provided it with the external signs of modernity.

Despite the lack of diplomatic links, Turkey is also a major supplier for the Armenian economy. Businesspeople from both countries claim to 'talk about trade without talking about politics', and advocate that deeds and perceptions should be shaped by facts, not rhetoric, and that priority should be given to the establishment of commercial ties.

Relations with Turkey are highly valued in political and economic circles in Georgia, and there are grounds for arguing that the country owes its independence to Turkey. Proximity to Turkey allowed Georgia to diversify its external links after the severe disintegration of its former trading patterns. The opening of the Sarp/Batumi border gate had a tremendous impact on Georgia's foreign economic relations and gave it a window on the world outside. Sarp/Batumi is the only operational land border between Turkey and the Caucasus and Caspian regions, and the only east-west route through the South Caucasus to Central Asia.

The development of regional integration strategies that strengthen links between Anatolia and the South Caucasus would be a major step towards boosting intra-regional trade and access to world markets. The development of transport routes across the Transcaucasus to Turkey will support the integration of production and distribution networks, and lead to the implementation of projects that accelerate regional integration. An Anatolia-Caucasus-Caspian route would add a cost-effective, commercially viable and strategically beneficial east-west railway that will ensure a direct link between Turkey, Baku and the Caspian region, and open Armenia and Nakhitchevan to international trade and investment. Armenia and Nakhitchevan form a unique logistical hub in the South Caucasus because they are at the crossroads of east-west and north-south communications.

Georgia is in a peculiar position regarding the region's tensions, since it serves as a buffer zone. Georgia is a transit country enabling east-west connections but it is also a major impediment on the north-south route. As a consequence, the country is a hotspot of regional tensions. Because it confronts the Russian Federation, it is often seen as a useful tool to roll back Russian influence from the Transcaucasus, the Caspian region and Central Asia.

Seen in this context, opening the Turkish-Armenian border would ensure a direct railway route between Turkey and Georgia across Armenia that would reduce the importance of the Sarp/Batumi crossing and the enclave of Adjara, and diffuse the tensions concentrated on Tbilisi.

The future of the region depends on a re-orientation away from regional polarisation. The Transcaucasus has historically suffered from being a grey area of confrontation in the managed rivalry between Turkey and Russia. There is a pressing need to transfer the unique model of economic cooperation between Russia and Turkey that verges on interdependence to the republics of the Transcaucasus. To this end, the Turkish-Armenian border, which is currently a frontline between conflicting interests, should become an area of communication and close cooperation.

2. METHODOLOGY

Official statistics fail to provide a clear picture of trade between Turkey and the South Caucasus. When available, their reliability is questionable and, because of the erratic nature of commercial transactions, they do not permit analysts to establish coherent patterns of trade. Consequently, the data in this paper has mainly been accrued from fact-finding missions in Turkey and the Caucasus. First-hand information has been solicited predominantly from professionals in logistics, a sector directly affected by conflict situations. This collaboration allowed us to follow existing trade routes in and out of the region.

The analysis is based mainly on profiles. The intention was never to provide an all-encompassing picture. In-depth interviews with private entrepreneurs were designed to extract an understanding of the perceptions and regional visions of those involved in economic transactions, with a focus on how individual strategies interact with broader ones. The research also used the commercial and personal networks of these private entrepreneurs.

The purpose of this paper is less to analyse Turkey's relations with the South Caucasus, but rather to consider the region in the light of its Turkish connections. The aim is to enlarge the classical grid used for analysing Commonwealth of Independent States (CIS) countries by introducing into the frame of reference a neighbouring country that was once at the western edge of the Iron Curtain. Priority is given to market-based monographs and the precise description of trade routes, a methodology that allows us to refer to 'on-the-ground' dynamics and the socio-economic realities of the region, rather than to immerse ourselves in abstract discourse and political argument.

Some findings are based on the author's personal experience. As well as being an analyst, the author was involved in the activities of the Turkish-Armenian Business Development Council (TABDC) from 2001-03.

3. CROSS-BORDER INTERACTION: FROM THE 1920S TO THE BREAK-UP OF THE SOVIET UNION

The break-up of the Soviet Union had far-reaching consequences for Turkey's immediate neighbourhood. Turkey discovered a new world in her vicinity that had remained separated by what might be called the 'Oriental' Iron Curtain.¹ Along with Norway, Turkey was one of NATO's only two flanking states to share a land border with the USSR.

The 600km Turkish-Soviet border was a major cause of concern in terms of national security. Russia's 'enemy image', which long predated the cold war, had overwhelming importance in military and intelligence circles. Before becoming the official frontier in 1921, however, the Transcaucasus had been the contact zone between the Ottoman and the Russian empires, a violent contact since the two empires had fought more than traded over the centuries. There have been 16 Russo-Turkish wars and most involved military operations in eastern Anatolia and the Caucasus. The Transcaucasus, a grey area between two powerful political rivals, acted as a buffer zone.

Between the 17th and 20th centuries, Turkey and Russia fought eight wars over the basic theme of a common border in the Transcaucasus. For Russia, this struggle was a continuing march of glory from 1768 to 1878. For most of the 18th century, the Ottoman empire's chief adversary was Austria and its main ally France, a pattern that radically altered in the 1770s after Russia's expansion in the Black Sea region. As a result, Russia replaced Austria as Turkey's most immediate threat. After Russia defeated Turkey in the 1768-74 war, the Ottomans were forced to sign the treaty of Kuçuk Kaynarca, which gave Russia a foothold on the northern shores of the Black Sea, navigation rights in the Black Sea and what was interpreted as a right of protection over Ottoman subjects of Orthodox faith. The port of Batumi, an Ottoman province since the second half of the 17th century, became an operational centre for Ottoman forces, but its strategic importance to Russia remained low until the Crimea War (1853-56). At the Congress of Berlin in 1878, called to revise the terms of the Russian-Turkish peace treaty of San Stefano earlier that year, the Ottoman empire ceded to Russian the districts of Kars, Ardahan and Batumi, as well as losing an important part of its Balkan territories.

The alignment of the common border resulted from an entente between Turkish nationalists and the Bolshevik regime during world war one. The Moscow Treaty of 1921, which delineated the Soviet-Turkish border, gave birth to 70 years of relative stability.

3.1 THE EASTERN BORDER

During world war one, Mustafa Kemal Atatürk, the founder of modern Turkey, looked to Soviet Russia as an effective counterbalance to the Allied powers. Foremost in his calculations was the need to eliminate the Caucasian barrier between Russia

and Turkey. He considered the Caucasus front crucial to turning the war around and rescuing Turkey from an irreparable Allies-imposed peace. By combining with the Bolsheviks over the Caucasian isthmus, Atatürk hoped to open the floodgates to Anatolia, Syria, Mesopotamia, Persia, Afghanistan and India.²

Consequently, the arrival of a Red Army cavalry battalion in Nakhitchevan in July 1920 was greeted enthusiastically in the Grand National Assembly since the linkage of Soviet and Turkish detachments opened a passage through Bayazit to Azerbaijan, and stymied an Armenian drive to recapture the lower Araxes river valley and lines of communication and transportation that reached to Persia.³

Under the Treaty of Moscow on 16 March 1921, Turkey received outright all the territories exacted in the Treaty of Alexandropol.⁴ Sharur-Nakhitchevan became an autonomous region under the jurisdiction of Soviet Azerbaijan, with the proviso that it could not be transferred to another party (Armenia) without Turkey's express consent. Though the Soviet Armenian government initiated steps to incorporate 'Mountainous Karabagh', a measure condoned in both Baku and Moscow, the decision was reversed in mid-1921 with the result that most, but not all, of the region was constituted as an *oblast* (autonomous district) of Soviet Azerbaijan.

Moreover, the Russian Soviet Federated Socialist Republic accepted responsibility for securing the confirmation of Armenia and the other governments in Transcaucasus, a pledge fulfilled in the Treaty of Kars on 13 October 1921 between Turkey and the Soviet republics of Azerbaijan, Armenia and Georgia. Turkey would ultimately gain Allied recognition of these boundaries, together with other major concessions, in the Treaty of Lausanne in 1923.⁵

After centuries of antagonism between Tsarist Russia and the Ottoman empire, Communist Russia and Kemalist Turkey cooperated after world war one to defend their independence, much reduced territories and the stability of their new régimes against the Western powers. This cooperation ripened into a friendship pact enhanced by a treaty of neutrality and non-aggression, signed on 17 December 1925. Turkey signed its first reciprocal economic agreement with the USSR. A bilateral economic agreement signed two years later granted preferential treatment to the other's economic representatives, further facilitating the transit trade, while Turkish traders were allowed use of the port of Batumi.

The USSR assisted the young Turkish republic in its industrialisation, and the basis of its textile industry was established due to a Soviet credit. Under a 1932 agreement the Soviet Union granted Turkey an \$8m credit for the import of manufactured goods and industrial equipment.

The demarcation of the Turkish-Soviet border in the 1920s ran through the village of Sarp/Sarpi.⁶ Peasants could freely cross the border to tend their farms or visit relatives until 1937 when, after an uprising on the Soviet side, it was sealed by a barbed-wire fence. It used to take two to three months to send a letter from Sarp to Sarpi. To visit one another, villagers had to make an arduous two-day journey through the Doğu Kapı border crossing, if permission was granted.

Doğu Kapı, the only official border crossing between Turkey and the USSR, dates back to 1927. The border gate is situated some 20km from the Turkish city of Kars and the Armenian city of Gyumri, and a railway connection between the two facilitated commercial traffic between the USSR and Turkey. The Dilucu border crossing between Turkey and Nakhitchevan was closed in 1921.

Just before the end of world war two, on 19 March 1945, the Soviet Union denounced the friendship treaty of 1925, and its policy towards Turkey became increasingly menacing. Georgia and Armenia laid claims to Turkish territories with the encouragement of Moscow, which also demanded the abrogation of the Montreux Convention of 1936 – which confirmed Turkey’s right to exclude warships from the Dardanelles and Bosphorus in time of war – and exclusive cooperation with Turkey for the defence of the Straits.⁷ Relations improved in the 1960s after Moscow renounced its territorial claims, particularly in the field of economics.⁸

A set of agreements signed at the end of the 1960s prepared the ground for an era of rapprochement. In a 1967 agreement, the USSR supplied Turkey with equipment and technical assistance to build several industrial plants. In 1972 and 1978, the two states signed a declaration of ‘principles of good-neighbourly relations’ and a ‘political document’ on friendly relations. A natural gas agreement in 1984 boosted bilateral trade on the basis of a clearing agreement between the two countries. By the end of the 1980s, moves to open the Sarp/Sarpi border crossing were symbolic of a warming in Turkish-Soviet relations that amounted to *glasnost*.

3.2 THE NEW REGIONAL SITUATION

The post-cold war context radically altered the scheme of border exchanges. With the dissolution of the Soviet Union and the independence of the Caucasian states, Turkey had to deal with new neighbours. The closure of its only border crossing with Armenia in 1993, and the opening of new border posts with Georgia and Nakhitchevan, are the most significant events in the early 1990s.

Turkey ‘discovered’ her new neighbour, Georgia, with the opening of the Sarp border gate in 1988, the opening of a second gate at Türkgözü and a 1994 measure that granted Ardahan the status of border city. The opening of Dilucu crossing in 1993 created links between Iğdır and the Azerbaijani enclave of Nakhitchevan. A Council of Ministers’ decision in the early 1990s permitted the provinces of Artvin, Ardahan and Iğdır to trade with their new neighbours.

In the meantime, Kars – historically known as Serhat Kars⁹ – had lost its status as a border city. During the NK war, Armenian forces launched an offensive in March 1993 to establish a second corridor between Armenia and NK through Kelbajar, a town north of Lachin, triggering a new flood of Azeri refugees. On 3 April, after Armenian forces attacked Kelbajar, the Turkish government retaliated by halting the supply of wheat across Turkish territory to Armenia. After the official closure of Doğu Kapı/Akhourian in 1993, direct land communications with Armenia were

severed and a proposal to open a second gate at Alican/Makara, near Iğdır, was postponed.

The opening of the frontier at Sarp was warmly anticipated by officials and business people on the Black Sea coast and the Trabzon Chamber of Commerce, in particular, had lobbied hard over the issue. In 1990, a total of 146,000 people crossed into Turkey, mostly to trade or to shop, though some came to visit relatives separated since the early years of the 20th century. Sarp was also gateway to the other Transcaucasian republics.

The opening of Dilucu border post between Iğdır and Nakhitchevan in May 1992 was of vital importance to the isolated Azerbaijani enclave, but it ran into a cul-de-sac. The 10km-long sliver of land border between Turkey and Azerbaijan had been closed since 1921, a separation so hermetic that the population of Nakhitchevan was reportedly unaware that their close neighbours spoke nearly the same language: the population of Sadarak only noticed their neighbours spoke the same language in the 1970s when they first received broadcasts from Turkish television.

4. BATUMI: EAST-WEST CORRIDOR

The study aims to put into perspective the impact of opening the Sarpi/Batumi border post on Georgia's external trading relations and the effectiveness of the east-west road corridor thus established. Special emphasis is given to Sarpi/Batumi's role in the economy of Georgia's autonomous republic of Adjara.

4.1 SARPI/BATUMI BORDER POST AND ADJARIA'S EXTERNAL ECONOMIC RELATIONS

Seized by the Russian empire in 1878, Batumi became a hub of the Transcaucasian economy following the construction of a railway (1883) and an oil pipeline (1897-1907) that connected the port to Baku on the Caspian Sea. Economic growth continued until the start of the Soviet era with the construction of several factories and an oil refinery. Batumi remained a major distributor of oil products until the end of world war two, after which Azerbaijani supplies were overshadowed by Siberian oil and gas, transported through Novorossisk or Odessa. Though Batumi gradually lost its external connections, the autonomous region of Adjara preserved its prosperity thanks to agriculture.

When Georgia gained independence in 1990, a new era also began for Adjara. After a 70-year closure, Batumi dreamed of becoming a window on the outside world. Since independence, Adjara has been one of Georgia's most peaceful regions and has made great strides towards economic recovery. The crossborder traffic with Turkey has been beneficial to both sides, and for Georgia as a whole, while the transit trade towards Tbilisi, Caucasus, southern Russia and Central Asia provides a major source of income. A number of maritime connections have also

been established with Trabzon, and two major railway stations and customs areas have been constructed. Although Georgians handle customs activities, Russians are in charge of border controls.

Control of the Sarpi/Batumi border post and the port give important leverage to the Adjarian authorities. Conflicts between Batumi and Tbilisi over distribution of customs income were a major impediment to growth in the transit trade, particularly from 1991-95 when Georgia established a secondary customs control point on its internal border with Adjaria in order to levy some income from the traffic.

TABLE 1. CROSSINGS AT SARPI BORDER GATE, 1988-93

Year	Entrance of foreigners	Exit of foreigners	Entrance of Turkish nationals	Exit of Turkish nationals
1988	230	181	74	232
1989	8,296	7,176	2,804	3,431
1990	135,649	135,552	7,439	7,717
1991	512,518	475,095	19,937	22,671
1992	781,621	545,486	38,689	37,998
1993	521,358	387,636	46,997	49,737

SOURCE: SARPI BORDER POST

TABLE 2. NUMBERS OF CIS CITIZENS ENTERING TRABZON, 1990-95

Year	CIS nationals
1990	144,000
1991	438,525
1992	693,657
1993	491,536
1994	584,626
1995	243,689

SOURCE: TRABZON TOURISM OFFICE

TABLE 3. INDIVIDUALS AND TRUCKS CROSSING THE SARPI-BATUMI BORDER PER YEAR, 1996-2000

Year	Individuals		Trucks	
	Exit	Entry	Exit	Entry
1996	198,541	161,958	21,255	26,425
1997	166,501	166,647	21,138	26,893
1998	210,714	230,097	30,105	33,367
1999	238,673	238,475	20,486	19,779
2000	223,291	222,037	12,396	12,346

SOURCE: STATE CUSTOMS REVIEW OF THE AUTONOMOUS REPUBLIC OF ADJARIA

TABLE 4. ADJARIA'S EXTERNAL TRADE, 1996-2000

Year	Exports(\$)	Imports(\$)	Transit(\$)	Internal transit(\$)	Total(\$)
1996	295,000	280,514	1,303,022	141,505	2,020,041
1997	283,172	445,114	2,751,392	136,108	3,615,786
1998	134,695	332,125	4,564,266	108,463	5,139,549
1999	82,462	235,641	5,704,727	100,727	6,123,557
2000	201,182	254,877	6,350,373	126,514	6,932,946

SOURCE: STATE CUSTOMS REVIEW OF THE AUTONOMOUS REPUBLIC OF ADJARIA

TABLE 5. SOURCE OF IMPORTS AND DESTINATION OF EXPORTS IN 2000

Countries	Quantity (tonnes)
Imports from	
Turkey	204,219,426
Romania	28,268,006
Ukraine	11,143,454
Russia	5,243,622
Exports to	
Turkey	168,554,944
Ukraine	10,482,883
Russia	7,277,244
UK	7,047,515

SOURCE: STATE CUSTOMS REVIEW OF THE AUTONOMOUS REPUBLIC OF ADJARIA

TABLE 6. TURKISH IMPORTS REGISTERED AT SARP CUSTOMS, 1997-99

Year	Imports (\$)
1997	27,282,872
1998	22,096,306
1999	24,042,519

SOURCE: STATE CUSTOMS REVIEW OF THE AUTONOMOUS REPUBLIC OF ADJARIA

4.2 DIVERSIFICATION OF GEORGIA'S TRADING RELATIONS

It is difficult to draw clear conclusions about Georgia's trade because of the lack of reliable data. A significant share is not recorded at all. Furthermore, figures often do not reflect effective transactions. There are 'mirror problems' with most bilateral statistics. In Turkey's case, the situation is equally problematic. Data from Georgian and Turkish sources differ significantly. According to the Turkish statistics, bilateral trade volume is much higher.¹⁰

Georgia's 10 leading trade partners account for 74% of registered trade with four, Russia, Turkey, Azerbaijan and Ukraine, accounting for around 46% in 2002. The CIS

and EU contributed 66% of Georgia's registered imports, while Turkey accounted for a further 12%. The main destination of Georgian exports is still the CIS, though the EU buys 17% and Turkey 15%. Georgia's trade volume with Turkey has mounted rapidly since independence. According to the Turkish State Institute of Statistics (SIS), bilateral trade worth \$12 million in 1992 was transformed into trade worth \$270 million in 2001. Turkey was Georgia's leading trading partner in 2001 with a 17.3% share worth \$173.7 million, followed by Russia (16.4%), Azerbaijan (8.3%), Germany (7.6%) and Ukraine (6%). Turkey fell to second position (13%) in 2002, after being overtaken by Russia (16%), with Azerbaijan (10%), Ukraine (7%) and Germany (6%) in the rear. Turkey's main exports to Georgia are sugar and sugar-based products (33.5% of the total in 2001), electrical engines (7%) and paper (6.9%). From Georgia, it mainly imports petroleum products (36.4%) and scrap metal (6.4%).

Turkish relations are highly prized in Georgia and have played a major role in helping it achieve some form of economic independence after the break-up of its traditional trading network. The opening of the border at Sarpi/Batumi clearly had a huge impact since it brought Georgia an opening to the world outside.

TABLE 7. EVOLUTION OF TURKEY-GEORGIA BILATERAL TRADE, 1992-2001

Year	Exports (\$000s)	Imports (\$000s)	Total (\$000s)
1992	11,571	1,252	12,823
1993	34,498	21,894	56,392
1994	67,190	25,652	92,842
1995	68,126	50,157	118,283
1996	110,319	32,495	142,814
1997	173,510	65,934	239,444
1998	164,146	91,007	255,153
1999	114,200	93,289	207,489
2000	131,769	155,314	287,083
2001	142,896	127,231	270,127

SOURCE: TURKISH STATE INSTITUTE OF STATISTICS

TABLE 8. BILATERAL TRADE, 1995-2001

Year	Exports (\$000s)	Imports (\$000s)	Total (\$000s)
1995	34,093	85,568	119,661
1996	25,897	76,625	102,522
1997	39,426	116,771	156,197
1998	20,291	98,438	118,729
1999	37,835	74,196	112,031
2000	73,623	108,633	182,256
2001	68,695	105,032	173,727

SOURCE: GEORGIAN STATISTICAL INSTITUTE

TABLE 9. TURKISH-REGISTERED TRUCKS ENTERING GEORGIA, 1998-2002

Gates	1998	1999	2000	2001	2002
Sarp	12,908	8,377	5,622	10,216	7,265
Türkgözü	1,430	1,315	815	717	904
Poti	-	-	573	-	818
Total	14,338	9,692	7,010	10,933	8,987

SOURCE: ASSOCIATION OF INTERNATIONAL TRANSPORTERS, TURKEY

Foreign direct investment in Georgia

From independence till 2001, foreign direct investment in Georgia has amounted to \$1 billion, most of it accruing after establishment of relative internal stability in 1995. Investment from 1995–2001 accounted for \$750 million of the total, with the US, the United Kingdom and Turkey the top three investors.

TABLE 10. THE MAIN FOREIGN INVESTORS IN GEORGIA IN 1995-2001 (\$000S)

	1995	1996	1997	1998	1999	2000	2001	Total
USA	408	1,506	22,318	94,137	25,709	11,728	23,881	179,686
UK	19,778	2,602	26,199	37,424	10,468	18,000	-	96,489
Turkey	102	6,710	7,486	19,000	4,773	17,020	15,590	70,681

SOURCE: GEORGIAN INSTITUTE FOR STATISTICS

5. AZERBAIJAN'S RELATIONS WITH TURKEY

5.1 TRADE RELATIONS BETWEEN THE TWO COUNTRIES

Azerbaijan's annual trade turnover, estimated at \$4 billion at the break-up of the USSR, collapsed due to the loss of markets and declining incomes. By 1995, turnover had fallen to \$1.3bn, having lost half its value each year from 1992–94. But 1996 was a watershed in both Azerbaijani politics and economics. Political stabilisation led to an improved macroeconomic performance with trade turnover rising by 22% to \$1.6 billion.

When foreign trade was at its lowest level in 1995, Azerbaijan's main trading partners were Iran (20.1%), Russia (15.4%) and Turkey (13.7%). By 1997, Russia had taken lead position with 21.1% of Azerbaijani trade, but it was overtaken by Turkey the following year. After Azerbaijan's oil and gas exports came on stream, the respective shares of its former leading trading partners were cut to Turkey (6.2%), Russia (5.8%) and Iran (1.7%).¹¹ In 2001, Azerbaijan is estimated to have had \$230 million worth of trade with Russia and \$215 million with Turkey. In the same year, the US assumed first trading position after delivering two new Boeings.

After years of war, when bilateral trade stood at around \$100 million a year, it steadily increased from \$212.7 million in 1992 to \$255.2 million in 1996 and \$355.5 million in 1998, a year in which Azerbaijani exports to Turkey reached \$135.8 million. By 2001, however, it had fallen back to wartime levels despite a threefold increase in Azerbaijan's total foreign trade and the signature of at least 200 commercial agreements between the two countries. Turkey was Azerbaijan's leading trading partner from 1996 to 1998, though the devaluation of the rouble boosted the competitiveness of Russian products. From 1999 onwards, the development of foreign trade has been biased towards large oil importers, although Turkey was still the country's third largest trading partner in 2001.

5.2 TURKISH INVESTMENT IN THE NON-OIL SECTOR

Turkey is the largest investor in the non-oil sectors of Azerbaijan's economy and the fifth largest in the Azerbaijan International Operating Company (AIOC) consortium that is developing the Azeri, Chirag and Gunashli oilfields in the Caspian Sea. In 2001, Turkey was overall third foreign investor, behind the US and UK. In that year, total foreign investment amounted to \$1.09 billion and Turkey accounted for 14.9% of foreign investment in non-oil sectors.

Turkish entrepreneurs can be categorised according to their date of entry in Azerbaijan. The first arrivals date back to 1992, although few from this first generation remain. Most had no previous commercial experience, their capital consisting of a mortgage on their house in Turkey, a loan or money from the sale of their car. The new generation of Turkish businesspeople is harsh in its criticism of these early pioneers who they refer to as 'doner sellers' and 'cab drivers'. Indeed, they opened Baku's first restaurants and taxi services. Others supplied foodstuffs and consumer products. A second wave of entrepreneurs, including large companies and institutional investors, arrived in 1996 after the country re-established a degree of political and economic stability. The Koç group was among these new actors. In 2001, a third wave arrived with strategies that embraced the entire Caspian region.

The Association of Turkish Industrialists and Businessmen of Azerbaijan (TÜSIAB) was established in 1994 and now boasts 200 members, with 20% of them involved in the service sector, 18% in industry, 9% in textiles or furnishing, and 18% in commerce. TÜSIAB has offices in Baku and Gence.

The large number of Turkish restaurants in central Baku gives Turkey's economic activity in Azerbaijan strong visibility, while the development of small shops has changed the city's image and atmosphere. Turkish entrepreneurs play a training role, allowing Azerbaijanis to learn about the market economy on the job and to acclimatise to new ways of working. Partnerships between Turks and Azerbaijanis have facilitated the transfer of know-how, while the development of the service sector has provided new sources of income and smoothed the shock of transition. However, the life expectancy of Turkish businesses is relatively short and many disappeared with the 1998 crisis.

The Koç Group has been interested in the republics of the South Caucasus since their independence from the Soviet Union. Its creation of the retail chain, Ramstore, had a positive impact on Azerbaijan's economy, accelerating the transition process and the introduction of market economy rules. The establishment of a distribution network brought new openings and boosted the development of small or medium-sized enterprises (SMEs). In 1997, around 80% of products sold in Ramstores were imported from Turkey. Seven years on, 75% of Ramstore products are sourced in Azerbaijan, and goods from Turkey or Russia comprise the balance. Parallel to the creation of the Ramstore brand, Koç Group created a distribution chain integrating Turkey, Russia and Azerbaijan.

Since domestic products are 50-70% less expensive than imports, Ramstore works with around 100 local suppliers, and the chain can claim some credit for restructuring the country's agricultural sector. Ramstore managers have been involved in modernising production facilities, elaborating new methods of production and introducing packaging concepts to local food producers.

An agreement between the government and the Turkish mobile phone company, Turkcell, led to the creation of a joint venture, Azercell, 64.3% of which is owned by Turkcell's holding company, Fintur. Bakcell, an Israeli-Azerbaijani joint venture, was the first to establish a mobile phone service in Azerbaijan, but Azercell introduced the Global System for Mobile Communications (GSM) and currently holds 85% of market share with 570,000 subscribers in 2002. With a \$145 million investment over five years, Azercell is the largest foreign investment in the non-oil sector and a significant taxpayer. The company has 228 employees, of whom only seven are Turkish. The corporate culture is well-rooted and young executives, mostly graduates from Azerbaijani universities, regularly attend training seminars in Istanbul.

5.3 IMPEDIMENTS TO PRIVATE SECTOR DEVELOPMENT

Prohibitive rents and an erratic fiscal policy seriously hinder the development of private enterprise. Not being entitled to purchase land under Azerbaijani law is a further handicap since foreign entrepreneurs are at the mercy of local landlords. Discretionary increases of rents are a frequent cause of bankruptcy.

Fiscal policy is also problematic. 'There is no mafia here, as in Istanbul,' said one Turkish businessman, 'but we have to comply with the system. A restaurant can be asked to pay a daily tax of \$800.' Taxes are collected on a daily basis according to the amount that the collector is told to gather. It is hoped that a new fiscal law will clarify the situation.

The oil sector enjoys preferential treatment since all products utilised in developing the oil industry are exempt from import duties. Foreign importers working in non-oil sectors can be seriously affected by current customs policy. A liberalisation process initiated in 1997 reduced customs duties but, under international pressure, Azerbaijan later agreed to unify its tariff rates. The

current average tariff rate is 15%. By 2000, 60% of all imports were oil-related and free of duty. Customs revenue represented 20.1% of budgetary resources in that year, up from 0.34% in 1994.

However, customs policy faces a dilemma. On the one hand, because promoting national production is a governmental priority, customs policy should aim at restricting imports. On the other, customs duties are an important source of income, so increased non-oil imports lead to increased revenues. Because customs policy has to meet budgetary objectives, often fixed for a very short term, foreign non-oil importers find it difficult to foresee how much duty will be required, while some Azerbaijani importers operate under ‘preferential conditions’ that lead to unfair competition. In the 1990s, ‘private importers’ were able to sell imported Pepsi Cola at a cheaper rate than the official distributor in Azerbaijan.

6. TURKEY’S RELATIONS WITH ARMENIA

The decision to close the border with Armenia in April 1993 and suspend trade was a major obstacle to developing commercial exchanges between the two countries. However, the decade also witnessed the evolution of wide-ranging strategies aimed at circumventing the embargo which allowed for a degree of bilateral trade. An air corridor was opened in 1996 to connect Istanbul with Yerevan, but transport by road requires crossing a third country, so goods and passengers to Armenia have to pass through Iran or Georgia.

6.1. TRADE LINKS BETWEEN TURKEY AND ARMENIA

Trade between Armenia and Turkey does exist despite the border’s closure, amounting to \$70-150 million each year. According to Armenia’s Ministry of Foreign Affairs and Ministry of Industry and Commerce, there are some 20 Turkish-Armenian joint ventures, although companies with Turkish capital are represented by nationals of a third country. According to the US Embassy in Yerevan, Turkey is Armenia’s seventh largest commercial partner although export destinations are usually registered as Georgia and Russia. Similarly, Turkey is not mentioned as the country of origin: exports tend to originate from third-party firms based in Switzerland.

The market in the popular district of ‘Bangladesh’, a few kilometres from central Yerevan, is known as Malatya Pazarı.¹² Turkish wholesalers in the import-export sector and the shuttle trade feed the market with goods. Even on a quick visit, it is obvious that a large proportion of its agricultural, cleaning, textiles and food products are Turkish brands. Indeed, asking if a product comes from Turkey is a sure way of starting a conversation and most traders understand Turkish (some say they speak it at home, while others picked it up on visits to

Turkey). Some wholesalers go directly to Turkey to purchase merchandise, but others prefer to buy from a Turkish wholesaler. Some try to pass off Turkish-made products as Iranian and Russian, either because Turkish goods are considered inferior or because previous boycotts have taught them to be prudent.

Most Turkish wholesalers in Malatya market are in the transport and logistics businesses and come from the Black Sea, particularly Trabzon. They mainly import raw materials, fruit, vegetables and consumer goods. Turkish merchants broadly divide into two categories. A minority came to Armenia in the first years of its independence and now have settled, but the majority spend only a few months there. That the majority come from the the Black Sea region is not accidental. Interviewees said they were attracted by travel, that it was possible to find ‘Karadenizli’¹³ throughout Turkey and that Trabzon traders were in nearly ‘every country of the world’. Many had been involved in Russia, Georgia and Azerbaijan before entering the Armenian market, which they unanimously preferred because ‘there are not many Turks’.¹⁴ They are prepared to supply any product, but readily confess that a large part of exports to Armenia¹⁵ are of low-end quality (they actually claim to suffer from this). Though they define themselves as businesspeople, they admit to having made irrational choices by staying in Armenia during the conflict and continuing to operate in a low-profit and high-risk market. They also admit to having a taste for adventure.¹⁶

Interviews with Turkish traders and businesspeople give an overview of the difficulties of the Armenian market:

- It is increasingly difficult to penetrate the Armenian market and remain there. The fact that the market has become more structured complicates access for businesspeople with limited capital, while the creation of new distribution networks has made it more difficult to profit from importing.
- Turkish businesspeople often complain about the behaviour of their Armenian partners who, they say, look for short-term profit and have little knowledge of marketing. Some insist on their lack of creditworthiness. Their main objective, they allege, is to drive Turkish traders out of Armenia and confiscate their merchandise.
- The cancellation of orders is a major risk, particularly with regard to perishable goods or products with high transport costs.
- The determination of prices is erratic. Sellers tend to increase prices if the buyer is Turkish, above all when he learns the merchandise is due to be exported.
- Settlement of transactions involves enormous problems and so is usually made in cash.
- Boycotts against Turkish products, organised during a period of political tension, continue to worry Turkish merchants.

Bus companies shuttling between Yerevan and Istanbul are an important source of information. Two Turkish firms, Aybaki and Mahmudoğlu, dominate the land connection between the two countries, but two other companies, AST and Buse, also run services. A wholly-owned Armenian company could not compete in the sector because vehicles registered in Armenia are not permitted to enter Turkey. Particular attention is paid to Aybaki in this study since it was the company chosen to make the journey.

Women between 35-40 years old comprise more than 80% of passengers and it is possible to categorise them according to the purpose of their journeys. Women in the shuttle trade constitute more than half of all passengers. They stay in Istanbul no longer than three days, since their objective is to shop as quickly as possible and to spend as little as possible. Others use Turkey to transit to their ultimate destination, the EU. The oldest are often travelling to work illegally for Armenian families in Istanbul. A fourth group indicates that they go to ‘work in the hotels’: prostitution is certainly one activity field.

Bus companies estimate that passengers on a single bus will spend around \$100,000 on shopping during a single trip. In the period up till January 2001, the total value of the shuttle trade was estimated at around \$2 billion per year. The four firms operating in the market each make two trips a week. Buses are equipped with an empty trailer that weighs nearly 15 tonnes on its return journey.¹⁷

In the early years, the shuttle buses’ final destination was Trabzon, but this was rapidly displaced by Istanbul where prices are more competitive. Commodities are purchased directly from the producer or wholesaler, and Armenian specialists know the Istanbul markets intimately. Armenian merchants have now begun to orient themselves toward other destinations since the entry into force of new Turkish visa legislation in 2001. As a result, Istanbul faces serious competition from Russia, Iran,¹⁸ Hong Kong, China and Dubai.

6.2 PRIVATE SECTOR COOPERATION

Disappointed with the slow pace of political reconciliation between Turkey and Armenia, the TABDC¹⁹ was founded in 1997 after the summit of the Black Sea Economic Cooperation pact in Istanbul to foster trade links between businesspeople in Armenia, Anatolia and the Armenian Diaspora. The TABDC’s initial goal was to help Armenian and Turkish companies streamline their operations and lines of communication, but the mandate quickly expanded to include the promotion of cultural activities as a means of creating new avenues of cooperation.

The TABDC’s first five years were a resounding success at several levels, from sponsoring trade missions and joint cultural activities to organising the supply of earthquake aid from Armenia to Turkey. Members opened new

dialogues between Turks and Armenians on many platforms with the help of the Black Sea Economic Cooperation Business Council and political leaders around the world. TABDC trade missions have introduced business leaders in sectors such as textiles and agriculture to counterparts across the border. From its early business focus, the TABDC has evolved into an influential channel of communication between the two governments, and it advocates opening the Turkish-Armenian border and the establishment of diplomatic relations.

The TABDC also engaged the media of both countries in efforts to bring the Armenian-Turkish reconciliation issue to the top of the public agenda and has enjoyed remarkable success in increasing the number of news stories devoted to the cause. They lobbied government agencies, political parties and think tanks to explore creative ways to heal the wounds of Turkey and Armenia's collective past. Forging ties between special interest groups in the two nations was put on a fast track and the TABDC sponsored exchanges between business leaders, journalists and women's groups. In 1999, Yerevan State University and the Middle East Technical University in Ankara signed a memorandum of understanding for student and faculty, and new contacts have flourished.

The TABDC identified tourism and the restoration of Armenian historical sites as other ways of contributing to economic development in Anatolia and Armenia, and to rebuilding a more congenial relationship between two peoples that have lived together for centuries. The first tour, organised by the Diocese of the Armenian Church of America and the TABDC in June 2001, included over 150 participants. Another TABDC aspiration was to mobilise the Armenian Diaspora to use its extensive business expertise and worldwide connections to develop new commercial opportunities for communities on both sides of the Turkish-Armenian border.

6.3 TURKISH-ARMENIAN BORDER: COST OF CLOSURE

Turkey's demand for Armenia's official recognition of the Turkish-Armenian border in the early 1990s, and Armenia's refusal to do so, initially prevented the two states from establishing diplomatic relations. Turkey established diplomatic relations with Azerbaijan and Georgia in 1992 but Armenia, as successor state to the Socialist Republic of Armenia, refused to recognise the Treaty of Kars of 1921. Armenia considers that its accession to the Organization for Security and Co-operation (OSCE) in the same year proves its alignment with the principle of the immutability of international borders. However, it was not this dispute, but the exacerbation of the NK conflict that ultimately led to the closure of the Turkish-Armenian border.

In November 1992, Turkey agreed to relieve Armenia's economic plight by delivering 100,000 tonnes of wheat. When Armenian forces attacked the

Azerbaijani city of Kelbajar, the government ended the supply and has halted all transit trade through Turkish territory, a decision that also ended direct communication between the two countries. Since 3 April 1993, opening the border has been directly linked to the resolution of the NK issue.

According to Turkish perceptions, opening the border and the normalisation of relations depend on Armenia's compliance with 'the principles of law and its willingness to solve problems with its neighbours'.²⁰ Since closing the border was retaliation for Armenia's occupation of Azerbaijani territory, ending the decade-long, Turkish blockade is inextricably linked to the political settlement of the NK conflict and the liberation of Azerbaijani lands. Any shift in this stance raises concerns in Azerbaijan, whose main leverage on Armenia is the border issue and which fears any weakening of its own position in the search for a political settlement. Consequently, Azerbaijan presses Turkey to maintain the status quo because the effectiveness of the blockade depends on Armenia being isolated from two directions.

The Turkish authorities have so far refrained from assessing the cost of maintaining this blockade, but former President Süleyman Demirel gave some inkling of the prevailing official opinion when he said in the 1990s: 'Turkey cannot take the risk of displeasing her Azerbaijani brothers in order to allow a few to make some profit.' Indeed, there are high economic risks, particularly Turkey's share in the AIOC and the Baku-Tbilisi-Ceyhan (BTC) pipeline project.²¹ President Heydar Aliyev's statement on his accession to power that Azerbaijan would 'conceal' the March 1993 Azerbaijani-Turkish agreement on building a \$1.4 billion pipeline from Baku to the Turkish Mediterranean shore via Iran was the first sign that a shift was about to occur in Azerbaijani politics.²²

Azerbaijan used the east-west option for transporting its energy to world markets as a bargaining tool in its relations with Turkey. In exchange for Azerbaijan's support for the BTC pipeline route, Turkey had to guarantee Azerbaijan's security, a trade-off that effectively silences Turkey in negotiations over NK. Azerbaijan sees Turkey as a military ally, rather than a diplomatic actor, in the region. While Turkey was asked to demonstrate her solidarity with Azerbaijan on the battlefield, Alyiev moved to improve relations with the Russian Federation in the hope that Moscow would help resolve the NK conflict on Azerbaijani terms. By November 1993, two important deals had been concluded and the Russian oil company, Lukoil, was invited to join the international production sharing agreements for the Chirag, Azeri and Guneshli oil fields. At first sight, the concessions to Russia appeared to be paying off. At the signing of the agreements, Russia's former minister of fuel and oil, Yuri Shafrannik, said that 'the signing of the treaty between Moscow and Baku will have an impact on solving the Karabakh conflict'.²³

While opening the Turkish-Armenian border presents no direct threat to Azerbaijan or the search for a political settlement over NK, there are other reasons to question the effectiveness of this *de facto* embargo. Economic sanctions have rarely been used successfully to attain political objectives. Despite the suffering of the war, living standards in Armenia have obviously improved, especially since 1996. During the first half of the decade, Yerevan only had electricity for 30 minutes a day, there was a critical water supply problem and its inhabitants had to cut down trees to warm themselves in winter. Although Armenia continues to have real economic problems, the population is aware of the amelioration that has taken place.

The embargo has had a very negative impact on Armenian public opinion, however. Turkey is considered the source of all daily difficulties and the author of Armenia's suffering. Turkey is regarded as a powerful country that arouses fear and seeks to oppress the newly independent Armenian state. Turkish policies towards Armenia have excited a distinctly anti-Turkish trend, including boycotts on Turkish products. Despite the border closure and the embargo, however, Turkish products still penetrate the Armenian market, providing further evidence of the inefficiency of Turkish policy in the region.

6.4 THE EFFECT OF DIVERSIFICATION OF ARMENIA'S EXTERNAL CONNECTIONS

Since independence in September 1991, Armenia has maintained a formal policy toward Turkey that looked forward to the establishment of full diplomatic and trade relations with its neighbour, while seeking to deny it any role in mediation over the NK conflict. Successive Armenian governments therefore downplayed the blockade and rarely complained about it either at home, or on the international stage.²⁴

Since 2001, the government has been more active in drawing international attention to the issue, arguing that the border closure contravenes a range of internationally recognised, legal principles.²⁵ Internally, it seems to have reached a consensus over whether to re-open the border. Broadly speaking, the government asserts that opening the border is not a matter for discussion since Armenia made no attempt to close it in the first place. However, the status of the Turkish border is proving to be a political and economic issue; as soon as the prospects for re-opening the border improve, the potential impact of closer economic and social contact with Turkey is also raised.²⁶

Furthermore, opening the border is depicted purely as a policy that will have a positive impact across the whole region. In response to a question about the possible ill effects it might have on Armenia's economy, Foreign Minister Vartan Oskanian pointed out that it had already adjusted to the blockade, and opening the border would only provide an additional impetus for development.²⁷

At a ceremony in August 2003 marking the 105th anniversary of Armenian railways, the Minister of Transport and Communications, Andranik Manukyan said:²⁸

‘All that remains is for Turkey to show political will and open the border. Opening the border is important since Armenia will then become a transit country for shipments from Georgia and our dependence on Georgia will lessen. Considering the trends of the past two to three years, Armenian railways will carry around 30% more cargo in 2003 than in 2002. In Soviet times, the number of carriages unloaded in Armenia was 2,000 per day. Now, the number does not exceed several dozen. Armenian railways are 800km long and work at 15% of their capacity. The furthest destination of carriages from Yerevan is currently Tbilisi.’

The cost of the border closures on Armenia’s economy is obvious. Armenia is far from the markets of Europe, North America and Southeast Asia. Access to Russia is limited by the mountainous relief, while the consumption centres are situated in the north of the country. The regional market includes Georgia, Azerbaijan, northeast Iran and eastern and southeast Anatolia,²⁹ a market of 50 million consumers with a combined GDP of \$10 billion. In GDP terms, east and southeast Anatolia and northeast Iran represent one third of the regional market. Turkish and Azerbaijani embargoes currently restrict Armenian access to 44% of the regional market – the markets of Anatolia and Azerbaijan. The embargoes also increase by 38% access costs to markets in northeast Iran.³⁰

Closure of the borders with Turkey, Azerbaijan and Nakhitchevan also harms communication with Iran. The distance between Yerevan and Tebriz is 350km, but the road traversing Turkish territory and Nakhitchevan became impracticable in the 1990s. The road that is currently used is 50% longer than its predecessor and crosses difficult terrain. The rail link across Nakhitchevan to Iran is also closed.

A study by the Armenian Ministry of Industry and Commerce estimated that, in the event of both embargoes being lifted, re-opening one railway line will increase Armenian exports by 25%, while re-opening all four will double them. The potential gains range from \$75-300 million. Nevertheless, the Armenian private sector has divergent views on the economic impact of opening the borders.

BOX 1. VIEWS ON OPENING THE BORDER

A seminar on the subject, organised on 17 September 2003 by the Union of Manufacturers and Businessmen of Armenia (UMBA) in conjunction with the periodical, *Armenia: Finances and Economy*, elicited some interesting insights, as reported in a local newspaper.³¹

The economist, Tatul Manaseryan, said it was premature to open the border. He noted that this issue did not emerge at the initiative of Armenia and that Turkey has bigger interests in the issue, notably the development of its eastern provinces. He said that opening the border would threaten Armenia's amorphous economy.

Harutyun Khachatryan, deputy director of Noyan Tapan news agency, said that opening the frontiers would certainly benefit Armenia while delivering a moral blow against Azerbaijan. Armenia would become a transit country for Turkey, Azerbaijan and the republics of Central Asia, with all the associated profits.

Ashot Markosyan, deputy head of the state property department, was in favour of developing trade relations with neighbouring countries. Vigen Sargsyan, the Yerevan representative of the World Bank, said that there can be no other answer but 'yes' to the question of opening borders. He said he had asked local and foreign economists whether they could think of a single example of two neighbouring countries developing when they blockaded one another. He received a negative answer.

Deputy Minister of Agriculture, Samvel Avetisyan, said that Turkey did not really need Armenia's small market. Economist, Ashot Eghiazaryan, said opening the frontiers was a priority of the US which links regional security to resolution of the blockades. In his estimation, the resultant state of affairs might not be very advantageous for Armenia.

Another economist, Artsvi Minasyan, warned that the borders will open regardless of Armenia's opinion and asked what the government was doing to prepare for this development. She stressed the need to determine which domestic industries were progressing or lagging behind before opening the borders.

Summing up, Arsen Ghazaryan, president of UMBA and co-chairman of the Armenian-Turkish Business Development Council, said that Turkish capital would hardly damage our industry, citing the example of Georgia where Russian investment is much bigger. Mr Ghazaryan said UMBA had held a virtual agro-marketing workshop at which it was made clear that Armenia has an opportunity to export agricultural produce to Turkey. Armenian energy, cement and textiles were also potential exports. In food products Armenia will naturally face competition, but it would

provide a good incentive for Armenian food producers to be content with moderate profits only, rather than the ‘super profits’ they now get. Armenian consumers could only benefit from open borders.

In a follow-up report published one week later, Khachatur Sukiasyan, head of the ‘SIL Group’ company and a parliamentarian, said that the earlier borders open, the better. ‘There is a popular opinion that open borders will result in the expansion of Turkish products in Armenia and create problems for local producers,’ he said. ‘Yes, some local products will not survive the competition, but I am sure the loss will be much less than the gain.’ He also believes hundreds of local products will be exported to Turkey and to further destinations. ‘Open borders will force Georgia to review its transit taxes and cut them,’ Mr Sukiasyan continued. ‘This will foster the export of local products to Russia. Today we face transport costs higher than the actual price of the product.’

Businessman, Mickael Vardanyan, who heads International Masis Tabak and is also a law-maker, was more reserved. He agreed that opening the borders will cut transit taxes via Georgia and decrease the net cost of our products, but that it will also benefit much larger Turkish producers. In his opinion, the flow of Turkish products will have very serious consequences for Armenia’s ‘fragile’ economy and will result in a long-term decline in domestic production, worsening the country’s foreign debt.

In Vardanyan’s opinion, it is necessary first to design an information register of both countries’ economies, markets and price shifts, elaborate customs regulations and clarify the conditions of trade. Without these preparations, he said, ‘we are ready for the opening of the borders only mechanically, but not politically, economically or even psychologically. This will require at least three or four years. Today, I repeat, we are not ready to open the frontiers.’

6.5 REVITALISING EASTERN ANATOLIA AND THE TURKISH BLACK SEA COAST

The opening of the Turkish-Armenian border is a vital issue for Armenia. Difficulties of access to the rest of the world increase transportation costs, while the smallness of the Armenian market and its inability to plan at a regional scale are disincentives to potential investors. For Turkey, however, opening the border and gaining access to Armenia’s market are only of secondary consideration.

However, the Istanbul Chamber of Commerce³² has been interested in Armenia for several years. The Association of Industrialists and Businessmen in Turkey³³ has openly advocated the development of relations with Armenia, and the Unions of Exporters,³⁴ official groups dependant on the Undersecretariat of

Foreign Trade, have criticised national policies toward Armenia.³⁵ The border closure has hindered the exports of small and medium-sized enterprises in regions remote from the economic centre, and punished Armenian consumers by increasing the price of imports. As mentioned above, Turkish and Armenian businesspeople have succeeded in finding strategies to circumvent the embargo.

Relations with the region and its distance from the centre determine the region's relation with the border. The approach developed at a national level usually contradicts the perception of the population in the border regions themselves. Opening the border and the establishment of direct relations with Armenia are vitally important for the cities of Kars, Iğdır and Trabzon.

Those who do not view opening the border as a priority are thinking within a national framework: for them, the region's underdevelopment is a result of the lack of interest by the economic and political decision-makers. They estimate that 'focusing on the border question' is only a diversion and that priority should be paid to the elaboration of a development programme for the peripheries. Furthermore, they argue, opening the border would only increase the region's isolation from the centre.

Others put forth arguments related to security. Since these regions are partly populated by Azeris or receive thousands of Azerbaijani visitors,³⁶ there is concern about possible confrontation between Azeris and Armenians. Opponents to opening the border, however, represent only a tiny minority.

Entrepreneurs and traders in the border cities expect an immediate gain from opening the border. The main motivation is to sell their products in Yerevan. According to interviewees, the need to open and even abolish the border altogether is justified by economic pragmatism. In an age of globalisation, they argue, borders create economic burdens and constitute an aberration in political terms. Borders have never protected countries against threat, they argue, and emphasis should be given to 'other means of watching what is going on the other side of the border'. As for security issues, they say that 'Turkey can easily invade Armenia if necessary'. Even if interviewees believe 'the conquest wars belong in the past', they cannot help but add that opening the border will modify the power balance in Turkey's favour. One official from the Iğdır Chamber of Commerce proposed that the border be temporarily opened for a determined time with the objective of increasing Armenia's dependence on Turkey.

The wish to establish relations with 'those on the other side' is just as strongly expressed as the economic benefits that are likely to emerge. The desire to communicate with neighbours is all the more important since many families in the region are originally from villages in Armenia.

Kars is situated 20km from the border gate at Doğu Kapı. The border village of Akyaka, which is also the last station on the Orient Express across Anatolia, borders on an Armenian village. Similarly, on the road connecting Kars and Iğdır, near Digor, Turkey and Armenia are separated by the Arpaçay river. On the

border, communication and mutual aid between Turkish and Armenian villagers is the norm: Armenian villagers regularly cross even at night to return cattle that have escaped across the border from Turkey.

Iğdır is situated half an hour by car from Yerevan. The road that leads to the border with Nakhitchevan at Dilucu continues on to Yerevan. The lights of Yerevan have fascinated the inhabitants of Iğdır for decades as these remarks from the Turkish side of the border testify.

BOX 2. YEREVAN FROM İĞDIR'S POINT OF VIEW

- 'In Soviet times, the lights from the Armenian side were very good and the electrification of the countryside was far advanced. We profited from the Armenian lights to plough our lands!'
- 'When we come from Ankara by car, after a turning, we see the lights of a city. Generally, people think that it is Iğdır, but in fact it is Yerevan! And in the Soviet age, the illumination was better.'
- The closure of the border is essentially perceived as a restriction of freedom of movement. In an 'age of globalisation and communication', such a restriction is considered senseless and 'inhuman'.
- 'It is totally absurd to restrict the freedom of movement of the people. If we want to, we should be able to spend some time in Armenia!'
- 'It is sad not to be allowed to get to the other side of the border and, especially for Armenians: to contemplate Mount Ararat without being able to come and visit it!'

6.6 FURTHER INTEGRATION BETWEEN TURKEY AND AZERBAIJAN

The opening of the border crossing at Sarp/Batumi offered a new transport corridor linking Turkey with the Caucasus, Caspian and Central Asia regions. In 1998, the number of trucks transiting through Iran amounted to 4,000, while those crossing Georgia accounted for a further 3,200. In 1999, 3,250 trucks registered in Turkey transited to Azerbaijan via Georgia, while 2,500 preferred the Iranian route. Since 2000, transits through Georgia have decreased steadily and in 2001, the Iranian route recovered its dominance with 2,370 trucks in transit, compared to 1,250 using Georgian territory.

This development also applies to connections with Central Asia and the Far East. Routes linking Turkey to Asia choose less and less to cross Georgian territory. Since 1997, the number of Turkish-registered trucks going to Georgia has fallen from a high of 20,458 to just 7,010 in 2000.

Turkey is linked to the Transcaucasian railway system built during the Russian empire and subsequently upgraded during the Soviet era. The construction of the

railway system of eastern Anatolia, running from Sarımakış to Kars, dates back to the Russian period. The Soviet rail system consisted of 32 railways, with a total length of 145,000km, and they carried 55% of all passengers and 25% of all commodities transported.

The Armenian railway system connects Turkey with the Russian/Soviet railway network, providing access to the Caucasus, the Russian Federation and Central Asia. Armenia is the hub of the regional railway network and several lines cross its territory, which is situated at the crossroads of east-west and north-south communications. Akyaka, the last station on the railway that links Istanbul with Kars, is also connected to the Armenian city of Gyumri, providing access to the Transcaucasian railway system. There have always been compatibility issues between the Turkish and Soviet systems, but the railway connection between Kars and Gyumri was operational until 1992. Gyumri is linked to several other railways, including the Yerevan-Julfa-Baku line that runs through Nakhitchevan along the Iranian border, and the Yerevan-Sevan-Dilian-Gazakh-Baku line.

Conflict, political disputes and closed borders have condemned this huge railway network, which was once essential for communication across the Transcaucasus.

The new Transport Corridor Europe Caucasus Asia (TRACECA) map, approved in December 2001 in Tbilisi, integrated the railway connection between the Turkish city of Kars and the Armenian city of Gyumri in the TRACECA transport corridor. The action plan for the 2002-04 period takes into account rehabilitation of the container terminal at Gyumri railway station.

The connection of the Turkish, Armenian and Azerbaijani railway systems will guarantee, via the Anatolian-Caucasus-Caspian route, the most favourable east-west transport corridor between the Caspian basin and world markets. Ensuring linkage with the Caspian basin is of utmost importance since investments are, and will be, mostly from Western countries.

The sea-rail combined transport route linking Anatolia and the Caspian basin is also the most cost-effective route. Turkish ports are cheaper than Georgian ones. Among all the Black Sea ports, Georgian ports are the most expensive, followed by Ukrainian, Russian, Bulgarian, Turkish and Romanian ports. Generally speaking, transportation costs for cargoes are cheapest using Turkish ports. If the cost per cargo is \$10,000 at a Georgian port, it will be \$6,000-7,000 in a Turkish one. In addition, security concerns are minimised. Consequently, the Samsun-Kars-Yerevan-Baku route, which is more competitive than the Poti-Tbilisi-Baku route, will ensure an important linkage for intra-regional transportation around the Black Sea.

Meanwhile, crossing the Dardanelles, the Bosphorus and the later deviation to the Black Sea all represent extra costs for shipping companies. For shipping lines coming to Istanbul or the Mediterranean region, Black Sea ports are less

favourable since the use of small feeder vessels requires transshipment. Most lines already make regular calls in ports like Istanbul and Mersin, and Istanbul is further linked to the Trans European Networks via Corridor IV.

The ports of Haydarpaşa and Ambarlı in Istanbul are of utmost importance since the Istanbul-Kars railway across Turkey has become part of TRACECA. The modernisation of these two ports and the rehabilitation of the railway to Kars, which requires minimum investment, would provide the most cost-effective and secure access from Europe to the Caspian region.

Furthermore, the connection between Turkish-Armenian-Azerbaijani rail systems would ensure a viable access to the Caspian for southeastern Europe and the Mediterranean region. Transportation costs between Samsun-Kars and Mersin-Kars being roughly equivalent, Mersin, which offers one of the best port facilities in the eastern Mediterranean, will prevent the need for the extra deviation and transshipment costs.

Further development of economic relations between Turkey and Transcaucasus depends on further improvement of their communication. Parallel to the construction of an energy corridor between the Caspian region and Turkey, the establishment of a transport corridor through the Caucasus is of utmost importance. The development of transport routes across Transcaucasus to Turkey will boost the integration of production and distribution networks, and lead to the implementation of projects that are regional in scope, further enhancing the process of integration.

Integration of Turkey in the TRACECA programme will bring new openings for regional cooperation, and the Anatolian-Caucasus-Caspian route will add a cost-effective, commercially viable and strategically beneficial east-west railway that will ensure direct links between Turkey, Baku and the Caspian region, eventually opening Armenia and Nakhitchevan to international trade and investment.

TABLE 11. TRIPS TO CIS COUNTRIES AND ASIA FROM TURKEY, 1997-2002

	1997	1998	1999	2000	2001	2001 (Jan-June)	2002 (Jan-June)
Georgia	20,458	14,338	9,692	7,010	10,933	5,409	3,762
Russia	27,703	19,232	12,560	10,514	10,146	5,080	3,960
Nakhitchevan	3,551	4,120	17,332	3,425	3,819	2,112	1,436
Azerbaijan	4,944	7,037	5,848	5,159	3,857	1,664	2,962
Kazakhstan	4,639	4,459	2,588	3,334	3,227	1,482	1,679
Iran	19,213	13,537	10,070	13,999	12,981	6,115	4,918

SOURCE: ASSOCIATION OF INTERNATIONAL TRANSPORTERS, TURKEY

7. NAKHITCHEVAN: INTERSECTION OF NORTH-SOUTH AND EAST-WEST CONNECTIONS

Nakhitchevan is said to be the oldest city in the world. Noé would have chosen to settle in Nakhitchevan when he came down from Mount Ararat where his Ark landed. In the 17th century, the traveler, Evliya Celebi, described the city as one of the wonders of the world.

With a surface area of 5,500km², Nakhitchevan is situated in a mountainous region bordering Iran and is drained in the south by the River Araxe. After the opening in the 19th century of the border gate at Culfa, 40km to the south, Nakhitchevan became an important communication hub and the Russian empire's chief access to Persia. Called the Gate to the Orient, the enclave is at the crossroads of the east-west and north-south railway connections. In Soviet times, 30 locomotives, each pulling 150 wagons, passed through Culfa every day.

Nakhitchevan was given to Azerbaijan in 1920 by Soviet officials despite Armenian protests. The Treaty of Kars in 1921 defined the border between the USSR and Turkey, and granted Turkey the status of guarantor of Nakhitchevan's territorial integrity. The NK conflict cut Nakhitchevan's communications with Azerbaijan. The Armenian offensive against Nakhitchevan was halted at Sadarax. The Turkish Prime Minister, Tansu Çiller, asked parliament for permission to send troops to protect the enclave in case of further Armenian attacks and a Turkish force was placed on a state of high alert. The measure had a dissuasive impact together with the diplomatic contacts between Haydar Aliyev, then President of the Council of Nakhitchevan, and Moscow.

The Autonomous Republic of Nakhitchevan, which has preserved its territorial integrity, is blockaded by Armenia on its west, north and east. All land communications with Azerbaijan are also blocked. Flights connecting Nakhitchevan and Baku are the only remaining direct link. The railway is disused for most of its length. The northern connection towards Russia, Georgia and Turkey across Armenian territory is severed, as is its eastern connection to Baku. A small portion is still used for an internal rail connection with Ordubad, a few kilometres from Armenian-controlled Meghri. The southern connection towards Iran is also operational.

The impact of the blockade is all the more pronounced because the Soviet-built infrastructure for energy delivery passed through Armenia, which has since interrupted gas and electricity supplies to Nakhitchevan. The collapse of the Soviet Union and closure of the Armenian border condemned the enclave to a total isolation that also included the loss of its export markets.

Nakhitchevan traditionally specialised in viticulture with annual production of 170,000 tonnes and 17 wineries. The closure of the Armenian border devastated the sector and large areas of vines have been uprooted. Exports to Turkey were impossible due to the state monopoly on alcoholic drinks and

exports to Iran were, of course, ruled out. All industrial production has stopped. The sheer size of the factories built in Soviet times made them obsolete since they had been designed to export to 20 countries, while the textile factory alone had the capacity to produce for all Turkey.

7.1 LINKS WITH TURKEY

The opening of the border post with Turkey provides an exit to the west which is vitally important for such an isolated territory. The 10km border between Turkey and Azerbaijan had been closed since 1921 and the separation was so intense that the population of Nakhitchevan was unaware that their neighbours across the frontier spoke nearly the same language. The Dilucu border gate, commonly known as Hasret Kapisi, opened in May 1992 and a bridge built over the River Araxe link Turkey to Nakhitchevan.

Nakhitchevan has to depend on Turkey and Iran as a result of the Armenian blockade and the interruption of all land communication with Azerbaijan. The links with Iran are commercial by nature, but those with Turkey are different by scope and nature. The enclave's economy has been entirely restructured with Turkish aid.

The power plant on the River Araxe has a capacity of 15mw but fails to meet the needs of the population. Electricity consumption per capita is very high, as in the rest of Azerbaijan. Since the interruption of gas supplies, the heating system depends on electricity. The enclave imports power from Iran under an arrangement whereby Azerbaijan compensates it with the same amount of electricity it exports to Nakhitchevan. Electricity delivered from Turkey is a de facto gift since the prospects of Nakhitchevan ever paying the \$110.8 million it owed in 2002 are very dim.

In winter, power is cut every two to four hours. Winters are very rigorous with temperatures falling to -25°C. Since few buildings have generators and the city lacks lights, most activity stops at nightfall. The electrical pylons along the road from Sadarax to Dilucu show how vital this link with Turkey is, but the border city of İğdir also suffers from its own power shortages.

Turkey has supported sugar production in Nakhitchevan with the goal of replacing one agricultural crop, grapes, with another. Seed and equipment are provided by Turkey which also pays for the crop to be transported to İğdir for processing. The volume of production is fixed by agreement at 94,000 tonnes. Since self-sufficiency has been reached, the need to find export markets has emerged.

Turkish financial aid to the Nakhitchevan University amounts to \$500,000. Some 3,000 Turkish students are at the university at an annual expense estimated at \$600,000.

Turkey supports the armed forces of Nakhitchevan with medical aid, food and clothing for 11,000 soldiers and the services of 23 Turkish officers. Turkish aid excludes weapons and ammunition.

Though Turkish relief plays an important role in sustaining the enclave, its economic impact is limited compared to the effect of the border trade in oil products with the Turkish province of Iğdır, which shapes the political economy of Nakhitchevan.

7.2 BORDER TRADE IN OIL PRODUCTS

Under a government decree passed in December 1992, the province of Iğdır was permitted to conduct border trade with Nakhitchevan. A second decree aiming at promoting economic relations with CIS countries allows the border provinces to import petroleum products within the framework of the border trade. The prefecture is responsible for regulating the trade.

The oil trade is conducted under licences from the prefectures of Iğdır and Nakhitchevan with the number issued dependant on the quantity of petroleum products transported. In Iğdır, licences are issued to vehicles, while the Nakhitchevani authorities grant them to individuals who are free to sell them on. Iğdır issues different licences for vehicles of four and eight tonnes; in Nakhitchevan, Russian, 3-4 tonne vehicles are most often used.

The quantity of oil imported in Turkey fell from a monthly average of 30,000 tonnes from 1997–98 to around 15,000 tonnes from 1999 onwards, due to further regulation by the prefecture. The lack of supervision at Dilucu – which did not have even a weighing scale – explains the huge quantities imported.

It is mistakenly assumed that the oil transported originates in Iran, but it is actually transported on Iranian trucks through Iran from Azerbaijan. Formerly, oil was unloaded at the Iranian port of Enzali but, by using Iranian trucks, exporters avoid paying the \$360 transit tax.

The oil trade is the most important source of income for large populations on both sides of the border. In Turkey, which initially issued 2,800 licences, each vehicle went to Nakhitchevan every 17 days, earning around \$400 profit. As the number of licences increased to 5,845, the frequency of trips was limited to one every three months, with a profit per vehicle of \$900-1,000. The 34-hour waiting time at the border was no great disincentive.

In Nakhitchevan, the sale of export licence at \$500 each provides an income sufficient for six months. Drivers earned \$50 per trip to Turkey. The concentration of licences in the hands of a very few has shaped the political and economic structure of the enclave. The rent generated by the border trade led to the making of several fortunes as well, with the consequence that the head of customs at Sadarax is considered one of Nakhitchevan's wealthiest figures.

In Turkey, the trade in oil stimulated Iğdır's rapid growth with cash flow estimated at around \$1.5 million per week. The high concentration of foreign exchange offices and hotels is quite impressive. Iğdır's mayor, who also owns the city's only transportation company, Iğdır Turizm, is the most important player in the oil border trade.

By boosting demand in Nakhitchevan, the oil trade created further bilateral exchanges. In 2001, exports from Iğdır to Nakhitchevan amounted to \$13.5 million, while imports from the enclave stood at \$1.6 million.

The decision to end the border oil trade was taken in July 2002 by a coalition government and implemented on 1 September. The main justification was the budgetary burden. In August, Nakhitchevani oil was selling at TL930,000 (\$1.89) a litre while the Turkish price was TL1,308,000 (\$2.67). Nothing prevented Nakhitchevani products from being sold in other Turkish towns. People interviewed in Iğdır and Nakhitchevan pointed to the curious coincidence of the decision to ban the border oil trade with the privatisation of the oil distribution company, Petrol Ofisi, subsequently purchased by the influential Doğan Group.

The ban is considered highly unfair by people in Iğdır whose incomes were suddenly subject to border taxes of TL631 million (\$129) per four-tonne vehicle. Turkish drivers had to pay a further \$650 on entering Turkish territory and then a tax of \$850. Meanwhile, by December 2002, 134 persons were under surveillance and a further 84 incarcerated due to investigations into illegal oil importing from Nakhitchevan.

The interruption of the border oil trade affected 300,000 Turkish people and 40,000 in Nakhitchevan. Prior to the crackdown, 1,000 vehicles entered Nakhitchevan every day, and 400 crossed to Turkey. By early 2003, the number of border crossings had fallen to 1,000 vehicles a month.

The border post at Culfa, 40km south of Nakhitchevan, opens to Iran, but trade is tepid with scarcely 150 people crossing daily. There is some shuttle trading, however. Under current legislation, Iranians are allowed to bring in products with a total value of \$80 each year, a ceiling reduced from \$300. Economic activity is centred in Culfa's free trade zone where there is a large number of small shops selling textiles, electronics and consumer goods, mostly from Turkey and the United Arab Emirates (UAE). Iranian nationals cross the border on foot, buy a few products and immediately return home. Trade is mainly conducted by old women whose sole qualification is the possession of an Iranian passport. The end of the oil trade drastically reduced Nakhitchevani purchasing power, so now the Turkish goods once purchased for consumption in the enclave are re-exported to Iran.

BOX 3. REACTIONS FROM NAKHITCHEVAN TO THE ENDING OF THE BORDER OIL TRADE

- The decision was unfair and unjustified. The regional authorities, as well as individuals involved in the trade, roundly condemn the government's decision which they characterise as a 'betrayal'.
- 'We miss former president Demirel, who said the Iğdır governor was also governor of Nakhitchevan and that Nakhitchevan was under Turkish protection.'

- ‘Turkey acts as if the Dilucu border post were a gate with Greece or Syria. At Dilucu, we are treated worse than the Armenians would do.’
- Turkish support was intended to help Nakhitchevan to resist Armenia.
- The ‘Gate of Hope’, as Dilucu is known, was opened to support the people of Nakhitchevan in the face of Armenian attempts to drive them away.

For many interviewees, the ban on the oil border trade is perceived as an official closure of the border.

- The opening of the Turkish-Armenian border, instead of harming Azerbaijan as it is often charged, is more likely to be the first step towards political settlement and the normalisation of relations in the region. Turkey and Armenia do not require any peace agreement since the two countries have not been at war, but Armenia and Azerbaijan do, and the opening of the border can trigger a new momentum in the search for a political settlement.
- The best way to access the Caspian is across Nakhitchevan, a province that has been under severe blockade. In the 19th century, Culfa was an important communication hub of the Russian empire as it is located at the intersection of the north-south and east-west connections. Armenia-Nakhitchevan, which straddles the east-west and north-west connections, also forms a unique logistical and economic hub for the region.
- The integration of the Kars-Gyumri rail link and the railway system of South Caucasus will add a Turkish dimension to the search for a political settlement of the NK conflict. The opening of the Turkish-Armenian border can prepare the ground for the political agreement needed to open the east-west and north-south transit routes that run through Nakhitchevan.

8. PROSPECTS FOR SUB-REGIONAL INTEGRATION: TURKEY, CAUCASUS AND SOUTHERN RUSSIA

8.1 THE TURKEY-CAUCASUS CONNECTION

The collapse of the Soviet empire had an important impact on Turkey’s relations with her close neighbours. The former Turkish-Soviet border, once NATO’s eastern frontline and a source of threat, had never been hermetically sealed but crossborder interactions were at a very low level. The rail connection between Kars and Gyumri ensured continued land communication between Turkey and

the USSR. Turks, nevertheless, lost contact with their ethnic neighbours who, as recently as 1991, they still considered 'Russian'.

The diversification of external relations by the new states of the South Caucasus allowed them to emancipate themselves from the Soviet space, and their new contact with Turkey reduced their dependency on the north. Access to the west offered new centres of economic attraction leading to a change of course and moderate, free-market reforms.

However, the new, east-west link between Turkey and South Caucasus is not fully operational and, paradoxically, Turkey's eastern border is still sealed in parts. The main east-west transport corridor is the land connection between Turkey and Georgia, with its major hubs on the Turkish Black Sea coast and the Autonomous Republic of Adjara.

Case studies of Turkish-Azerbaijani and Turkish-Armenian economic relations highlight the inefficiency of existing connections via Georgia and the cost of closing the Turkish-Armenian border. The reshaping of Georgia's external trade links after the opening of the Sarpi/Batumi border crossing is noteworthy, but the fact that the opening occurred in the context of a severe breakdown of north-south connections generates a serious bias.

Armenia is Turkey's gateway to both the Caucasus and Central Asia, and re-opening the Turkish-Armenian border is of the utmost importance for the development of Armenia's external trade relations. Furthermore, land communication with the Caucasus will transform Anatolia into a crossroads of north-south and east-west trade. The strengthening of transport through the Caucasus will also boost the integration of production and marketing networks, and lead to the implementation of projects that encompass the entire Caspian region. For the time being, communications between Turkey and Azerbaijan cannot transit through South Caucasus because one of the roads is blocked and the route through Georgia is not attractive. The Iranian option remains the most cost-effective.

Neither Turkey nor Azerbaijan can play a central role in developing east-west connections, although an Anatolia-Caucasus-Caspian trade route would foster Turkish-Azerbaijani trade links and strengthen the potential of transit countries. Nakhitchevan's predicament reveals how hard it is to consider an east-west connection through Georgia to Azerbaijan. Nakhitchevan, once at the intersection of east-west and north-south trade in the Russian Empire, now leads to a dead end. The enclave leans on Turkey for survival and has become a centre for smuggling to Iran.

Paradoxically, the opening of the Caucasus to Turkey sparked competition with the region's northern connections to Russia, and bipolar thinking, the legacy of the cold war, continues to be applicable to the region. But the tensions have not so much involved Russia and Turkey as the countries situated between them. South Caucasus, where both have important interests, has been doomed to repeat its history as a grey area for Russo-Turkish competition.

So far, the confrontation has been mainly based on perceptions rather than deeds. For Turkey, Russia continues to be a power driven by a dynamic of territorial expansion. The Russian Federation appears to be trying to reverse its withdrawal from its former outposts and borders in a bid to reconstitute itself as a new power centre. While Federation policies and covert actions effectively ended the prospect of Turkey sharing an official land border with Russia, it remains a 'virtual' neighbour along the same borders defined by the 1921 treaty of friendship.

In this regard, the sealed Turkish-Armenian border is also the frontline between Turkish and Russian interests, and Nakhitchevan the place where the two came closest to the brink of war. Turkish troops were on alert and Russia resorted to explicit nuclear intimidation to deter Turkey from intervening to help Azerbaijani forces repel the Armenians.

Seen from Russia, Turkey is one of the main beneficiaries of the Soviet collapse, a rival out to cherrypick pieces of its former realm. Most fears concentrate on Turkish policies in the Caucasus which are considered likely to contribute to a break-up of the Federation's territorial integrity.

Turkey's position at the forefront of regional polarisation gave birth to the 'new-old' divisions and exacerbated the confrontational discourse and stance. Turkey, in its alliance with Ukraine, Azerbaijan and Georgia, was seen as pitted against Russia and Armenia. In addition, Turkey's closure of the Black Sea straits to large oil tankers and its endeavour to construct pipelines from the Caspian that bypass Russia are seen as clear signals that Russia is being rolled back. This leaves it only with Armenia, which does not share a border with Russia, but relies on it for its own security.

As strange as it may seem, however, bilateral economic relations have been steadily developing on a parallel track.

8.2 TURKISH-RUSSIAN COOPERATION: TOWARDS INTERDEPENDENCE

Turks and Russians have never had such amicable contacts, never intermingled and cooperated so closely, and for so much mutual economic advantages, as in the last six years. 'Russia still wants to reach the warm waters of the Mediterranean through Turkey,' Mikhail Gorbachev said in a speech in Ankara, 'but with Russian tourists.' Business communities in both countries have been crucial in this transformation of relations: business leaders knew that mutual interdependence, woven by trade, would eliminate many of the remaining traces of enmity.

Russian shuttle traders have turned Istanbul into a major hub of their commercial operations, whose volumes now rival official commercial turnover between the two countries. Antalya and other resorts on the Turkish Mediterranean have replaced the Crimea as the favourite vacation address for those Russians who can afford to go on holiday. Turkish construction workers,

meanwhile, have given a new look to Moscow by building dazzling business headquarters for Russia's new rich, or rebuilding such seats of political power as the State Duma and the White House.

Turkey is Russia's second largest trade partner after Germany. Economic exchange, foreign trade (both official and unofficial), tourism, the retail business and construction by the Turkish business community sustained peak levels in the mid-1990s with trade volumes rising from \$500 million in 1986 to \$4 billion in 1997. Mutual trade reached \$8-10 billion annually until Russia's financial crash in August 1998. Official trade accounted for \$3.5 billion of this amount in 1998, with Turkish exports to Russia worth \$1.35 billion and imports of \$2.15 billion. The balance was made up of the unofficial 'shuttle trade', estimated at reaching a peak of \$6-10 billion annually from 1991-96. It began a downward spiral even before the 1998 financial crisis, after which Turkish trade with Russia drastically declined.

According to the Turkish-Russian Business Council, Russian exports reached \$3 billion in the year 2000, while Turkish exports fell to \$600 million. A similar gloom enveloped Turkish construction activity whose value fell from \$5.5 billion in 1998 to \$100-150 million in 2000.

Russia is Turkey's single largest supplier of natural gas which has been the biggest single item in Turkish-Russian trade since 1987, when Russia first began deliveries. Russia is scheduled to deliver 14 billion cubic metres (bcm) of gas annually to Turkey. The Blue Stream project, negotiated in December 1997, will increase the annual amount to 30bcm by 2010. The Russian media estimate that total earnings from natural gas exports to Turkey will reach at least \$7 billion annually by 2020.

In terms of energy security, Turkey's dependence on Russian gas supplies is more critical and will increase significantly in several years. Unlike oil, which Turkey has no difficulty in acquiring, the country is entirely dependent on imports to meet domestic demand for natural gas. Turkey signed its first gas agreement with the Soviet Union in 1986 when domestic consumption was close to 500 million cubic metres; by 2002, it had reached 19bcm. Demand is expected to reach 55.1bcm in 2010 and 87.9bcm in 2020.³⁷ Some 23% of electricity production is from natural gas, a share expected to grow to 30% by 2010.³⁸ Turkey has signed six gas agreements,³⁹ three with the Russian Federation which supplies 14bcm annually through the Balkans and a further 16bcm planned through the Blue Stream.⁴⁰

Prime Minister Viktor Chernomyrdin's visit to Turkey on 16-17 December 1997 was the first by a Russian head of state in the post-Soviet period. Its purpose was to close a huge natural gas deal, dubbed Blue Stream. Turkish Prime Minister Mesut Yılmaz expressed the government's desire to cooperate, rather than compete, with its neighbour and Chernomyrdin declared: 'If Turkey shakes the hand extended by Russia, we shall become strategic partners in the economy in the 21st century... We shall be able to do much together in third countries and contribute to the assurance

of stability and tranquillity in the region.’ The \$30 billion project envisages Russia supplying 16bcm of gas a year to Turkey by 2010 through underwater pipelines across the Black Sea.⁴¹ The 1,200km pipeline will run from Izobilnoye to Arkhip-Osipovka in Krasnodar region, underwater to the Durusu terminal near Samsun and overland to Ankara. The Blue Stream project was finalised in a very short time. A memorandum was signed between Russia’s Gazprom and the Italian construction company ENI in February 1999, construction began in September 2001 and the work was completed in June 2002. Gas supply started in February 2003.

The Blue Stream tightly links Turkey and Russia under the Black Sea and the emphasis has been on the project’s bilateral nature which excludes any intermediary countries. Meanwhile, the Caucasus is increasingly seen as a crossing zone between the two countries.

8.3 PROSPECTS FOR FURTHER INTEGRATION BETWEEN TURKEY, CAUCASUS AND SOUTHERN RUSSIA

Russia’s economic, and particularly private, interests may be leaning towards compromise as economic interests achieve precedence over political ones. The softening of Russia’s opposition to the BTC pipeline project may be testimony to the growing success of pragmatically oriented Russian business interests in the Caspian-Caucasus zone.⁴²

- In 2002, Lukoil officials voiced interest in the BTC project which it was considering joining with a 7.5% share. The Russian government sent conflicting signals about letting it take part, but the Kremlin’s ultimate influence over Lukoil is a matter of debate.
- An agreement was signed on 27 April 2002 between Rosnestgazstroy, the Russian pipeline construction firm, and the Georgia International Oil Corporation (GIOC) in Tbilisi. Russia now plans to send its own oil through the Tengiz-Novorossisk line to the BTC, via a pipeline that has yet to be built.
- In May 2002, Russia signed an agreement to transport some oil through a pipeline connecting its main export terminal, Novorossisk, with BTC, to reduce tanker traffic in the Bosphorus.⁴³

Parallel with the above improvements in Russian policies towards the BTC pipeline, Russia has also shown its willingness to engage Turkey in north-south energy projects in the Caucasus. In October 2000, Russian Prime Minister Mikhail Kasyanov on a visit to Turkey proposed to raise bilateral relations to the level of a strategic partnership. Russia offered to sell more electricity to Turkey through a tripartite scheme involving Georgia and, more recently, the Russian company RAO-EEC⁴⁴ is ready to export electricity to eastern Anatolia from the Georgian power plant at Inguri. Russia, a major supplier of power in the South Caucasus, is planning to set up a unified energy system in the region, and export

towards Turkey. Georgia is where Russia and Turkey meet and its central position in north-south links has also been acknowledged.

As a buffer zone, Georgia has suffered acutely from tensions in the region. On the one hand, it is a transit country enabling east-west connection but, on the other hand, it is a major impediment on the north-south route. As a consequence, it is a focus of regional tension and the object of Russian ire since Georgia is seen as a useful tool to roll back Russia's influence from Transcaucasus, the Caspian region and Central Asia.

Georgia ensures Turkey's land communication with the Transcaucasus and Central Asia, Sarp/Batumi being the access gate. The link is vital for Georgia, since access to Turkey has enabled it to reshape its external relations. Relations with Adjara are also important because it controls Batumi port.

The search to circumvent Adjara and create more reliable communication links between Georgia and Turkey has brought to prominence the opening of a third border post at Çıldır-Aktaş. Preparations are complete in Turkey, and Georgia has asked for financial support to create the facilities required for opening the crossing. The second border post at Türkgözü can not easily be used in winter due to bad weather. The opening of the third gate will, moreover, shorten the distance to Azerbaijan by 140km.

While Turkey strives to strengthen transport links with Georgia, the long-standing Kars-Tbilisi railway project is also under consideration. The planned line will be 98km long, with 68km on Turkish territory and 30km across Georgia. This project faces serious challenges. Due to difficult weather conditions, the track is likely to be closed in winter. Feasibility studies have had a negative effect on international donors, who are vital to the scheme because Georgia cannot finance its share of the railway.

In this context, opening the Turkish-Armenian border would ensure a rail connection between Turkey and Georgia across Armenia, reduce the centrality of Sarp/Batumi and diffuse the tension concentrated on Tbilisi by creating a Turkish-Georgian connection within a north-south scheme.⁴⁵

Sochi is an important access gate to Southern Russia and 5,000 Turkish businesspeople are said to be based in the city. Trabzon has developed its relations with Sochi for over 10 years and the two have a twinning agreement and their chambers of commerce are sister organisations. A Turkish honorary consul will shortly be appointed and a Turkish business centre is under consideration. Turkish entrepreneurs have expressed a willingness to invest in the port's modernisation and they are considering building a port for Turkish freight. Turkish businesspeople around the Black Sea regard Rostov and Krasnodar regions as very promising business opportunities.

Although the Trabzon-Sochi maritime line is an important commercial route, Turkish entrepreneurs bitterly recall the time when they could reach Sochi by road through Batumi in six hours. The sea connection takes 12 hours. This

interruption of the north-south connection through Georgia has caused serious concern in the business community.

Besides not having road access to Sochi, the Turkish Black Sea coast once had close trade links with Suchumi, and Turkish businesspeople were major suppliers of Abkhazia. Although these links created concern in Tbilisi, Turkish ships continued to supply Suchumi from Trabzon in defiance of a Georgian maritime blockade. Under article 6 of the CIS Summit declaration of 19 January 1996, Abkhazia is officially under a trade embargo.⁴⁶ Trade between Trabzon and Suchumi declined at the end of the 1990s after Georgia tightened its maritime patrols, but the interception and confiscation of Turkish vessels by the Georgian coast guard have caused serious trouble in bilateral relations.⁴⁷

9. CONCLUSION

Trade links between Turkey and the South Caucasus are shaped by existing conflicts that have impacted severely on logistics in the region. The Caucasus, once a hub of communications, became a cul-de-sac with the breakdown of traditional transportation routes. The restoration of transport links has the potential to mitigate tensions. In this regard, it is essential to deal at once with the east-west and north-south connections that link Turkey to the regional network. Broadly speaking, the Turkish-Armenian route is the most efficient east-west connection, while the Turkish-Georgian route is the most efficient north-south link. Armenia also provides the best access to Azerbaijan, and Georgia the best access to southern Russia.

The fear of economic domination is widespread, economics being perceived as leverage to achieve political goals. Foreign investment is often associated with ownership, control and territorial gain. There is a need to promote pragmatically-oriented approaches based on self-interest and business initiative, and to stress the importance of competition, rather than confrontation and domination. The Turkish private sector has an important role to play.

Borders are lines, walls, barriers or hedges that designate the limits of a given property or domain. By their nature, they divide and exclude. More often than not they follow lines of past confrontation, indicating an earlier military balance or stalemate, and they are viewed as changing only after conquest or expansion. But it is also possible to view borders as links between countries through economic or human exchanges. Cross-border cooperation provides the tool. Cross-border regionalism has flourished in the past two decades, beginning in the heartlands along the western border of Germany, but taking new steps in the 1990s when, in response to the opening of the Iron Curtain, new 'Euro-regions' were established from the Finno-Russian border to Austria, Slovakia, Hungary and Slovenia.⁴⁸

The future of a region depends on its re-orientation away from regional polarisation. There is a pressing need to transfer the unique economic cooperation between Russia and Turkey – a cooperation that verges on interdependence - to the Transcaucasus. In this regard, the Turkish-Armenian border, which is a frontline separating conflicting interests, must become an area of communication and close cooperation. In the mid-term, strengthening connections between the Caucasus and Turkey by enhancing cross-border cooperation will anchor its states to Turkey and foster a sub-regional integration involving southern Russia. The opening-up of economies and diversification of external connections is more likely to create a momentum for regional integration than to increase centrifugal dynamics. The strategies of opening-up are the most efficient way to break the rent-generating trade patterns shaped by blockade and embargo. By redefining and broadening the region, internal oppositions will be mitigated.

In this regard, the economic dimension of the political settlement of conflicts should not be underestimated. Border openings and the establishment of official trade relations carry the potential to foster new dynamics to defreeze conflicts by questioning the status quo, rather than recognise the facts on the ground and exacerbate centrifugal forces. The very fact that, in most cases, borders remain frontlines emphasises the need for peace agreements.

What is of utmost importance is that political settlement should not be a precondition for establishing economic relations. Economic interactions are a tool for reaching political agreement because they provide common ground for establishing a first level of trust and increased interdependence.

Endnotes

- ¹ The 7,056km Iron Curtain ran from the Kora peninsula to Mount Ararat, crossing the Baltic, the heart of the European continent, the Black Sea, and the borders of Turkey, the Soviet Caucasus and Iran.
- ² Dumont, P. (1977) 'L'axe Moscou-Ankara : les relations turco-soviétiques de 1919 à 1922', *Cahiers du Monde Russe et Soviétique*, 18-(3).
- ³ Hovannisian, R.G. (1973) 'Armenia and the Caucasus in the Genesis of the Soviet-Turkish Entente', *International Journal of Middle East Studies*, 4.
- ⁴ The Treaty of Alexandropol was signed on 3 December 1920 between Turkey and Armenia. The boundaries set by the treaty turned out to be the permanent Soviet-Turkish border, as well as the borders between Turkey and the three Transcaucasian republics.
- ⁵ Hovannisian, R.G. (1996) *The Republic of Armenia vol. IV Between Crescent and Sickle: Partition and Sovietization*, (Berkeley, USA: University of California Press, 1996).
- ⁶ The village is called Sarp by Turks and Sarpi by Georgians.
- ⁷ The claim was tantamount to a demand for naval and air bases in the area. In reaction, Turkey joined NATO in February 1952.
- ⁸ The Soviet Union renounced its claims on Turkey in the note of July 1953, signed by the former foreign minister, V.M. Molotov. 'In the name of preserving and strengthening peace and security,' it read, 'the governments of Georgia and Armenia have found it possible to renounce their territorial claims on Turkey.' Molotov's note ends with the words 'the Russian government has no territorial claims on Turkey.'
- ⁹ 'Border city' in Turkish.
- ¹⁰ For instance, Georgian exports to Turkey amounted to \$53.6 million in 2002 according to Georgian official statistics, whereas \$137.5 million of Turkish imports from Georgia were reported by the State Institute of Statistics of Turkey (SIS). Georgian exports to Turkey in 2001 amounted to \$68.7 million according to the Georgian statistics, while the SIS registered \$127.2 million. Among the main reasons for the discrepancies are the use of double invoices to avoid high taxation at customs, and the fact that Turkish trade with Armenia transits mainly through Georgia, and thus is registered by Turkey as trade with Georgia.
- ¹¹ The overwhelming importance of oil products in Azerbaijani's trade since 2000 has modified the geographical destination of exports. The main importers of crude oil from Azerbaijan are EU countries and Israel.
- ¹² 'Market of Malatya'. Malatya is a Turkish city in Anatolia.
- ¹³ A person who comes from the Black Sea region. 'Karadeniz' means the Black Sea in Turkish.
- ¹⁴ 'I was told that there were no Turks in Armenia and I never hesitated to go there,' said one of the merchants interviewed.
- ¹⁵ 'There was a tendency, at one time, to deliver very poor merchandise, products that were impossible to sell in the Turkish market.'

- ¹⁶ ‘The more we lose, the more we continue,’ said one merchant. ‘It is impossible to give up!’
- ¹⁷ The companies also transport merchandise.
- ¹⁸ Iran is not a frequent destination since visa fees increased to \$150.
- ¹⁹ For more information see www.tabdc.org.
- ²⁰ Statement by President Ahmet Necdet Sezer of Turkey, 1 October 2003, Anadolu Agency.
- ²¹ *Milliyet*, 9 September 1997. In a column, entitled ‘Brotherhood, of course, but ...’ Sami Kohen explains that ‘from the Turkish perspective, the need to take into account the sensitivity of Baku and to accept its Caucasus policy ... are not only a matter of solidarity based on brotherhood, but also a necessity in terms of interests... The increasing importance of Caspian oil will ensure major gains for Turkey in the production and transit transportation; in this context Turkey cannot take the risk of turning its back on Azerbaijan.’
- ²² Because of the need to restore relations with Turkey, Aliyev’s government afterwards confirmed its acceptance of the March 1993 agreement, though the question of the route between Turkey and Azerbaijan remained unsettled.
- ²³ Shoumikhin, A. (1999) ‘Russia: Developing Cooperation on the Caspian’ in M. P. Croissant and B. Aras, (eds) (1999) *Oil and Geopolitics in the Caspian Sea Region* (Westport, USA: Praeger).
- ²⁴ Address by Armenian Foreign Minister Vartan Oskanian at a conference by the Turkish Economic and Social Studies Foundation, held in Istanbul on 26 June 2002: ‘It is evident that we are not as fragile as some would wish us to be. On the contrary. Certain hardships can harden the resolve of people who are unfairly besieged. And we are no exception. It is not too soon for our neighbours to realize that the last decade’s politics of pressure, discrimination and blockades have not achieved their intended goals. Instead, they may have added to our determination to solidify and strengthen relations with those of our neighbours who value our friendship and share with us common interests both bilaterally and in the region.’
- ²⁵ Tavitian, N. and B. Gültekin ‘Les Relations Arméno-Turques: la Porte Close de l’Orient’, *Les Rapports du GRIP*, Brussels, 2003/1.
- ²⁶ Caspian News Agency, 21 July 2003. When asked by the press about the possible negative consequences for the Armenian economy if the border with Turkey were to open, Armenia’s Foreign Minister, Vartan Oskanian, replied: ‘I do not suppose that the possible lifting of the blockade from the Armenian-Turkish border will have any negative consequences for our country’s economy, such global problems need a broad approach. I am absolutely sure that the opening of the border is beneficial not only to the two countries, but also to the region as a whole. Certainly, I suppose that negative nuances may come up in individual spheres. But in the end, it is only beneficial. It is good because the republic will gain access to the Turkish market, and then to the Arab market through Turkey. For example, the railway that starts from the Armenian border and goes through Turkish territory as far as the Syrian port of Latakia is not functioning at the moment. But if it starts functioning, Armenian commerce may receive high dividends.’
- ²⁷ Mediamax News Agency, 6 October 2003.
- ²⁸ Arminfo, 4 August 2003.
- ²⁹ This region represents 9% of Turkey’s GDP. The Turkish road network would allow Armenian producers to reach the Turkish market quickly.

- ³⁰ Beilock, R. 'Armenia's Economic Dead End,' Working Paper, University of Florida <http://bear.cba.ufl.edu/centers/ciber/workingpapers/armenia1.pdf>
- ³¹ *Azg Daily*, 18 September 2003.
- ³² İstanbul Ticaret Odası.
- ³³ Türkiye Sanayiciler ve İşadamları Derneği.
- ³⁴ İhracatçılar Birlikleri.
- ³⁵ Our conclusions are based essentially on the interviews in Trabzon.
- ³⁶ Data from the prefecture of Iğdır reveal that about 100,000 Azerbaijanis from Nakhitchevan were visiting Iğdır every day in the second half of the 1990s.
- ³⁷ Botas, Turkey's natural gas demand forecast.
- ³⁸ The increased rate is more important than the average rate for OECD countries: 30% of electricity will originate from natural gas by 2020.
- ³⁹ Turkey has signed agreements with Russia, Iran (10 bcm), Algeria (4 bcm) and Nigeria (1.2 bcm).
- ⁴⁰ The first Blue Stream pipeline was completed on 1 March 2002.
- ⁴¹ Sales to Turkey will represent 15% of Russia's natural gas exports.
- ⁴² 'The oil business ignores Russian government attempts to pressure her southern neighbours into submission, particularly by declaring former Soviet Islamic republics the zone of her special interests...they are much more interested in getting their share before the final division of the Caspian riches takes place. Consequently, they have much more respect for the national ambitions of the "Near Abroad" states.' Russian analyst Yakov Pappe, *Segodnya*, 15 August 1995, in Shoumikhin, op.cit.
- ⁴³ *Turkish Daily News*, 28 May 2002.
- ⁴⁴ The RAO-EEC company is also planning to build a new power plant in Turkey near the city of Denizli.
- ⁴⁵ In this regard, the new Georgian President, M. Saakashvili, said before his visit to Turkey: 'Georgia is ready to assist in normalising Turkish-Armenian relations.' Mediamax, 12 March 2004.
- ⁴⁶ 'Abkhazia is an undivided part of Georgia. The Member Countries of Community without the permission of the Government of Georgia:
- a. will not carry out any trade - economic, financial, transport and other operations with the so-called Government of Abkhazia;
 - b. will not contact representatives of the existing structures and officials, also the members of its armed unit.'
- ⁴⁷ According to Georgian sources, about 40 ships, most flying the Turkish flag, transported commodities and passengers to Abkhaz ports between 1999-2003. Two Turkish fishing companies, Kiyak Kardeşler and Konew Ltd., have agreements with Abkhazia's Ministry of Economics. Ships intercepted include *Mithat Ereğli* arrested for transporting wood; *Bezat Kaptan*, detained for fishing; Gustem Oğlu, for fishing; Abal Balıkcılık, for fishing and transporting passengers; *Şakir Reis-2*, for fishing; *Yıldızlı*, for transporting coal from Abkhazia; *Şakir-Baba-3* and *Selim-1*, both confiscated for illegal fishing, and both sold at auction.

⁴⁸ Cross-border regionalism seemed to develop in the German-Czech borderlands despite the fraught negotiations between Germany and the Czech Republic on coming to a final agreement about the property of, and compensation for, the Sudeten Germans. The accord of January 1997 took nearly a year to be fully implemented, but it is generally seen as opening up new opportunities for intensified cross-border regionalism.

CHAPTER TWO

The role of economic cooperation in the settlement of conflicts in the South Caucasus

AGHAVNI KARAKHANIAN AND ARTUSH MKRTCHYAN

1. INTRODUCTION

The continuing changes in the political composition of the world triggered by the collapse of the Soviet Union and the formation of new independent states on its territory have created a radically new situation in the world as a whole, and the South Caucasus in particular. The geopolitical chessboard is no longer two-sided.

The South Caucasus is a complex social and cultural mosaic, a region populated by ethnic communities with long historical ties but which strive to preserve their cultural uniqueness. Ethnic and historical factors are no more to blame for conflict in the South Caucasus than any of its individual republics or unrecognised states: the concept of shared responsibility is more fitting. A significant amount of the responsibility can be attributed to politicians and national leaders. Average citizens can be blamed insofar as they have broken the law or the moral norms of society. External actors with their own interests also played no small part.

It can be unequivocally stated that conflict in the region is complex in character, with both internal and external causes. That not a single one of these conflicts has been pre-programmed, either by history or human nature, is equally important. Settlement of the region's conflicts will not, and cannot, follow a uniform scenario. However, the basic principles of conflict transformation, especially the primacy of the security and well-being of people in all the region's political-territorial entities, should be inviolable.

The political rhetoric of South Caucasian countries in their respective 'velvet' or armed struggles for independence (though not recognised, Karabakh fought to secure its independence) formed a psychological amalgam of past humiliation and present supremacy that has led to a general weakening of loyalty and tolerance among all nations participating in the political processes in the region – and not

only among them. In most cases, prescriptions on integration within the post-Soviet space, and the improvements it could bring, have turned out to be less persuasive than the radical variants of ethnic sovereignty that the conflicts brought to birth.

Settling the region's many conflicts is a much discussed issue, and search for modalities for resolving them has theoretical, practical and political significance. This is especially clear when trends toward regional integration and economic cooperation, instituted by bilateral and multilateral partners, collide with the suspended nature of conflicts whose insurmountable nature only makes their resolution that more urgent. At the forefront of any plan, therefore, is the problem of correlating the sense of integration through economic cooperation with political realities that are anchored in the intractable nationalisms tied to the surfeit of conflicts in the region.

2. THE KARABAKH CONFLICT AND ARMENIAN-TURKISH RELATIONS: HISTORICAL AND POLITICAL CONTEXT

The Karabakh conflict is the region's most notorious conflict, constantly appearing on the agendas of the UN, the European Parliament, the Council of Europe, the European Union, NATO and the OSCE.

The Karabakh problem can be viewed within a dizzying number of contexts, including the collapse of the Russian empire, the formation of the USSR, the ethnic framework of the South Caucasus, the history of the Armenian people and contemporary international relations.

In terms of 20th century political processes, the Karabakh conflict began in 1918 with the formation of nation-states in the eastern Transcaucasus after the enfeeblement of the Ottoman empire, the collapse of the Russian empire and the Russian Revolution of 1917. As a result, two administrative units were formed – NK and the Baku Commune.

After the overthrow of the communist government in Baku, the proclamation of the Azerbaijani Democratic Republic (ADR) and subsequent activation of Turkish aspirations to intervene in altercations between Armenians and Azerbaijanis, the Armenian population of NK came out against separation from Russia. In June 1918, the first congress of representatives of NK declared the region an integral part of the Republic of Armenia.¹

It was around this time that the term 'Karabakh conflict' came into use as a formula to describe the ethno-political disputes surrounding the formation of nation-states in the eastern Caucasus. Later, after the political and geographic focus of the issue shifted, the 'conflict' was transformed into the 'Karabakh question', followed by an embedded understanding in the term

‘NK’ and finally, after the collapse of the USSR, the ‘conflict in NK’. In November 1920, after the establishment of a Soviet government in Armenia, Azerbaijan recognised all disputed territories, including NK, as integral parts of Soviet Armenia. On 4 July 1921, the plenum of the Caucasus Office of the Russian Communist Party also decided in favour of Soviet Armenia. The following day, the decision was reversed and NK was included in the territories of Azerbaijan (by now also Soviet) on the understanding that an autonomous regional government with broad powers be formed. The borders of the new autonomous region enclosed only part of NK and large areas of the region remained subject to Azerbaijani rule. The NK Autonomous Region was made an enclave inside the Azerbaijan Soviet Socialist Republic (SSR).

Calls to review NK’s status were voiced on numerous occasions until the late 1980s when, following the declaration of *glasnost* in the USSR, the Armenians of Karabakh put forward a demand for unification with the Armenian SSR. A special session of the Soviet of People’s Deputies of the NK Autonomous Region appealed to the Supreme Soviets of the Armenia and Azerbaijan SSRs, as well as the USSR, to transfer the region from Azerbaijan to Armenia. There were massive demonstrations in NK and Armenia, and the Supreme Soviet of NK voted for separation from Azerbaijan. After an outbreak of violence and massive pogroms against Armenians in Baku and Sumgait, Russia declared martial law in NK and dispatched troops to Baku.²

In April 1991, Azerbaijani police and the Soviet military began large-scale punitive operations throughout NK. In October of the same year, the independence of the NK Republic was overwhelmingly endorsed in a referendum.

Azerbaijani forces launched their first military operations against NK in the same year. In March 1992, the NK Republic officially notified the UN Security Council of its right to self-defence against Azerbaijan’s military aggression. In this way, an internal administrative-legal conflict in the USSR between an autonomous region and a Union republic was transformed into an ethno-political conflict between the Armenian and Azeri nations in Azerbaijan.

Under the mediation of Russia, Kyrgyzstan and the Inter-Parliamentary Assembly of the CIS, the Republic of Azerbaijan, the NK Republic and the Republic of Armenia signed a protocol on 5 May 1994 in Kyrgyzstan known as the Bishkek Protocol. Agreement on a ceasefire was reached on 12 May.³ In the nine years that have passed since the ceasefire, the political, diplomatic and direct search for a settlement to the Karabakh conflict has not halted for a minute. The majority of external actors tie almost all large-scale economic projects in the South Caucasus, as well as the region as a whole, to the settlement of this conflict.

The NK conflict is augmented and made more complex by another component of regional character – the state of Armenian-Turkish relations. The lack of diplomatic relations between Armenia and Turkey, Turkey’s blockade of the joint border, historical enmity due to the 1915-23 genocide of Armenians in Ottoman Turkey and its unconditional support of Azerbaijan at the regional and international levels in relation to all questions related to the Karabakh conflict have had a highly negative effect on the already tense relations between Armenia and Turkey, and make their improvement directly dependent on settlement of the Karabakh conflict.

3. RESEARCH DESIGN

3.1 RESEARCH QUESTION

The main research question was whether the prospects for a peaceful mutually acceptable solution to the Karabakh conflict could be improved by repairing and institutionalising economic relations between Armenia and Turkey, followed by the integration of Azerbaijan and other countries in the region into this bilateral cooperation.

At root, the issue is whether or not – and, if so, to what degree – can joint business contacts and shared institutions contribute to the development and strengthening of bilateral relations between Armenia and Turkey. Related to those questions are others about the prospects for opening the border between the two countries and re-activating the Kars-Gyumri-Kazakh railway connection.

Traditionally Turkey has made the improvement of relations with Armenia directly dependent on resolving the Karabakh conflict. We propose to change this logic and explore whether the noted enlivening of economic relations between the two countries’ private entrepreneurs, largely dictated by pragmatism, could also have a beneficial influence on Armenian-Azerbaijani economic and trade relations, and, in the end, influence a settlement of the Karabakh conflict.

It is important to follow the links between economy and conflict both in the context of the involvement of the private sectors of Armenia and Turkey, but also in the broader regional context where practically all neighbours that share borders and lines of communication – Azerbaijan, Georgia, Iran and others – would be inclined to be involved in different region-wide projects. The main task consists in providing a prognosis of how much the realisation of the latter could spark further integration between countries of the South Caucasus, and if it could lead to the resolution of the Karabakh conflict and to the alleviation of conflict in the region as a whole.

This requires not only the most effective forms and structures of regional cooperative organisation and the identification of methods for forming them, but

also the detailing of mechanisms for the efficient functioning of organisations such as a regional development bank, regional agricultural market, regional chamber of commerce and industry, regional business forum, and so on.

In conducting their research, the authors were interested in the following questions:

- What does the regional element of economic development consist of?
- How, and to what degree, can regional initiatives and regional cooperation encourage bilateral relations and the settlement of conflicts?
- Can the South Caucasus constitute a unified, single, political and economic space?
- What would the possible creation and work of a continuously operating economic development institute offer states in the region?
- How would the economic activities of such a regional organisation influence the region's existing conflicts if it were truly multilateral in character?

3.2 RESEARCH OBJECTIVES

The authors viewed the purposes of their research as:

- To study the current situation in the spheres of business and trade, and describe possibilities for coordinated joint efforts in the area of economics, particularly trade between Armenia, Azerbaijan and Turkey.
- To depict how the economy of regional actors functions outside the framework of cooperation and delineate prospective plans for regional cooperation.
- To evaluate the overall costs and benefits of economic cooperation between Armenia and Turkey, and the participation they and their neighbours might have in the framework of regional structures in general; and to assess the opening of the Armenian-Turkish border and the Gyumri-Kars rail connection within this context.
- To evaluate the economic and political aspects of lifting the blockade of the Armenian-Turkish border; and to identify mechanisms to overcome contradictions between the economic and political dividends accruing from opening the border.
- To define areas of economic potential for all parties, detailing the mechanisms that lead to contradictions and present obstacles to bilateral and multilateral cooperation, but also to final settlement of the Karabakh and other regional conflicts.
- To assess the influence of cooperative and integrative projects on settlement of the conflicts; and to describe the circumstances under which regional institutions might deepen existing contradictions between countries, and which circumstances might contribute to conflict resolution and regional peace.

3.3 RESEARCH CONTEXT AND GEOGRAPHICAL FOCUS

Analysis is carried out in the contexts of:

- General characteristics of the Karabakh conflict and the historical and political peculiarities of Armenian-Turkish relations;
- The dynamic of the inter-regional and geopolitical situations;
- The influence of third parties in relations between Armenia and Azerbaijan, and Armenia and Turkey.

Geographically, the current paper covers the following cities in the border region surrounding northern Armenia:

- Gyumri and Yerevan in Armenia;
- Kars and Iğdır in Turkey;
- Sadakhlo and Marneuli (Azeri areas in Georgia);
- Akhalkalaki, Akhaltsikhe and Ninotsminda (Armenian areas in Georgia).

Border areas were chosen for the following reasons:

- Traditional residents of border regions demonstrate the most openness to contact and tolerance, and border regions are the best proving grounds for pilot projects and initial interstate relations.
- Because border regions are at the political and economic periphery, their inhabitants are personally interested in direct economic ties with those on the ‘other side’ of the border in order to fulfil their own business and consumer priorities.

3.4 METHODOLOGY

Work on the project was carried out in three phases:

1. Field research, surveys and analyses;
2. Theoretical-conceptual analysis;
3. Conclusions and recommendations.

In particular, the field research included the following components:

- Monitoring economic developments in the countries that are the focus of the current research;
- Study of the de facto trade and business relations between Armenia and Azerbaijan, and Armenia and Turkey;
- Surveying the following focus groups in the above mentioned areas:
 - > Owners of SMEs;

- > Representatives of municipalities and other associations;
- > Representatives of chambers of commerce, commercial markets and banks;
- > Representatives of customs control points (Vale, Georgia; Posov, Turkey; Sadakhlo, Georgia; and Bagradashen, Armenia);
- > Store owners (small traders and retailers);
- > Traders and representatives of medium-sized businesses;
- > Representatives of large business;
- > NGO representatives.

The interviews were conducted in the form of private conversations. This tool brings out as much information as possible on topics the respondent knows well and has personally experienced, without limiting the response. Focused interviews are considered along with the interviewer's observations, analysis of documents and other tactics so that preparation is made before the focused interview in order to formulate questions that draw out the *subjective* opinion of the respondent based on his or her personal experience of the subject. Considering the controversial nature of some of the topics discussed, both for respondents and the countries they represent, surveys were anonymous, without survey forms, and interviewees' names and places of employment were kept confidential. Those questioned represented a wide variety of backgrounds, including businesspeople and employees of state and private organisations. Efforts were made not to rely on the opinions of a specialised group, but to survey as wide a range as possible of people involved in state and/or private interaction in the border trade. The research set out to answer the questions listed in the research objectives outlined above.

The questions and topics included:

- What is your relationship to Armenian, Azerbaijani, Georgian and Turkish businesspeople?
- Do you have joint activities in Armenia, Azerbaijan, Georgia or Turkey?
- Do you have partners in Armenia, Azerbaijan, Georgia or Turkey?
- How would Armenian and Turkish businesspeople benefit from the opening of the Gyumri-Kars rail link? Why is this railroad not currently functional?
- What kind of joint structures are needed for coordinating and developing business?
- What influence would the legalisation of business between Turkey and Armenia have?
- What influence would the reactivation of business have on Armenian-Turkish problems?
- What do you think of the Forum of Provincial Cities of the South Caucasus, and other joint organisations?

4. RESULTS OF THE RESEARCH

4.1 TURKISH PERSPECTIVE ON BUSINESS RELATIONS WITH THE SOUTH CAUCASUS COUNTRIES

The majority of those questioned have no business activity in Armenia and Georgia. Individual representatives of business circles began in Azerbaijan, but only 3% of those questioned had started joint ventures.

Assessment of business relations with Georgia

The laws do not work; roads are poor to non-existent; law enforcement organs are corrupt; criminal chaos rules; there are no prospects for business; the country is made up of a poor lower class; many are not used to civilised methods of conducting business; and only primitive business laws are in effect. The country has commercial relations with Turkey, but only in small amounts. There are few examples of established businesses.

Assessment of business relations with Azerbaijan

A ‘big brother/little brother’ pattern of relations operates between Turkey and Azerbaijan. Small enterprises wanted to start businesses in Azerbaijan, but most initiatives were not crowned with success and were terminated. They failed because of the different mentality and legal system in Azerbaijan; the large amount of corruption; and the continuing clan system. Respondents listed a series of failed initiatives, but joint ventures do exist, and some work.

Assessment of business relations with Armenia

Relationships with Armenian businesspeople develop in conditions where there are no interstate relations, but they develop relatively intensively. Some members of the Chamber of Commerce of Antalya have businesses in Armenia. Turkish owners of businesses in Gyumri were identified, including the Prestige network of stores. The opening of the Gyumri-Kars railroad could serve as the basis for the intense development of this part of Turkey. Turkish businesspeople hope to enter the Russian and Iranian markets through Armenia and expressed no dissatisfaction with their Armenian partners. Armenian-Turkish businesses face a certain risk factor and other problems; a solution would greatly ease commercial relations between the two countries.

4.2 POTENTIAL IMPACT OF THE OPENING OF THE GYUMRI-KARS RAIL LINK

Armenia

The answers of those surveyed included diametrically opposed, and sometimes mutually exclusive, opinions:

- Opening the border will lead to growth in the volume of Armenian-Turkish commercial and industrial exchanges.
- Opening the border will lead to the legalisation of business between the two countries, bringing it out of the grey economy and into the legitimate economy.
- Opening the border will cause irreconcilable damage to Armenian producers selling local goods into the external market. It will encourage a competitive playing field while stimulating local production.
- Opening the border will lead to a significant decline in prices, reduce Armenia's technological difficulties and lower transport costs through Georgia.
- Opening the border will mean vehicles will bring products directly into the country, bypassing Dzhavakh and depriving Armenians in this part of Georgia of much of their income.
- Opening the border will provide a powerful momentum for the development of eastern Turkey, in as much as the majority of commercial trade will run not through Istanbul but through eastern Anatolia.

Turkey

Different reasons were given for Turkey's closure of the border in 1993, and respondents named different obstacles to re-opening it. The majority were related to difficult interstate relations and the lack of diplomatic contacts between Turkey and Armenia. They included:

- Armenia's failure to recognise Turkey's territorial integrity.
- Problems connected to Turkey's genocide against Armenians during world war one.
- The Armenian Diaspora's categorical position on the subject.
- The 'Georgian factor', according to which opening the border will divert cargo shipments and cause great losses to its economy.
- The opening of the border means Armenian and Turkish entrepreneurs will have to legalise their operations and expose them to new taxes, which will be less profitable.
- The population of Kars region is mostly Kurdish, and it is feared that opening the border will lead to closer Armenian-Kurdish contacts, which is not in Turkey's interests.
- An open border would increase competition between Istanbul and Kars.
- A partial opening of the rail link between Kars and Gyumri is under discussion and not the extended Kars-Gyumri-Kazakh link, which is in the interests not only of Armenia and Turkey, but also Azerbaijan.
- The powerful Istanbul business lobby can supply Armenia through the Istanbul-Yerevan air link, which cannot be said of Kars-based businesspeople.

- The lack of a railway connection between Armenia and Moscow hinders Turkish provision of the Russian market along the Kars-Gyumri route. According to the majority of respondents, opening the Moscow-Yerevan line (which passes through embargoed Abkhazia) would encourage the re-opening of the Kars-Gyumri-Kazakh line.

Ethnic Armenian entrepreneurs from Georgia

- The majority listed the following obstacles to opening the border:
- The lack of diplomatic relations between Armenia and Turkey;
- A conflict of interest involving third countries;
- The conflict of interests between the Armenia-Russia axis, and the Turkey-US and the Georgia-US axes;
- Georgian interests framed by Georgia-Turkish-US-NATO cooperation;
- The Georgian business lobby in Turkey;
- The military alliance between Turkey and Georgia, which presupposes the penetration of Georgia's market by Turkish businesspeople circumventing Armenia and Azerbaijan.

Ethnic Azeri entrepreneurs from Georgia

Opinions were gathered from Azeri traders working in the Sadakhlo and Marneuli regions of Georgia. The first peculiarity of the answers they gave was the extremely politicised approach that Azeris have with regard to economic activities. Any economic ties between Armenia and Turkey are viewed exclusively in the context of the Karabakh conflict. The reasons they cited for continued closure of the border and rail link included:

- The problem of NK and genocide;
- Armenia's lack of recognition of Turkey's territorial integrity;
- Azerbaijan's influence over Turkey regarding the Karabakh conflict;
- The influence of third countries, mainly Georgia;
- Closure as a means of excluding Armenia from participating in regional processes;
- To put pressure on the OSCE Minsk Group to include Turkey in mediating the Karabakh problem.

4.3 JOINT INSTITUTIONS AND MECHANISMS NEEDED TO DEVELOP BUSINESS ACTIVITY

Armenia

Opinions divided into two conflicting camps. The first believed joint institutions would lead to coordination and legalisation of business activities; the other, that legalising business is synonymous with banning it, particularly in Turkey where

commerce is strongly controlled by the state. But the majority were of the opinion that such institutions would be conducive to, and supportive of, business activities, and were sorely needed. Respondents thought there was an acute need for the creation of an agency that would pursue issues of regional development, finance business projects and guarantee joint activities. The respondents were aware of the project to create a South Caucasus Forum of Provincial Cities.⁴ The majority thought the creation of such an institution would encourage bilateral interstate relations, and it was viewed as an important step towards full Caucasian cooperation.

Turkey

Respondents answered this question with an unequivocal 'yes'. Everyone was of the view that the creation of a joint organisation would lead to the legalisation of existing commercial relations, a move that could only benefit Turkish businesspeople who have a longer history of working under free-market conditions. Another factor was that such an institution would be tantamount to an official 'green light' to Armenian-Turkish business relations and might attract government patronage. Business structures will also contribute to more dependable financial flows, including cash, through the territory of Georgia. Such an organisation would facilitate the creation of Armenian-Turkish-Azerbaijani joint business ventures which today are only realised unofficially between Sadakhlo, Baku and Yerevan. Because such activities are currently confined to the grey economy, Azerbaijani traders periodically face problems from government. Neither official statistics nor indirect estimates fully capture the scale and structure of the shadow economy, but an array of indicators testifies to its comparatively large size.⁵

Ethnic Armenian entrepreneurs from Georgia

Individual businessmen and companies involved in wholesale trade, all of whom circumvent the laws of three countries in their transit activities, spoke out against the formation of joint institutions. But small merchants at a market level were in favour of them as a means of reducing the risk involved in commerce and transport, and as a way of gaining access to security and insurance mechanisms that would convert their businesses into safe enterprises, ridding them of the 'guardianship' of state and non-state criminality.

Ethnic Azeri entrepreneurs from Georgia

Opinions differed greatly. The authors were unable to interview representatives of the big and small businesses that are active at Sadakhlo, where Armenia, Azerbaijan and Georgia all converge, but they may not have a close relationship to the cargoes and products shipped between Azerbaijan and Armenia. Trade between Azerbaijanis and Armenians relies on protection either from government officials, or criminal gangs. Small traders in Sadakhlo market are

controlled by international criminal groups with membership drawn from Armenia, Azerbaijan and Georgia. This is a salient example of ‘commercial cooperation’ – a sort of ‘criminal integration’ – where every product and trader has its allotted place but cannot operate without protection.

4.4 POTENTIAL IMPACT OF LEGALISING BUSINESS BETWEEN ARMENIA AND TURKEY

Legalising business would facilitate:

- Institution of diplomatic relations;
- The formation of civilised business relations;
- The opening of the border;
- The taxation of business;
- The itemisation and prioritisation of the main directions of joint development.

Reactivating economic links would lead to the creation of structures to coordinate the current situation, propose directions for future development, choose the methodologies to be used and evolve into an entity capable of lobbying governing circles with non-politicised models of cooperation. This, in turn, would contribute to the breaking of stereotypes and the creation of an atmosphere of tolerance, as well as legal and more civilised models for bilateral relations.

4.5 POTENTIAL IMPACT OF BUSINESS DEVELOPMENT ON RELATIONS BETWEEN ARMENIA AND TURKEY

According to various estimates, the volume of Armenian-Turkish commercial trade amounts to \$250-300 million per year which, even under conditions of closed borders, places Turkey in fourth or fifth place among Armenia’s trade partners.⁶ There are several examples of Turkish capital participating in the Armenian economy, and joint ventures are operational in both countries. According to the Antalya Chamber of Commerce and Industry, commercial relations with Armenia have become quite stable, and a series of joint Turkish-Armenian enterprises exist in Turkey. Armenia’s Ministry of Foreign Affairs and the Ministry of Industry and Commerce say there are 20 companies in Armenia with shared Turkish-Armenian capital.⁷ Against this background, many respondents expressed the opinion that trade between the two countries is significantly higher than official statistics indicate. A wide variety of Turkish products enter Armenia, and their volume is relatively significant even for a country like Turkey with a population of 80 million.

It follows that all indicators of Armenian-Turkish economic turnover estimate indirect trade, rather than direct. Turkish cargoes and products enter Armenia through Georgia and Iran, which increases their cost. This leads to the importation of poorer-quality products to compensate for the additional

expense.⁸ Longer transit routes lead to higher prices, which are reflected in Armenia's socio-economic situation. The end result is a reduced interest in small business in both countries and unfulfilled possibilities.

The reasons for such economic losses are political in character. Officially, Ankara justifies its position: by condemning Armenia's 'unjustifiable' pretensions to international recognition that the slaughter of Armenians in the Ottoman empire was genocide; by Armenia's refusal to recognise Turkey's territorial integrity, and the Armenian Diaspora's intractable position – from the Turkish perspective – on the settlement of the genocide issue. The Karabakh conflict merely exacerbates this traditional set of obstacles. Through its unconditional support of Azerbaijan, Turkey has also fallen under the influence of its Turkic brother, an ally that demands a peremptory and uncompromising approach to Armenia – over which Azerbaijan has pretensions of its own.

Another obstacle on the path to normalisation is the corruption of the state apparatus, complying with the general business lobby. The picture is completed by a series of other factors – for example, the interest of third countries in maintaining the status quo in the NK conflict with no hope of resolution. Georgia has no interest in improving the situation because it is the main transit route for Turkish goods bound for Armenia.

4.6 FORUM OF PROVINCIAL CITIES OF THE SOUTH CAUCASUS AND OTHER JOINT ORGANISATIONS

The regional Forum of Provincial Cities of the South Caucasus, a topic on which nearly all respondents spoke positively, could contribute to the creation of different business structures at a time when there are no diplomatic relations between Armenia and Turkey and, at the same time, provide positive momentum for developing Armenian-Turkish and Armenian-Azerbaijani relations.

It could also take upon itself the coordination of forces interested in opening the borders. Such an organisation could eventually contribute to the synchronisation of laws, the legalisation of business and the introduction of businesses to the official, taxed economy.

Activities in the framework of the Forum of Provincial Cities of the South Caucasus as a shared organisation will facilitate the formation of political relations, and form a model for cooperation in the South Caucasus, an advance on the current state of relations. The new format would also allow for raising the joint activities of different NGOs to new levels of cooperation, ensuring its continuing significance.

5. BUSINESS AND CONFLICT: ADDITIONAL COMMENTS

The above analysis of the respondents' opinions on perspectives of economic cooperation makes it clear that problems of a political character render

cooperation and business activities extremely difficult for all involved. A few comments on the theory and practice of conflict settlement, and the political and economic relations between the countries of the region, should also be added.

5.1 POLITICAL ASPECT

Even if one tries to separate economics and politics, it is still impossible to resolve problems of economic cooperation outside the context of the region's political situation. In addition to other factors, the political situation is determined by problems in relations between Armenia and Turkey over the genocide issue, and their different approaches to the Karabakh conflict.

With regard to the genocide question, Turkey is unlikely to be ready to 'publicly apologise for the genocide committed against the Armenian minority before the modern Turkish state was created'.⁹ Nevertheless, and despite Turkey's announcement that it will support 'any decision that is accepted by the Azerbaijani nation' over the Karabakh issue, one can detect subtle changes in relations between Armenia and Turkey. On the one hand, Armenian leaders have stated on several occasions that Turkey's recognition of the genocide will not be the main precondition for establishing diplomatic recognition. Turkey has also expressed its readiness to establish 'diplomatic contacts' without prior conditions. Other factors are pushing Turkey to demonstrate greater flexibility in its policies towards the Caucasus, and Armenia in particular. These include the Kurdish question, internal rivalry between Turkey's Islamic and secular wings, Ankara's desire to join the EU and its increasing integration with European structures.

Therefore, it is impossible to ignore a certain forward political momentum in the context of establishing bilateral relations between two regional actors with direct interests in settling the region's conflicts.

5.2 ECONOMIC INTEREST

If the realisation of political goals faces serious obstacles, economic arguments have acquired greater force. Objectively, Turkey cannot but aspire to economic rapprochement with Armenia. The realisation of the Transcaucasian energy transport corridors that, in part, already exist will not be possible without opening communications between Armenia and Turkey. These developments would transform Turkey into a Central Asia-Europe-Middle East crossroads, strengthen its economic and political influence in the region, and increase its importance for the West. East-west transport through the corridor, the deepening of commercial ties between east and west, and the modernisation of Caucasian infrastructure will also strengthen Turkey's energy security by diversifying its sources.

The implementation of economic projects that strengthen regional cooperation in the South Caucasus – a necessary condition of peace and stability – will open up opportunities for other countries in the region to access and integrate with global markets. The participation in these processes of countries

that do not produce energy, such as Armenia, will allow them to take their place in the region's economic development as well. In that context, strengthening bilateral economic cooperation, particularly between Turkey and Armenia, would simultaneously be a way of participating in regional projects, facilitating domestic socio-economic development, negotiating internal disputes and contributing to the settlement of conflicts between states.

5.3 THE OIL FACTOR

Politics and economics follow crossing paths: pipeline routes link the region's political and economic meeting points. In the search for arguments for or against one position or another, it is important to escape worn-out, but invariably dangerous stereotypes. The extreme politicisation of issues, as a rule, leads to dead ends, while potential solutions only become visible with the separation of the political and economic factors. Stereotypes such as 'Azerbaijan is an oil granary', and Georgia and Armenia are only 'corridors for the transport of raw materials' define issues politically, more than economically. In the 1990s, the North and South Caucasus, Southern Russia and the Caspian Basin, forming the Caucasus-Caspian Region (CCR), assumed global significance as a potential source of oil and natural gas. However, far from constituting an alternative to the Persian Gulf, the CCR contains scarcely 3% of world reserves according to recent estimates, and the Azerbaijani shelf is the least rich area of the Caspian in terms of oil. The role of the South Caucasus in the CCR is peripheral, since its republics lack natural resources. Their importance is primarily as a transit route for oil pumped in Kazakhstan.¹⁰

According to many experts, Azerbaijan – which produced half of all the world's oil at the beginning of the 20th century – has no great potential as an exporter, based on its reserves, their quality and the cost of transit. Nor has Azerbaijan realised truly large income from oil and probably will not do so in the near future. Its current share of world oil production is 0.3%,¹¹ but estimates of its reserves vary considerably. The French news magazine *Express* has reported that the Caspian contains from 70-250 billion barrels; the US State Department, that proven reserves are 163 billion barrels, with a hypothetical reserve of 15.6 billion barrels (a total of about 30 billion tonnes); Khazarnftegaz-97 experts base their calculations on a figure of 200 billion barrels; the Turkish Embassy in the US suggests 42 billion barrels, or around 7 billion tonnes; and Russia's *Expert* journal estimates the Caspian resources as 7-8 billion tonnes. Until recently, the official figure was that Azerbaijan controlled 4-5 billion tonnes of the total amount, but the president of the State Oil Company of Azerbaijan, Natic Aliyev, has upgraded the figure to 27.5 billion tonnes, with hypothetical reserves of 70-100 billion tonnes. Azerbaijan has signed 19 oil contracts on the strength of a hypothetical reserve of 4 billion tonnes, but detractors dispute even this amount. The above figures, as well as the 178-191 billion barrels cited by the US Energy Information Department include the maximum possible reserves in the Caspian basin, but should be filed in the category of 'prognoses'.¹²

5.4 COMMUNICATIONS: THE FIRST STEP

The economic needs of Armenia, Azerbaijan and Turkey – not to mention their geographical proximity – may remove them from foreign tutelage and bring them closer together. According to Turkish estimates, the volume of Turkish exports to Azerbaijan, Central Asia and China would increase threefold if the rail and road connections through Nakhitchevan and Armenia were re-opened. The World Bank estimates that opening the Armenian-Turkish and Armenian-Azerbaijani borders would increase Armenian exports to \$269-342 million, increase GDP by 30-38% and cause trade volume to exceed \$300 million. Similarly, opening the Armenian-Azerbaijani border would drastically increase Turkey's trade traffic with Central Asian countries by cutting transport costs by about 35%.¹³

It is not accidental that the governments of Turkey and Armenia are increasingly speaking in favour of reintroducing international cargo services by rail along the Gyumri-Kars-Istanbul route, directly connecting the Caspian region and the Persian Gulf basin with south-eastern and central Europe. The closing of this route cost Turkey \$500-600 million a year in the early 1990s. Unblocking the border and its related transport routes would therefore be profitable not just for Armenia, but also for Turkey.¹⁴

5.5 POLITICS VS. ECONOMICS?

There have been negative experiences in regional collaboration, notably the failure of the joint Armenian-Turkish-Georgian-Azerbaijani project to pool their energy systems, while a Russian plan to export natural gas to Turkey through a Georgian-Armenian 'corridor' faces uncertain prospects.

Nevertheless, while politics has demonstrated a lack of compromise in terms of establishing diplomatic relations and the recognition of genocide, Turkish companies and businesspeople have followed different routes. Traditional 'images of the enemy' have not prevented Turkish and Armenian business circles, entrepreneurs and traders realising projects dictated by economic sense and mutual interest. The logic that economic integration in the region is,¹⁵ in the end, inescapable should lead, on the one hand, to rapprochement between Armenia and Turkey and, on the other, to a certain understanding between Armenia and Azerbaijan on the settlement of the Karabakh conflict. In view of her special relationship with Azerbaijan as a strategic partner, Turkey could have a wholly positive influence on Azerbaijan in the latter regard.

However, the prospects of economic cooperation between Azerbaijan and Armenia without a solution to the Karabakh conflict raises certain doubts, because there are, albeit indirect, ties between settling the Karabakh problem and normalising Armenian-Turkish relations. The success of any economic project depends on a two-track task: settling the conflict and creating conditions conducive to regional economic cooperation.

It is a positive development when an increasing number of voices in Armenian political circles come out in support of opening the border and expanding economic, political and cultural cooperation with Turkey – historically considered ‘foreign’ and even hostile. Economic pragmatism is increasingly dominant in relations between the countries of the South Caucasus.

The main economic argument to use in promoting neighbourly relations in the region is the immutable truth that the main source of jobs and income for the populations of Armenia, Azerbaijan, Georgia and Turkey will not be generated by international oil projects, but by the commercial and business activities of Armenians, Azerbaijanis, Georgians and Turks. The common regional market – and not Caspian or Central Asian oil – constitutes, and will remain the main source for, the future development of these countries. The watchword, therefore, is not ‘peace in exchange for economic prosperity’, but ‘peace and economic prosperity for the region’s well-being’.

6. CONCLUSION

In view of the above research, analysis and evaluation of the economic situation in the region, one can venture the following conclusions regarding the need for new business structures:

- Economics and conflict are directly related. Conflicts have economic causes, contexts and consequences not only for the economies of the conflicting sides, but practically all regional actors. For example, the conflict in Abkhazia led to partial closure of Azerbaijan’s and Georgia’s border with Russia, which in turn brought large losses to both their economies, while negatively affecting the economic development of Armenia and Turkey by cutting off access to the Russian market.
- There are two forms of business activity between Armenia, Georgia, Azerbaijan and Turkey. The first are large ‘invisible’ businesses that are virtually impossible to control. The second are small businesses that function in a few spontaneously formed markets in a framework of ‘special’ regulatory mechanisms. A high level of criminalisation in the economy and, by extension, the criminalisation of daily life, are the direct result of a large, informal shadow economy, a difficult transitional period, imperfect market relations, the lack of legal norms and the continuation of a tradition of secondary employment in which income is hidden from the tax authorities. In reality, the current mechanisms for regulating the activities of small business have been designed by criminal structures, which have reduced to a minimum the participation of state structures and their representatives. Criminal and government structures often

penetrate each other and work towards shared goals and interests, at a time when economic cooperation in the region should be dictated by the interests of traders, businesspeople and the consumers concerned.

- The main form of entrepreneurial activity is trade funnelled through markets located in border areas, particularly Sadakhlo and a few others. Located as a rule on Georgian soil, the markets have helped strengthen that country's criminal structures, which have thereby become the main 'owners' and 'controllers' of the region's trade flows. The lack of regulation by the state and professional commercial and economic institutions has facilitated the flowering of criminal structures that control shadow businesses whose volume exceeds \$10-20 million per year, with an annual potential loss of trade between Armenia and Azerbaijan amounting to \$3-4 million.¹⁶
- Businesspeople and entrepreneurs are forced to come to terms with shadow controls on their activities because the prospect of facing excessive customs fees and taxes is considered an even less attractive option. Regulation of commercial relations is also hampered by the incompatibility of legislation from state to state. Regional institutions with the power and expertise to advise their governments on the synchronisation of laws would make a valuable contribution to their country's participation in regional cooperation activities free from criminal control, a necessity for the development of civilised business.
- Another important pattern emerged from the research. The regions that suffer most from the closed Armenian-Azerbaijani and Armenian-Turkish borders are the border regions themselves which, following the normalisation of relations between neighbouring countries, would immediately become zones of heightened interaction. Armenia's Shirak Marz region, which has the highest unemployment level and lowest standard of living in the republic, is just such an area. Our research showed that people in this region are the most enthusiastic about establishing economic and commercial relations with Turkey.
- The South Caucasus is a zone of intense competition between world powers seeking to strengthen their economic position in the region. But opportunities for them to exert influence on economic policies in the region depend on the socio-economic situation in individual countries, as well as settlement of the region's conflicts.
- The main factor supporting the region's economic development can only be internal resources in as much as external (foreign) investment is withheld due to regional instability. The mobilisation of these resources requires the development of the small business sector, in which investment provides quick profits. Despite the difficulties of economic reform, the republics of the South Caucasus can still find financial resources, though in insufficient volumes. The attraction of internal

capital investment depends not only on stability, but the energetic efforts of individual countries and regional institutions to promote the possibilities for profitable business.

- The diversity of legal models of economic interaction that exist and are developing in many countries may prove to be more effective than a ‘unitary legal space’, the creation of which is practically impossible in the South Caucasus.
- Despite the continuous significance of geopolitical factors in international relations, the various parties have the power to regulate their own relations, given the political will. Every conflict brings with it the potential for external interference, but simultaneously contains the potential to limit the possibilities of such interference.
- The most important requirement of the South Caucasian economies is their full inclusion in the broader regional market and, through it, in global markets. In this context, entrepreneurial activity must be supported both at national and regional levels.
- International trade and closer economic ties not only lower the risk of conflicts breaking out, they foster the atmosphere of tolerance and trust that is necessary both for the resolution of conflicts and – working in reverse – the facilitation of business activities. The settlement of conflicts can be more effective when it is supplemented by the emergence of economic cooperation and mutual benefit. The creation of a unified economic space and economic cooperation are not goals in their own right, but the means and way to settling the region’s conflicts.

7. RECOMMENDATIONS

Analysis of collected materials summed up above allows the authors to put forward a series of recommendations that can facilitate further economic development of individual South Caucasian countries, as well as regional integration and the creation of a single economic space that would undoubtedly contribute to conflict settlement and an atmosphere of long-term stability. As a strategy for economic integration, we propose the realisation of programmes entitled ‘energy resources in the South Caucasus’ and ‘communication routes of the South Caucasus’.

The strategy concerns the creation of a South Caucasus energy and transport complex, with the further creation of a transnational energy/railway company (consortium). The goal is to overcome the communication blockades of individual countries and the region as a whole, guaranteeing them entry at European and global levels. This, in turn, will create the necessary conditions for sustainable socio-economic development of the countries in the region, and stimulate trade and investment.

The programme's main direction is to identify and realise the economic, social, scientific and cultural potential of all countries in the South Caucasus for their further integration, and the formation of community ties to facilitate inter-ethnic accord.

The structure of the transport-energy-communications integration programme

The programme should be an aggregate of projects, measures and technologies directed at resolving a complex of political, socio-economic, inter-ethnic, budgetary, agro-industrial and cultural problems, as well as problems related to international cooperation and national security. The programme foresees the construction of transport and communication routes, oil and natural gas lines, information technology ties and improved transport flows.

It also foresees measures providing for the stabilisation and transition to sustainable growth of industrial and agricultural production; increased employment and professional training of persons able to work; enhanced state support for impoverished sections of society; and social protection for refugees and displaced persons. Questions of science, culture, art and the creation of an integrated educational space to train professional cadres for all levels of management, all have important places in the programme.

By way of justifying the programme's framework decisions, it will be necessary to start with the 'bottlenecks' and priorities in the development of the region's energy and transport/road complex; define the level of cooperation of the South Caucasus countries in the area of economics; as well as unveil the potential for establishing cooperation in energy, commerce and transport communications.

Role of Armenia in the transport-energy-communications integration programme

Though dependent on imported oil, natural gas and other fuels, Armenia has the potential to become the main delivery base and distributor of electricity in the region. With output potential of 3,600 megawatt-hours (mwh), electricity production is one of the most developed branches of Armenian industry. Hydroelectric potential is estimated at 21.8 billion kilowatt-hours (kwh) per year and current production potential is 7-8 billion kwh. The network of high-voltage transmission lines stretches 1,323km from 14 substations (220 kilovolt) and another 3,169km from 119 substations (110 kilovolt). Armenia's electric grid is linked to all countries in the region: 63km with Georgia, 78.5km with Iran, 65km with Turkey and 100km with Azerbaijan. A number of international organisations, including the International Monetary Fund (IMF), the World Bank and the European Bank of Reconstruction and Development have identified Armenia as one of the most advanced CIS countries in terms of reforming its energy sector.¹⁷ The Russian electric giant, RAO-EEC, recently invested in the Armenian energy sector. Georgia is the main consumer of Armenian electricity exports, but there is considerable potential to expand.

Financing the transport-energy-communications integration programme

Multinational corporations, international organisations and individual third countries are all potential partners for countries in the region and could provide financial support. A number of projects are already being implemented, while others are at the planning stage. The World Bank provided Armenia with \$33 million (of the \$1.7 billion needed) for the transmission and distribution of electricity. Reconstruction of the region's transport infrastructure has also intensified. As far back as 1996, the World Bank recommended the provision of \$60 million (of a needed \$92 million) for restoring the Sadakhlo-Gyumri-Kars highway; \$8.5 million (of a needed \$19 million) for the Sadakhlo-Echmiadzin-Iğdır road; and \$700-800 million for reconstruction of the Gyumri-Kars rail link. Proposals for US participation in financing the reconstruction of railways connecting the three republics of the South Caucasus have also been aired in Congress.¹⁸

But foreign investment can only cover a small proportion of the overall needs: the economies of the South Caucasus will need to work on the region's socio-economic development themselves. Success in realising the programme will depend to a large degree on the proper choice of order for financing its constituent projects.

The path of integration followed by Europe is seen as an example for the suggested future formation of an energy or transport consortium in the South Caucasus. The European Union began with the creation half a century ago of the European Coal and Steel Union by the French political activist, Robert Shuman. The European Customs Union is another potential model. The EU experience demonstrates that the development of integrationist processes is the most effective means to decide political, economic and, it follows, social problems while supporting peace and economic prosperity.

Phases of the regional integration of the South Caucasus

The following projects relating to the creation of a regional market have been identified as priority projects:

- A regional fund for realisation of the integration programme;
- A regional information and analysis centre;
- A regional chamber of commerce and industry;
- A regional wholesale market for agricultural goods;
- A regional investment bank for development;
- A regional investment agency for development;
- A regional insurance agency;
- A regional association of municipalities.

At a political level, the creation of a permanent Inter-governmental Conference of South Caucasian States could become a mechanism for discussion of the region's problems and the adoption of operational decisions. Similarly, a South Caucasian

Parliamentary Assembly could be formed allowing the resolution of some of the region's shared problems at a higher level than is currently possible. A South Caucasus Association would provide a forum for addressing the region's socio-economic challenges, while a Regional Association of Municipalities would improve dialogue for local governments. The administrative centres of these structures would be located in different South Caucasian cities.

These institutional measures would help overcome the isolation of the republics' political and socio-economic life, create multiple centres of political life, and build a system of checks and balances that will signify the appearance of new ways of solving the problems of participants in regional cooperation.

Though formed on an economic basis, the joint institutions would also embrace the political, social and cultural spheres. They would play a lead role in improving legal codes so as to protect investors in the region, advise on the profitability of project capital allocation and grant privileges to domestic or overseas structures implementing programme projects. The joint institutions would provide a base for planning how to tackle the challenges defined by the regional development programme.

The current ethno-political situation in the region dictates the need to realise a multi-level method of common action, involving state, regional and local governments, power ministries, social and scientific associations, the media and international organisations.

However, to create favourable internal premises and realise the programme's main targets, it is vitally necessary to define its interests and goals strictly, and create a single coordinated strategy if foreign capital is to be successfully attracted to the South Caucasus. This can be achieved in the following manner:

Economic sphere

- Attraction of Western companies to the implementation of commercial projects in the South Caucasus, such as the rehabilitation of existing communications links or the construction of new ones.
- Active participation in projects within the framework of the TRACECA programme, maximising the region's transit potential; and the development – including with foreign participation – of the region's transport and communication infrastructure.
- The introduction of supplemental – or better, integral – initiatives to the TRACECA programme that support the development of transit ties throughout the South Caucasus in a north-south direction.
- Promotion of Georgian-Abkhaz dialogue so as to facilitate agreement on the reconstruction of a north-south transport corridor through Abkhazia and the re-opening of rail links.
- Normalisation and development of relations with direct neighbours; development of mutually beneficial, commercial and economic relations

between Turkey and Armenia; and the increased interest of business circles in partnership.

- Further involvement in projects realised in the framework of the Black Sea Economic Cooperation pact.

Political sphere

- Development of dialogue at a non-governmental level.
- Institutionalisation of continuous dialogue between Armenia, Turkey and Azerbaijan; and raising awareness of the benefits of mutual understanding and the damage caused by failure to cooperate.
- Realisation of a complex of measures directed at the historical reconciliation of these states and nations.
- Idea-based and organisational consolidation of all social forces around the policy of healthy pragmatism.
- Development of a registry of development problems in the region through the joint efforts by the region's academics and politicians.
- Efforts by the region's research communities to challenge fictitious interpretations, historical and political distortions, manipulation of mass consciousness, the planting of inter-ethnic hatreds, and nationalist historic myths.
- Intensification of the activities and projects that facilitate the harmonisation of inter-ethnic relations: participation in conferences, seminars and symposia; and staging events in the framework of peoples' diplomacy, celebration of joint holidays, days of culture, festivals and media events.
- Creation of adequate professional information and advocacy support for governments' responses to conflict situations.

Endnotes

- ¹ Armenian Center for the National and International Studies (1997) 'Nagorno-Karabakh: A White Paper'; Manassyan, A.C. (2002) *The Karabakh Conflict in its Key Understandings and Selected Topics in an Expanded Format* (Washington DC, USA: Armenian Assembly of America).
- ² Cox, C. and J. Eibner (1999), *Ethnic Cleansing in Progress: War in Nagorno-Karabakh*, (London, UK: Christian Solidarity Worldwide).
- ³ *ibid.*
- ⁴ The Forum of Provincial Cities of the South Caucasus is a non-governmental organisation regulating relations between municipalities in Armenia (Gyumri, Vanadzor, Idzhevan and Armavira) – and the cities bordering them in Azerbaijan (Ganja, Akstafa and Kazakh), in Georgia (Akhalkalaki, Akhaltsikhe, Ninotsminda and Marneuli) and Turkey (Kars, Ardvin, Ardagan and İğdir). The Forum is the first attempt to build such ties. The task is to develop these relations at a higher, interstate level.
- ⁵ Kirichenko, N. 'Non-Caucasus Economy', *Izvestia*, 11 August 1999; *Inter-ethnic Relations and Conflicts in Post-Soviet States*, Annual Report of the Network of Ethnological Monitoring and Early Warning of Conflict (Moscow, 1999).
- ⁶ According to Turkish sources, this figure varies between \$70-150 million. According to data of the US embassy in Armenia, Turkey occupies the seventh place by volume in Armenia's external trade. Gültekin, B. (2002) *The Stakes of the Opening of Turkish Armenian Border*, TABDC (Istanbul, Turkey: TABDC), p.10.
- ⁷ ICHD (2003) 'Lost Potential in the South Caucasus: Aspects of Interstate Trade', (Yerevan, Armenia: International Center for Human Development, pp.82-91).
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- ¹⁰ Fueg J.C., (2002) 'The Caucasus Region at the Crossroads of Major Evacuation Routes for Caspian Oil and Gas: Geopolitical and Regional Implications', Proceedings of the International Conference 'Shaping an Environment for Peace, Stability and Confidence in South Caucasus: The Role of International and Regional Security Organisations', held by ICSRD on 25-26 April 2002, (Yerevan, Armenia: CSRC Publications).
- ¹¹ See: Hishmeh, G. S. *Caspian Basin Seen As Not Replacing Middle East as Oil Source*, USIA Washington File, 26 September 1997; Kuliev H., 'Myths and Realities: Oil Strategy of Azerbaijan', *Journal of Social and Political Studies*, available at <http://www.ca-c.org/journal/eng-01-2000/12.kuliev.shtml>.
- ¹² See: Kuliev H., *op.cit*; Blandy, C.W. (1999) *The Caspian: Communitary Crosscurrents*, (Camberley, UK: CSRC), pp.21-22; Blandy, C.W. (1997) *The Caspian: A Catastrophe in the Making*, (Camberley, UK: CSRC), <http://www.da.mod.uk/CSRC>; Fueg, *op.cit*, <http://www.da.mod.uk/CSRC>.
- ¹³ 'Pallone Discusses Effects of Ongoing Blockades of Armenia at United Nations Conference', TABDC, 8 September 2003, available at <http://www.tabdc.org>.

¹⁴ From: CNNTurk TV Programme on Armenian-Turkish Relations, 26 April 2002.

¹⁵ It should be remembered that the development of economic ties between the states of the South Caucasus has been raised numerous times. The US proposed the idea of a Caucasus Cooperation Forum in 1999.

¹⁶ See *Lost Potential in the South Caucasus*, op. cit., p.183.

¹⁷ See *Lost Potential in the South Caucasus*, op. cit., pp.164-165; Drummond, P., B. Horváth and N. Thacker (1996) 'Armenia's Economy: A Success Story in the Making', *Transition Newsletter* available at <http://www.worldbank.org/transitionnewsletter/novdec96/doc9.htm>; Cohen, J. (1999) 'Conflict and Peace in the Caucasus: Obstacles and Opportunities' in McCormack (ed.) *Media and Conflict in the Transcaucasus* (Düsseldorf, Germany: European Institute for the Media).

¹⁸ See Cohen, op.cit; Drummond, op.cit; *Pallone Discusses Effects of Ongoing Blockade*, op.cit.

SECTION TWO

PERSPECTIVES ON INTERNAL BUSINESS DEVELOPMENT

CHAPTER THREE

The role of international organisations in the development of small business and the peaceful settlement of the Nagorno-Karabakh conflict

VALERY BALAYAN

1. INTRODUCTION

The NK conflict was and remains the most intractable problem facing the South Caucasus. The active phase of the war left the greatest number of victims of any conflict in the former Soviet Union, with hundreds of thousands of refugees on both sides. The 1994 ceasefire froze the problem, but brought a certain degree of peace to the region.

The conflicting sides and the international community both understand that the current environment of ‘neither war, nor peace’ is unstable and that it is necessary to take steps to advance the situation beyond its current stalemate. The instability of relations based only on a delicate balance of power is clearly understood.

The South Caucasus is a security threat not only for Russia, but for the European Union. The growing numbers of refugees from the South Caucasus, as well as an array of other problems, have forced the EU to look more closely at the region’s stability in the context of intra-European politics. This development is analogous to the break-up of Yugoslavia which went from being an ‘external issue’ to a major challenge that required active military involvement by EU members, the United States and Russia. For its part, the US sees opportunities for international terrorists to establish bases in the region and now includes the South Caucasus in its sphere of national interest.

Regardless of the differences between their approaches to problems in the South Caucasus, the EU, the US and Russia are united in one conviction: that the region’s socio-economic development and integration in the broader global economy is not possible without a permanent solution to existing conflicts. In turn, a permanent solution is not possible unless the history of ethnic relations in the Caucasus – its religious, ethnic, historical and other peculiarities – is taken fully into account.

Even before globalisation transformed the political environment, the Caucasus was not noted for its stability. An understanding of the genesis of conflict in the South Caucasus requires a broad view of the problems at hand, and a larger number of factors than usual need to be taken into account.

The least risky, and the most appropriate, approach in the current situation is one that considers the realities and the balance of power on the ground. The specific character of the region is the existence for many years of unrecognised states alongside its internationally recognised governments. Their number, and the intensity of sovereignty conflicts in the South Caucasus, is a phenomenon unique in the world's political system. According to British expert, Thomas de Waal, the number of such unrecognised statelets constitutes 'a world record and there is no sense in viewing it as a temporary phenomenon'.¹ This needs to be addressed when elaborating approaches to conflict resolution in the region.

Centuries of experience dictate and determine the behaviour of both recognised and unrecognised states in the South Caucasus towards one another. Attempts to pressurise the region's conflicts into some form of compromise could lead to another explosion of violence and destabilisation. Similar processes have been witnessed in the arguably less problematic Balkan and Middle East regions.

It is necessary therefore to abandon oversimplification and move towards the painstaking, decades-long 'social work' needed to bring lasting peace. The most important component of this effort is the transformation of the broad intellectual climate, and the political, economic and social awareness of Caucasian ethnicities towards better mutual understanding and more constructive approaches to problem-solving. A vital step would be the organisation of ties between different groups in the region, encouraging stabilisation of the situation and creating the necessary atmosphere for internal transformation.

The international community and the peoples of the South Caucasus need to understand that new initiatives are required to lift the region out of its crisis-ridden instability, achieve balance and lower tensions in the region. Individuals and organisations – particularly NGOs – with readily available methods and instruments need to be activated to influence the situation.

Analysis of previous international NGO operations – including humanitarian relief and targeted programmes in NK sponsored by foreign donors – is useful since they directly or indirectly affect settlement of the conflict and the region's economic development.

2. CONTEXT AND BACKGROUND

The Republic of NK is an internationally unrecognised state that appeared on the territory of the NK Autonomous Region, a national, administrative unit with its own government within the USSR.

The NK Republic (historically named Artsakh) is located in the centre of the South Caucasus, occupying the east and south-eastern foothills of the Lesser Caucasus range. NK borders Armenia to the west, Azerbaijan to the east and south, and Iran to the south. The republic's surface area is 5,000km², with Stepanakert its capital. NK consists of seven administrative regions: Shaumian, Martakert, Askeran, Shushi, Martuni, Gadрут and Kashatag. Stepanakert is a separate administrative unit.

On 1 January 2003, the republic's population amounted to 145,298 people, 77,434 living in urban areas and 67,864 in rural areas. The natural growth rate was 8.6 persons per 1,000 of population in 2002. The official language is Armenian.

The population of major cities and settlements is as follows: Stepanakert – 57,134, Martuni – 4,627, Martakert – 4,492, Kashatag – 3,110, Shushi – 2,970, Gadрут – 2,544, Askeran – 2,077, Shaumian – 480. In terms of ethnic composition, Armenians represent 99.7% of the population. A few Azeris, Belarussians, Greeks, Jews, Russians and Ukrainians also live in the Republic.

3. HISTORY OF THE CONFLICT

1918-23

NK's self-determination struggle traces its roots back to the dissolution of the Russian empire and the formation of Transcaucasian states after world war one. From the first days of its existence, the Azerbaijan Republic claimed territories stretching from the Caspian Sea to the Black Sea, including Karabakh.

The legitimacy of Azerbaijani claims was based on the fact that the head of the British armed forces in Baku, General W. Thompson, had named the Azerbaijani General H. Sultanov as temporary governor-general of Karabakh. Azerbaijan was silent on the fact that the British military mission left it in no doubt that Sultanov's position was a temporary one that reflected purely personnel considerations, and could not influence the fate of the disputed territory. Even with the above stipulations, the people of Karabakh and Armenia never accepted Sultanov as governor-general. Eight subsequent congresses of Armenians in Karabakh rejected Azerbaijan's territorial claims.

The development of internationally legal and contractual relations between the 'Armenians of NK and the Azerbaijani government'² after world war one needs to be noted, as well as the fact that the agreement between the representatives of the Karabakh people and the government of Azerbaijan agreed to respect the outcome of a future peace conference.

This agreement lost all meaning when a Soviet government was installed in Baku on 28 April 1920, after which Armenia was given an ultimatum to forfeit

Karabakh. In reaction, the Ninth Congress of Armenians of NK, meeting on 28-29 April 1920, adopted the declaration that:

1. The agreement concluded in the name of the Seventh Congress of Armenians of Karabakh with the Azerbaijani government is declared violated by the latter in the form of organised attacks by Azerbaijani soldiers on the peaceful Armenian population of Karabakh and the extermination of the population in Shushi and other villages;
2. The unification of NK with the Republic of Armenia as an integral part of the country is declared.

Karabakh's disputed status became a contentious issue with regard to the question of international recognition of Armenia and Azerbaijan, and the acceptance of both countries into the League of Nations.

1923-88

Throughout the existence of the NK Autonomous *oblast* within the Azerbaijan Soviet Socialist Republic (SSR), the republic's leaders showed a consistent disregard for the rights and interests of Karabakh's Armenian population. This manifested itself in restraints on the region's socio-economic development, active demographic expansion of the Azeri population, and the destruction and appropriation of Armenian memorials and cultural sites.

Karabakh's Armenian population never gave up its goal of seceding from Azerbaijan and viewed secession as the sole guarantee of its survival, and the only way of avoiding the fate of Nakhitchevan, where the Armenian proportion of the population fell from 40% – when Nakhitchevan was given regional autonomy – to 1.5% in 1959 and almost zero in 1988.

Karabakh's Armenians struggled for their rights in different ways depending on the political constellation of any given period and the opportunities that were at hand. As early as the 1920s, the Communist Party of Azerbaijan was forced to discuss possible solutions to the national movement in Karabakh. In the 1920s and 1930s, many regional and local leaders were accused of nationalism and repressed, or outright murdered, after being expelled from party organisations.

After world war two, the Armenians made numerous attempts to raise the NK issue with the central institutions of the USSR (in 1945, 1956, 1965, 1967, 1969 and 1987). The 1965 petition amassed 45,000 signatures. On 8 August 1966, the Secretariat of the Communist Party of the Soviet Union commissioned the communist parties of Armenia and Azerbaijan to prepare a joint report on the Karabakh issue. In retaliation, Azerbaijan instigated inter-ethnic clashes as a pretext for cracking down on the nationalist protest. Some 20 Armenians were shot or otherwise liquidated in prison, 10 more disappeared without a trace and 150 were repressed.

1987-91

The NK struggle for self-determination entered a new phase at the end of 1987, characterised by appeals to Soviet leaders, the organisation of demonstrations and public meetings, and the dispatch of delegations to central party and state institutions. More than 80,000 people signed a petition demanding the unification of the NK *oblast* with the Armenian SSR.

On 20 February 1988, the NK Regional Soviet of People's Deputies appealed to the Supreme Soviet of the USSR, the Azerbaijani SSR and the Armenian SSR requesting the transfer of the *oblast* from Azerbaijan to Armenia in keeping with the Soviet constitution. This appeal followed similar decisions at district levels.

In response, anti-Armenian pogroms were carried out on 27-29 February 1988 in Sumgait, 100km from NK. People were thrown from balconies and stabbed with sharpened steel pickets. The Azerbaijani authorities once again signalled that this was their chosen method of solving the Karabakh problem.

Pogroms and killing Armenian civilians were a continuation of Baku's official policy of blocking peaceful resolution of the Karabakh problem.

The events in Sumgait were also the signal for a massive deportation of Armenians from Azerbaijan. The Armenian population of Kirovobad (Ganja), Shamakha, Khanlar, Dashkesan and other districts were forcibly expelled in the autumn and winter of 1988, a process accompanied by murder and looting. Around 240,000 refugees entered NK and Armenia between March and December 1988, but a significant proportion of the Armenians displaced also found refuge in the USSR, especially the North Caucasus.

The Soviet central government and Azerbaijan used force and violence to confront the constitutional and democratic mechanisms used by NK to formulate the popular demand for self-determination. Historically, these events may have been the first example of ethnic cleansing on European territory since world war two.

1989

On 12 January 1989, the Executive of the Supreme Soviet of the Soviet Union set up a commission to take responsibility for all branches of NK's government. The *oblast* was effectively under direct rule from Moscow.

Baku responded by establishing an economic blockade of NK and Armenia – unprecedented in the history of the USSR – that exploited NK and, to a degree, Armenia's dependence on the transport infrastructure running through Azerbaijan. NK was isolated from the outside and even closed to visiting members of the European Parliament.

Repressive and punitive measures increased, especially in Shaumian district which was removed from the *oblast*. The area's mainly Armenian population seemed to be facing physical extermination. To pre-empt that possibility, the

Shaumian District Soviet of People's Deputies declared that the district was an inseparable part of NK at a special session on 26 July.

With no means of defending itself, the regional government of NK appealed to the highest levels of Soviet government, but the authorities did nothing to halt the bloodshed. An appeal to the UN Security Council to protect the region's Armenian population similarly went unanswered. Meanwhile, the Soviet Commission on NK had been dismantled by order of the Presidium, which established a Republican Organisational Committee for NK in its place. The same leadership undertook terrorism to force NK back into the Azerbaijani SSR. The republican committee, working with the Ministry of the Interior and the Soviet army, developed and began to implement a plan for the forced deportation of Armenians from NK and its surrounding areas. It also authorised the Azerbaijani riot police, OMON, to raid homes at night and imprison their residents in Shusha prison, without investigation or trial.

Meeting together on 1 December, the Supreme Soviet of the Armenian SSR and the People's Soviet of the NK *oblast*, 'drawing on the general human principle of the self-determination of nations and responding to the legal ambition to unite two forcibly separated parts of the Armenian nation',³ adopted a decree on the unification of NK with the Armenian SSR.

Recognising that the situation had dramatically worsened, the Presidium ordered the imposition of martial law in NK, its surrounding areas, Goris district in the Armenian SSR and a zone along the USSR's international border to the south of Azerbaijan.

1991-94

On 2 January 1991, Azerbaijani television broadcast an announcement by the president of Azerbaijan that direct presidential rule had been introduced in NK and the adjacent regions.

The leaders of the Azerbaijani SSR and the Soviet Ministry of the Interior organised punitive actions against the Armenian population. Operation Ring, conducted by Azerbaijani and Soviet Special Forces at the end of April 1991, was among the most notorious. Unprecedented acts of terror were conducted under the pretext of enforcing the country's passport regime. In three weeks, the population of 24 Armenian villages was deported.

On 30 August, Azerbaijan accepted the Declaration on the Reinstatement of State Sovereignty of Azerbaijan, referring to the original Azerbaijani state that existed from 1918-20, a period when NK was not administratively part of Azerbaijan and held the status of a disputed territory. Furthermore, the law of the Soviet Union 'On the Departure of a Soviet Republic from the Union of Soviet Socialist Republics' stipulated that autonomous areas, as well as regions inhabited by a compact national minority, had the right to determine their own sovereign status and future.

A joint meeting of deputies at all levels of government in NK and Shaumian district met in Stepanakert on 2 September and adopted the 'Declaration on the Proclamation of the NK Republic in the Borders of the NK Autonomous *oblast* and Shaumian District'. Azerbaijan responded with the first rocket attacks on Stepanakert.

On 26 November, the Supreme Soviet of Azerbaijan decreed the cancellation of NK's autonomous status and the *oblast* was liquidated as a special national-territorial unit. However, on 28 November 1991, the Soviet Committee of Constitutional Oversight ruled that the status of the NK *oblast* was secure and the Azerbaijani decision invalid.

On 10 December 1991, 99.89% of the electorate in a referendum in NK voted for independence. On 28 December, elections were held for the new republic's first Supreme Soviet under intense artillery bombardment.

The first battles between Armenian and Azerbaijani forces broke out in NK in the same year, degenerating into a full-scale war that lasted until 1994. In keeping with article 51 of the statutes of the UN, the NK Republic officially informed the UN Security Council in March 1992 that it had begun to defend itself against Azerbaijani military aggression.

On 5 May 1994, the republics of Azerbaijan, NK and Armenia signed an agreement in Bishkek, the capital of Kyrgyzstan, which has become known as the Bishkek Protocol. The agreement, with Russia, Kyrgyzstan, and the Parliamentary Assembly of the CIS acting as intermediaries, formed the basis for a ceasefire agreement achieved one week later.

Meetings between the defence ministers of Armenia and Azerbaijan, Serge Sarkisian and Mamedraf Mamedov, respectively, and the commander of the NK military forces, Samvel Babayan, confirmed each side's commitment to the ceasefire agreement on 16-27 May. An agreement on the separation of Karabakh and Azerbaijani military units, and the creation of a buffer zone between them was drawn up at the same time. Although the Armenian defence minister, the commander of Karabakh's army and Russia's Minister of Defence, Pavel Grachev, all signed the document, the Azerbaijani defence minister was suddenly recalled to Baku. Nonetheless, the ceasefire has held ever since.

4. FOCUS OF THE RESEARCH PAPER

This paper examines how international organisations impact on conflict regions, specifically exploring how international aid in NK influences peacemaking processes; the development of SMEs; relations between business and NGOs; as well as building socially responsible local business supportive of local NGOs. This is a pilot research project that will be extended to other conflict zones in the region.

For the purposes of this research, international aid was divided into two kinds: humanitarian and investment. Humanitarian aid is understood as the provision of food, clothing, medicine, housing, etc. Investment is understood as the aid that entered NK from the International Committee of the Red Cross (ICRC), Médecins sans Frontières (MSF) and other organisations, as well as from private business. Investment by the ICRC, MSF and other international NGOs was largely spent on rebuilding hospitals, polyclinics, and sewage, water and energy systems.

Humanitarian aid began to enter the region in the first days after the ceasefire was signed, mostly as temporary housing, food, clothing and medicines. By the end of military operations, the nature of the aid became more goal-oriented and investment aid began to flow into the country.

The ceasefire changed the balance between humanitarian aid and investment aid in favour of the latter. Annual assistance of \$8-12 million from the US government, channelled through Catholic Relief Services (CRS) and targeted at rebuilding destroyed housing and infrastructure, was one example of this trend. Information on investment is not published and is hard to trace, but the renewal of infrastructure and provision of necessities lent momentum to the development of small business. Foreign investment grew continuously from 1995, and by 1997 it was so intensive there was a noticeable growth in the development of SMEs.

This paper focuses on the relationship between humanitarian aid and investment, and how the development of business has influenced people's views of the settlement of the conflict with Azerbaijan.

4.1 RESEARCH METHODOLOGY

Through in-depth interviews with residents of NK and focus groups with NGO representatives, attempts have been made to assess the effect of each type of aid and its influence on the development of society and business.

Four questionnaires were created that targeted distinct groups of respondents. The target samples were as follows:

1. Beneficiaries of humanitarian aid;
2. Employees of private companies;
3. Entrepreneurs in SMEs;
4. Representatives of the intelligentsia.

It was possible to survey around 100 people from private companies that had received investment through visits to companies and villages using personal contacts. The survey of refugees was conducted using a 'snowball' sampling method and 30 respondents were questioned. Their passivity can be explained by the fact that the majority do not consider themselves refugees, while the rest are

indifferent to surveys. It was only possible to obtain responses from businesspeople through personal contacts. The small number of respondents in this category (36 people) can be explained by the fact that most businesspeople are wary of the authorities and not every respondent was willing to fill out the questionnaire.

5. RESULTS OF THE RESEARCH

5.1 HUMANITARIAN AID

To understand the positive and negative impacts of humanitarian aid fully, a survey was conducted among those members of society who regularly benefited from it. For the most part, the respondents were former refugees who have integrated into Karabakh society and no longer consider themselves refugees. All have acquired housing, some work and others run small businesses.

A completely separate group was asked a single question to judge any differences in perceptions of humanitarian aid between former beneficiaries and non-recipients.

BOX 1. RESULTS OF THE SURVEY AMONG BENEFICIARIES OF HUMANITARIAN AID

The questionnaire was completed by 30 former beneficiaries of humanitarian aid, while a further 50 non-recipients evaluated its role by answering the final question. Out of those who completed the questionnaire, 60% were men and 40% women, all living in urban areas; 20% were under 40; 50% were under 50; and 30% were over 50. By education, 40% had a secondary school education; 25% had an incomplete higher education; and 35% had completed university or the equivalent.

Of those surveyed, 15% had received aid for up to one year; 30% for over two years; and 55% for three years or more. All 30 respondents received aid in the form of food and clothing (usually, second-hand). 75% also received housing and 22.5% were given work, but only 10% received aid in all four forms.

None of those surveyed named the food or clothing they received as a circumstance that significantly contributed to their adaptation into mainstream society. 82.5% chose - or combined - the answers 'own initiative' and 'assistance in finding work' as the main factors in assisting their return to normalcy. The remaining replies were divided in the following manner: 10% chose 'assistance in finding work' and 7.5% named 'provision of housing'.

77% conceded that the development of business in NK helped them

overcome the problems that piled up in less fortunate times; 10% were sceptical about the impact of business on their lives; and 13% were indifferent to changes in the business world.

The refugees' answers to the survey's final question – and that of the other 50 respondents to whom it was posed – are of considerable interest. The receipt of aid changed opinions of 20% of respondents in favour of a peaceful settlement. 14% had changed their views in favour of military settlement. The views of 66% of respondents were unaffected, of whom 26% remained predisposed to a peaceful settlement and 40% still believed in a military settlement.

Responses to this question demonstrated the degree of hope this category of the population places in the development of business, and its bearing on positive changes in their own lives. It is interesting that everyone, without exception, evaluated humanitarian aid during the period 1989-94 extremely critically. In the end, the regular delivery of food and clothing aid only encourages dependency. A once gainfully employed person begins to live in expectation of the next 'hand out', in the words of one respondent. The respondents to this question shared the common opinion that assistance needs to be structured to help individuals earn money on their own. Humanitarian aid in the form of food and clothing should be of short-term duration, and only be available in the initial stages of a refugee crisis. The international community and humanitarian organisations need to focus a greater portion of their energy on the creation of work and the building of housing.

The building of temporary settlements for refugees in a conflict is of great importance. The ICRC, whose employees have worked in NK for more than 10 years, provides a good example. Over this period, ICRC restored 66 medical stations in the territory of Nagorno-Karabakh. This not only improved the inhabitants' health, it created 66 medical jobs, not counting the workers hired to carry out the building. ICRC spent \$350,000 on this programme and a further \$85,000 training medical personnel.

The NGO also carried out a huge amount of work providing 24 villages with clean drinking water. An average of \$6,000 was spent per village on the restoration of artesian wells and water pipelines, for a total of \$145,000.

ICRC's mine awareness programme from 2000-02 also made a large difference. Lessons educating children on the hazards of mines were conducted in 168 schools and a sizeable part of NK was demined. The programme included the construction of safe play-areas in Stepanakert and many border villages. The ICRC spent \$217,000 on the programme.

The contribution that international organisations and members of the Diaspora have made, and continue to make, in providing schools with computers and

equipment is also worthy of note. This provides a foundation for improving human resources in NK, with all its positive consequences for the republic.

Concerning the attitudes to peaceful or violent resolution of the conflict, the still fresh memories of homes abandoned or destroyed in the war, the pain of losing relatives and other loved ones, and the years of hardship still fuel the desire for revenge. Despite this, the arguments for a peaceful solution or a military solution have almost equal numbers of supporters, though those preferring a military settlement are in a slight majority.

5.2 INVESTMENT

NK's leaders have declared their intention to create an attractive investment climate at any price, but certain realities often stand in the way, including:

- Lack of international recognition;
- The blockade on transport;
- The possibility that hostilities will break out again.

In our opinion, a weakly developed competence in government and corruption also plays a large role. Nonetheless, progress in this area has been notable.

There are around 60 enterprises and companies in NK founded by foreign investors, though not all still function. They include: the ATA Vank Les timber company; mining of gold deposits in Drmbon in Martakert region; a plant assembling watch bodies for the Frank Müller company; a factory processing precious stones; a dairy-processing plant in Stepanakert; two poultry factories in Askeran and Martuni; a macaroni factory in Askeran region; and other enterprises. They all bear witness to the fact that conditions are being created that favour investment.

BOX 2. RESULTS OF THE SURVEY AMONG EMPLOYEES OF PRIVATE COMPANIES

The researchers surveyed 50 workers at ATA Vank Les and the watch-assembly factory (whose average monthly salary of \$250 is far above the norm), representatives of village-based businesses and workers at a diamond-processing plant. The questionnaire attempted to measure not only social changes in the lives of the respondents, but any transformation in their opinions regarding settlement of the NK conflict.

Of the respondents, 64% were men and 36% were women with ages ranging from 21 to 57. In terms of education, 18% had a secondary education, 54% a specialised secondary education, 26% held a university or

equivalent degree and one did not complete university. 34% had lost relatives in the war; 66% had not. 56% of respondents live in urban areas, while 44% live in villages.

16% served in the army prior to their current employment, 18% worked elsewhere and 66% were not previously employed. 22% of respondents have been with their current employers for less than one year, while the remaining 78% have been at their current place of employment less than five years. 36% of respondents have other family members who also work, while 64% are the only employed person in their families.

The households of 22% of respondents are made up of three persons, 28% have four-member families, 32% have five-member families and 18% have families with six or more members. 40% of the families had recently had a child, while 18% had expanded through marriage, and two had been joined by relatives from elsewhere. 57% of families were unchanged. 4% of respondents had purchased apartments, 2% a house and another 4% were building new homes. 4% of respondents had recently purchased cars and 12% had either purchased or built a garage. Not a single respondent had a dacha. 74% of families had not purchased any property. 4% of respondents had purchased large livestock, while not a single respondent reported having bought any small domestic animals. However, 44% of the respondents who reside in villages reported an increase in the number of their livestock. Only 34% of the respondents had purchased furniture. 4% of respondents had bought a television, refrigerator, washing machine and gas stove. Another 6% had purchased three household appliances, while 34% had purchased two household appliances. All the respondents had purchased some household appliance or another.

Families of 18% of respondents had a stall on the market and another 4% reported family ownership of a small shop. These were the same families that reported having purchased the largest number of household appliances. 36% of respondents or their family members had travelled outside NK, 60% had never travelled outside – of whom 4% said they had no wish to travel outside – and 4% had sent children to study abroad. 78% of respondents took some vacation, while the remainder did not. 84% of respondents are satisfied with conditions at work, 6% responded negatively and 10% were reasonably content with their working conditions.

The views of 52% of respondents had changed in favour of peaceful settlement of the conflict. 2% of respondents had been 'reinforced in the belief' in a military solution. 38% had not changed their views and still believed in the need for a peaceful settlement, while another 8% remained in favour of a military settlement.

Analysis of these answers showed respondents' desire – irrespective of where they lived – to improve their living standards by building or buying housing, enlarging their families or livestock, or purchasing household appliances or furniture. Furthermore, workers in regular employment and confident in what tomorrow will bring also demonstrate a tendency towards changing their views in support of a peaceful settlement of the conflict. Their natural desire is to safeguard the stability they have achieved, a well-being that could easily be lost if fighting resumes. 'I don't want to have to build my house for a second time and live through all the horrors of war again,' said one.

BOX 3. RESULTS OF THE SURVEY AMONG BUSINESSPEOPLE WITH SMEs

The questionnaires were completed by 36 respondents. The number was not as large as originally anticipated because of their reluctance to participate in surveys. The respondents worked in construction, publishing, wholesale trading, livestock breeding and farming. Almost 89% of the respondents were men. Female respondents were mostly active as organisers of pre-schools or as traders. Their ages ranged from 29 to 50. Of the respondents, 22.2% had a secondary education, 27.8% had a specialised secondary education, 41.7% had completed higher education and the remaining 8.3% had not completed higher education.

28.8% lived in rural areas, while 72.2% lived in cities (all the female respondents lived in urban areas). 31.7% respondents lost relatives in the war, while 68.3% had not. 58.3% served in the army before becoming entrepreneurs, 36.1% worked elsewhere and 5.6% did not work. 75% had been entrepreneurs for more than one year, but less than five; 25% had been entrepreneurs for more than five. No one among those surveyed had been an entrepreneur for less than a year. 19.4% of respondents received their start-up capital in the form of personal loans and 72.2% received partial help. Another 8.4% set up with their own capital, though the authenticity of this response seemed questionable. Only 5.6% received assistance in the form of a formal bank loan, the rest making do with unofficial sources. In conversation, one respondent revealed he had gone bankrupt due to high interest rates (up to 4% per month, with a repayment period no longer than one year). The situation has improved in the past year and banks now provide credit to agricultural enterprises for three years at 6% interest.

88.9% of respondents have relatives who work, but 11.1% are the only breadwinner in the family. 16.7% had households of up to three persons, 58.3% had four family members and 25% had five-member

families. 38.9% of families had a recently newborn child, 13.9% grew through marriage and 11.1% had been joined by relatives from other regions. 41.7% were unchanged. Entrepreneurial families display a notable degree of stability. 36.1% of respondents had purchased houses or apartments, while the remaining 63.9% had improved their living conditions in some way or another. 5.6% had bought apartments in Yerevan, 86.1% bought a car, or traded up an older model. 27.8% had two cars. 25% bought or built garages and 32.7% built or bought dachas. 19.4%, three of whom lived in villages, had acquired livestock. All the respondents had purchased furniture. Unlike the surveyed workers, entrepreneurs did not buy furniture as separate pieces, but complete sets.

As is obvious from the list, owners of SMEs spend significant sums on improving their living conditions and comforts. 5.6% of respondents, involved in trade, admitted to business contacts on the other side of the conflict. One of the respondents stated: 'My Azerbaijani friend helped to drastically increase the turnover of my trade.' The Azerbaijani in question, a trader at Sadakhlo market in Georgia, provided goods on credit.

All of the respondents or their family members had left NK on vacation. The children of 38.9% of respondents study at universities outside NK, of whom three are in Russia and Greece.

The views of 44.4% of respondents had changed in favour of peaceful settlement; 2.8% had changed the view in favour of military settlement; 33.4% said they had always supported a peaceful settlement; and 19.4% were firm in their view that the conflict could only be resolved militarily.

No matter how surprising, the survey data displayed a lesser change in favour of peaceful settlement among entrepreneurs than workers. This may be due to the larger number of ex-combatants among the entrepreneurs, though there may be other factors not revealed by the research. Contrarily, the number of potential participants in military activity among workers is far larger than among entrepreneurs, possibly due to the greater number of workers who lost family in the war. However, the responses could be influenced by a more 'demonstrative' display of patriotism among the entrepreneurs.

Another questionnaire was distributed among a less numerous social stratum, the intelligentsia. Respondents included artists, poets, teachers, doctors, scientists and academics. Some had stable jobs, some lived on royalties while others relied on help from relatives or friends living outside NK. This group of people do not simply express opinions, they play a role in moulding the opinions of the rest of the population. Other sections of society listen to and believe the intelligentsia,

and the government must also reckon with them. The questionnaire was distributed to 25 representatives of this group.

5.3 INTELLIGENTSIA AND NGOS

Before reviewing the intelligentsia's responses, it should be remarked that the influence of business on their activities is indirect, although it has been growing since government support for artistic work was cut to a minimum.

BOX 4. RESULTS OF THE SURVEY AMONG INTELLIGENTSIA

Out of 25 respondents, 56% were men and 44% were women. The respondents were between 30 and 68 in age. 76% have a higher education, 16% did not complete their higher studies, 4% had a secondary education and 4% had a specialised secondary education. 18% of those surveyed had a family member who died in the war.

Of the respondents, 84% live in urban areas and 16% live in villages. 72% are regularly employed, while 28% work as circumstances allow, but 84% received support from relatives living outside NK. Their average wage is around \$40-50 per month, less than a quarter of that of workers in private enterprises. 12% said the development of business had noticeably improved their quality of life, 48% reported insignificant improvement, 8% reported a significant worsening and 28% reported some deterioration. 4% did not think that business development had any effect on his living standards. Of those who reported a noticeable improvement, 66% were artists who are much in demand. Most who reported some improvement earn money by providing private lessons in their specialist fields. Doctors and teachers faced the most difficult situation, with monthly salaries of \$25-30, around 10-15% of earnings in the private sector. 'It creates a feeling of unease and discomfort to enter the class, and see a student better dressed and taken care of than us,' said one of the teachers interviewed.

Only 12% responded positively when asked if there had been an improvement in education. 4% reported an insignificant improvement in education, while 16% reported an insignificant worsening. 60% consider the level of education has significantly worsened, while 8% answered that there had been no noticeable effect. This pessimism results from two factors: the destruction of the old educational system and the lack of business involvement in education. Concerning pre-school education, 44% of respondents are convinced that the level has improved, but 12% reported that it has not. 44% noted an insignificant improvement. All

pre-school institutions in NK (except for one kindergarten sponsored by a philanthropic organisation) are private, commercial enterprises. The 88% of respondents who noted some degree of improvement in pre-school education demonstrates the impact of business not only on pre-school education, but education as a whole. 52% consider that business has positively influenced their main sphere of activities, 20% reported it had had a negative effect and 28% said business had had no noticeable effect. The majority reporting a positive effect of business on education were teachers in higher education or those in the performing and other arts. Medical workers and secondary school teachers tended to report that business either had no effect, or a negative influence.

84% of respondents believed that business facilitates the creation of a state based on the rule of law. 16% consider that business development is in no way connected with the building of the rule of law. It is symptomatic that not a single person responded negatively – that business hinders the development of the rule of law. One respondent noted in the margins of the questionnaire: ‘Civilised business is the basic building block of any law-based state.’ 36% reported that they had more or less regular contacts with Azerbaijanis. They were mostly journalists, scientists and academics who had participated in inter-regional conferences and seminars, or NGO representatives working on joint projects. 64% had had no contacts with Azerbaijanis since the outbreak of the conflict, with many relating this not to a lack of desire, but the lack of any reason for doing so.

44% of respondents had changed their position in favour of a peaceful settlement and no one respondent had changed his opinion in favour of a military solution. 24% were firm in their conviction that the conflict required a peaceful settlement, whereas 32% were still convinced that a military settlement was needed.

Of all four groups surveyed, the intelligentsia is the most contradictory and inconsistent in its answers, possibly due to the original thinking that characterises this section of the population. Broad contacts with members from the conflicting side may explain the wider range of views held by respondents, as well as the high communication skills and patience demonstrated by the intelligentsia.

But it is also impossible to ignore the fact that this group is also the most belligerent. The early engagement of the intelligentsia in drawing attention to, and addressing, historic injustices may have played a role in the responses given. In any case, the present analysis makes clear the need for more serious research into this

section of society, taking into consideration its influence on the larger population. Nonetheless, the positive role of business is evident from this sample group.

In addition to that, the research discovered a general optimism in the development of business and NGOs. That such a vibrant, non-profit sector could come into being was scarcely imaginable during the war or the post-war period when the economy was shattered and local sponsorship impossible. The first NGOs took wing with the initial reconstruction of the state and social institutions. Their number has increased from 57 to 78 in the last three years, and most remain active. The most prominent NGOs include:

- ‘Tradition’, which organises summer sport and fitness camps for young people and also encourages the dissemination of computer technology in villages;
- ‘Young Democrats’, which participates in joint projects and inter-regional seminars;
- *Aiky Serund*, which organises meetings between Armenian-speaking youth organisations from different countries and participates in joint projects with other NGOs;
- ‘Youth Centre’, which has set up a radio station for NK youth;
- ‘Veterans Union of Artsakh’, which participates in actions to support veterans and former combatants;
- ‘Union of Afghan War Veterans’, which has recently renewed its activities.

All the above organisations receive all or part of their funding from sponsors in NK, and other forms of support in kind are common. ‘Tradition’ receives support for its summer camps from the open stock company, ArKGrup, and in-kind support from the closed stock company, Garni and Mrakats. *Aiki Serund* also receives funding from ArKGrup, and Garni and Mrakats. ‘Youth Centre’ was supported by the closed stock company, Karabakh Gold. In addition to these, there are smaller companies and private sponsors that, for various reasons, do not wish to publicise their philanthropic activities. Nonetheless, there is a general impression that people are beginning to realise the need for further development of the NGO sector. The main criteria for choosing what programmes to support are personal acquaintance, a project’s utility and the prestige associated with sponsoring.

Five years ago, not one of the cited business sponsors would have dreamed of donating money to an NGO. If asked, one entrepreneur related, he would not have been able to ‘decipher the term “NGO”’. Asked how he viewed the connection between business and NGOs today, he replied that the ‘development of a network of NGOs in Karabakh is to a certain degree also a guarantee of the independence of my business’. The tendency for entrepreneurs to change their views on NGOs has been crucial to the development of the third sector in NK, but the same is also

true in reverse. The expansion of the NGO network facilitates the development of the service industry and tourism as well. The expansion of NGOs and business is mutually related and complementary.

The non-profit sector is highly international and has increased the number of countries with dealings with NK. A multitude of connections have been made with organisations from different countries, including Azerbaijani NGOs, and many organisations work on joint cross-border projects. This has led to the consolidation of new acquaintances, exchange visits and the formation of joint plans. NGOs such as the Stepanakert Press Club, the Institute of National Diplomacy, Helsinki Initiative 92 (the first NGO to be established in NK), the Centre of Civic Initiatives and others have joint projects with Azerbaijani counterparts.

It is difficult to evaluate the peacemaking role such contacts play in conflict settlement, particularly since this is currently the only real peacemaking factor inside NK. No one marvels at the arrival of visitors from Baku anymore. Such visits are considered necessary and normal contacts by the government as well as society, underlining the influence of NGOs in the current search for a peaceful settlement to the conflict.

Focus-group research was conducted to furnish a broader understanding of these issues, as well as the attitude of NGO representatives to the research questions.

How did you imagine humanitarian aid functioning, and how did it function in reality?

- A participant with experience of receiving medical aid noted that 40% of it was expired. It is important that developed countries do not treat developing countries as second-class states where it is possible to dump outdated equipment, representing it as new.
- A participant with experience administering children's camps for temporarily displaced persons noted the importance of all kinds of humanitarian aid in the initial stages of a conflict. However, such aid eventually has a negative impact on children, turning them into 'beggars' who may be used by 'certain powers' to manipulate society and attain their goals. One foreigner representing certain interests, he noted, had asked: 'When will Armenians become beggars?'
- The next participant believed that people are prone to choosing a 'parasitic lifestyle', in continuous expectation of the next handout. This participant, recalling his/her own experience in collecting clothing and other goods for those affected by earthquake, noted that aid does not have to be brand-new. However, all food aid must be fit for consumption and meet international standards. Food aid often turned out to be unfit for various reasons.
- A young participant, who was a teenager in an aid-receiving camp, believed aid should be 'similar and equal for all. In actual fact, this did not turn out to be

the case'. Initially, many people declined aid in the form of used clothing, but in time they accepted it despite the fact that such aid was 'killing within them a feeling of their own worth'.

- The next participant reminded the group that, immediately after the war, aid entered Karabakh in the form of flour, clothing and baby food. 'I imagined that this aid would be honestly distributed and, perhaps, this happened at first,' she said. 'Later, it became a business from which money was made.' In her opinion, humanitarian aid should be distributed according to fixed categories from the start, but it was best if it was delivered only during times of recovery because 'it is better to provide for oneself'.
- A participant from the veterans' movement noted that those who controlled the flow of aid made 'big money' and that 'certain people delivering medical aid were mixed up in the drug trade'. He said such abuse created a negative view of aid in general. Others added that society was not then ready for such developments and that abuses would be rooted out today.
- Another former aid recipient in the focus group noted that aid did not take into consideration the specificities of the region and included food 'alien to our people' that was simply thrown away. Occasionally, 'they would give away clothes in our neighbourhood,' the participant said, 'but they never reached the refugees who had no clothes'.
- The last participant noted cases where representatives of aid agencies had arrived to supervise aid distribution, but their presence was formal and lasted only one or two days. They could not influence the actual distribution of aid, this participant asserted, but they also did not want to get too closely involved in such sensitive situations.

What do you think about targeted humanitarian aid?

- There was a consensus that targeted aid is the only proper way of distributing humanitarian aid. Different social categories that were in need of aid today were mentioned. Commissions responsible for the distribution of targeted aid should contain government representatives and members of the recipient categories. There was agreement that a mechanism needs to be created that allows humanitarian organisations and government representatives to ensure periodically that aid is actually reaching the targeted groups.

What was your original view of investment in NK's economy and how do you rate the results of this investment?

- The first participant's view of investment was that it should increase the national budget, create new jobs and develop the economy in general. Investors have an overriding goal, which is to realise profit.
- The second participant argued for investment in areas that improved the standard of living, notably in 'connection with the production of bread'. In

his opinion, such sectors are controlled by ‘unknown people’ who can increase prices at any time, influencing the minimal needs for the population’s survival. But there are positive examples of investment. One such is a Swiss company producing watches and clocks that is built on a mutually beneficial basis: ‘it provides cheap labour for them, and high wages and new jobs for us.’ This model should be replicated in policies designed to attract foreign investment to NK.

- The next participant believed that the economic situation should be surveyed to identify the branches most in need of investment. She cited as a positive example the activities of AMKOR-Aregak, an organisation that provides women with family or group credit to launch small businesses. A number of women have benefited from such credit.
- Almost all participants underlined the importance of infrastructure investments made by the US government through CRS.
- Two participants observed that investors are insufficiently protected by law. A prime example was the closure of ATA Vank Les, a company that once employed 250 people, due to a dispute between the owner and those in power. As a result, the entire sub-region was deprived of its largest employer and the government lost the taxes it would otherwise have collected.
- Almost all participants agreed that it was not important whose money was invested. The main object was to create new jobs, though it was noted that local businesspeople were in an unfavourable position in this regard due to a lack of capital.

What role does and should SMEs play in the development of the NK economy?

- ‘SME are the only ones possible in NK.’ All participants agreed with this view.
- Due to NK’s limited population, small territory and lack of natural resources, large-scale business can only exist in exceptional cases, such as the trade in oil products or Drmbon gold mine.
- A number of participants cited the possible danger that small business could be monopolised and controlled by a few individuals.

Can NGO activities support the development of SMEs, and do any examples of this process exist?

- The participants agreed that such a possibility exists.
- One participant observed that one NGO generates small business to provide long-term support to its own philanthropic activities. In her opinion, such projects contribute to the development of civil society in as much as such entrepreneurs enjoy an independent status and way of thinking.
- ‘I would like to mention the example of a number of NGOs that have begun different lines of production and are already selling products,’ said one participant. ‘This is part of an eventual transition from NGO

to small business.’ The patients of one rehabilitation centre sell the arts and crafts that they make. A computer centre created by the NGO Tradition acts as a self-sufficient business, and has the capacity to invest its own resources in further charitable works.

- One participant noted that ‘profits from such businesses suffice only for continued survival, not further development’.
- Another expressed the opinion that NGOs should try to create businesses in order to support their own programmes and projects, instead of ‘waiting with an open palm for help from others’. This opinion was not unconditionally accepted by the others.
- There was a consensus that the creation of independent business structures with independently minded owners was the most effective means of developing civil society.

Can the development of SME positively influence the peaceful settlement of the conflict, and in what way?

- People in business have a different approach to life, the first participant said. Business has ‘no nationality’ and the larger the business, the more readily it develops beyond national categories. There are many examples of Armenians and Azerbaijanis trading at Sadakhlo market who then combine for joint ventures in Russia. Finally, people who have something to lose as a result of war are extremely unlikely to start military action.
- Another participant was of the opinion that ‘conflicts will always exist, irrespective of whether people are well off or not, because life cannot exist without conflict. However, it may be that the development of business to a certain degree decreases the probability of conflict’. He noted that the development of business is synonymous with economic development, the development of commercial ties and the introduction of new information, all of which lead to the democratic values that in the end facilitate a peaceful settlement
- Another participant added that the same factors lead to the recognition of an unrecognised state; when ‘you are economically strong, you must be taken into account’.
- The next participant noted that conflict regions share the experience of maintaining refugee camps where the main means of survival is humanitarian aid. Manipulating such people was not particularly difficult.
- Finally, the opinion was expressed that people who can provide for themselves – or are well provided for – and those who have business contacts with the conflicting side do not want to go to war. All participants agreed with this opinion. It was recalled that, at the beginning of the conflict, Armenian businesspeople in Baku had tried to convince people not to deepen the conflict because they feared everything they had would be lost.

6. CONCLUSION AND RECOMMENDATIONS

Through the research carried out for this paper and the analysis of the data, the author has been able to identify the following trends:

- Large-scale humanitarian aid is effective and has a positive impact during the initial stages of a refugee crisis in as much as it helps people recover from a state of shock, and gives them a feeling of solidarity and hope for the future. With the establishment of peaceful civilian life, the continuation of humanitarian aid begins to foster a dependency syndrome and a desire for revenge among beneficiaries. Recipients suffer psychologically from their lack of self-reliance. The provision of work and living space more quickly relieves the psychological stress associated with the horrors of war and ethnic conflict, and the victim has a better chance of becoming a full member of society.
- The research underlines the fact that refugees who obtained work or were provided with permanent, private housing adapted most quickly to their new conditions and became participating members of society.
- The work of ICRC, MSF and other NGOs in rebuilding infrastructure and medical institutions was wholly positive. This is expressed in the following types of projects:
 - > The reconstruction of infrastructure during the military stages of the conflict, even on a temporary basis, allows the population to carry on more or less normally;
 - > The reconstruction of the public health system and the provision of modern medical equipment and medicines;
 - > The continued functioning of medical and other infrastructure supports the revitalisation of other infrastructure over time, creating employment and the spread of modern technologies;
 - > The provision of seeds and fertilisers to farmers hastens the revival of agriculture;
 - > The provision of computers to schools and other educational facilities speeds up the region's integration with the international community.
 - > In this manner, the activities of the above organisations not only lessened tensions in the region, they facilitated economic progress.
- Regarding the influence of investment on the level of economic development, it should be noted that investment helps:
 - > Lower the prices of basic necessities and other products, simultaneously increasing the population's purchasing power;
 - > Growth in the birth rate and the number of pre-school and school institutions;
 - > Increase the number of students at university-level institutes inside and outside the republic;

- > The development of tourism and service industries;
- > The expansion of construction;
- > The development of modern technologies;
- > The international exchange of experience and the establishment of a tradition of development in SMEs;
- > Creation of new jobs;
- > Creation of new possibilities for expanding markets through investment.
- The research also demonstrated that increases in investment influence the general mood of the population, which is expressed in the following:
 - > Confidence in the present, but also in the future;
 - > Investment of private domestic savings in SMEs;
 - > Study of the experience and traditions of developing SMEs in developed countries;
 - > Understanding of the value and significance of one's own role in the development of business.
- The development of SMEs changes the population's attitudes toward the conflict with Azerbaijan in favour of peace. This is evident in:
 - > The search for new contacts with the opposing side;
 - > The development of contacts between NGOs on both sides of the conflict;
 - > The realisation that peaceful co-existence is the only path to one's own well-being and prosperity.

The following recommendations can be drawn from all of this:

- Intensive humanitarian aid should only play a role during the initial and most difficult stages of a conflict. Later, it is better if aid takes on a more focused character since the continuation of large-scale humanitarian aid leads to overdependence and cultivates a desire for revenge. Refugees, others who have lost homes, single mothers, multi-member families and other special needs groups require special attention.⁴
- The ICRC, MSF and other international organisations that provide aid to conflict regions should work from the start on rebuilding infrastructure and medical facilities, providing the latest modern technology and equipment, as well as training medical personnel.
- The region should facilitate the creation of a positive investment climate by adopting the proper legislative and tax policies, and introducing active measures to combat corruption.

Endnotes

- ¹ de Waal, T. (2003) *Black Garden: Armenia and Azerbaijan through Peace and War*, (New York, USA: New York University Press).
- ² Barsegov, Y. (1989) *The Right to Self-Determination: The Democratic Basis for Deciding Problems between Nations* (Yerevan, Armenia: Aiastan Publishers), (in Russian).
- ³ *Kommunist*, 2 December 1989; Central Committee of the Communist Party and Supreme Soviet of the Armenian Soviet Socialist Republic. Joint declaration of the Supreme Soviet of the Armenian Soviet Socialist Republic and the National Soviet of the Nagorno-Karabakh Autonomous *Oblast* from 1 December 1989.
- ⁴ In keeping with the recommendations above, the author would suggest a future business project that would foster cooperation between the conflicting sides in NK, and with the international community. The Sarsang reservoir in NK used to irrigate large areas of Azerbaijan close to the border prior to the outbreak of the conflict. In spring and summer, water from Sarsang was distributed through numerous canals to fields where cotton and vegetables were grown. The irrigation system, partially in NK and partially on Azerbaijani territory, was heavily damaged during the fighting and the canals have been neglected. The author suggests renovating the irrigation system with international assistance and establishing a market on the border, which would provide a large boost to local farmers. This would, in turn, facilitate the development of SME in both Azerbaijan and NK. This project could also have positive impact on the peacemaking process.

CHAPTER FOUR

Georgia: conflict regions and economies

DAVID CHKHARTISHVILI, ROMAN GOTSIRIDZE AND BESSARION KITSMARISHVILI

1. INTRODUCTION

A final, peaceful settlement of Georgia's conflicts with Abkhazia and the Tskhinvali region (South Ossetia) is vital to the country's economic development, the improvement of the population's socio-economic situation and the formation of a democratic civil society. The breakaway republics find themselves in an especially difficult situation. Central and regional authorities must use all the means at their disposal to narrow the differences in the conflicting parties' positions and reach a solution that would lead to normalisation of relations and the return of refugees.

An important aspect of the conflicts is their negative impact on economic potential: economic instruments could also serve to promote conflict settlement. Freezing the conflicts, with no normalisation of relations, has extended the political and economic damage caused by the military conflict. The state continues to be responsible for assisting the internally displaced, political stability is still in jeopardy, transport routes are blocked and the region's economic ties destroyed.

Most of Georgia's population continues to suffer the economic side effects of the conflicts in Abkhazia and South Ossetia, and the collapse of the USSR. Although Georgia has managed to establish a coherent monetary policy, stabilisation of prices and some economic growth, GDP per person amounts only to \$700 (less than \$2 per day), a figure that is only 40% of pre-independence levels. Georgia's expenditure is among the lowest in the CIS, at 18.5% of GDP in 2001.

According to data from 2000, 23% of the population lives below the poverty line and up to 60% face the threat of falling into poverty. Public health indices and the quality of education have drastically worsened. The poorer sectors of society, moreover, suffer disproportionately from unequal access to services and deteriorating infrastructure.¹

The informal or shadow economy constitutes a huge proportion of economic

activity, with some estimates putting its size at half of the total. Meanwhile, Georgia has \$1.7 billion in foreign debt, almost half of GDP or approximately \$340 per person.

The continued existence of the conflict regions is one of the main contributing factors to worsening, socio-economic conditions. The government in Tbilisi has no control over 16% of its original territory, an area that contributed around \$1 billion to GDP each year before the outbreak of fighting. For comparative purposes, Georgia's total GDP in 2002 was around \$3.5 billion.

The direct and indirect socio-economic effects of the two conflicts include:

- Lack of control of Georgia's borders, growth of illegal trade, lack of protection of the internal market and the criminalisation of business;
- A massive shadow economy and pervasive corruption;
- Sharp financial and budgetary shortfalls due to inefficient tax collection and growing trade imbalances;
- Declining investment and capital flight;
- Growing foreign debt;
- Decline in manufacturing output;
- Government expenditure on large refugee or internally displaced populations;
- Political destabilisation arising from the extreme poverty of refugees and others in temporary housing;
- Population decline caused by migration and a decreasing birth rate;
- Growth in crime, especially among refugees who face higher than average unemployment rates.

2. RESEARCH DESIGN

A specific feature of Georgia's internal conflicts is their location in strategic border regions. The major land routes that connect Georgia with Russia and Europe run through separatist territories.

The scale of smuggling to and from neighbouring states, especially Russia, is dangerously large. Untaxed and unregistered imports flow into Georgia via the conflict zones, where customs officials have no control, creating unfair competition for legal importers, reducing import revenues and disadvantaging local producers. The illegal export of unregistered goods is also sizeable.

The main purpose of this paper is to analyse the economic characteristics of the self-proclaimed republics on Georgia's borders as a consequence of freezing the two conflicts.

The data were collected through surveys, document and press analysis, and expert assessments. It was difficult to locate the necessary data since no competent Georgian

agency has reliable statistics on Abkhazia and South Ossetia’s financial, economic and social situation, and nor do their own governments maintain precise information.

We used the following sources during our research:

- Newspapers published in Abkhazia and South Ossetia, as well as materials from other mass media;
- Material published in Russia, other foreign press and the Internet;
- Polls conducted in Abkhazia and South Ossetia (mainly in Gali and Tskhinvali regions);
- Information from Georgian ministries and institutions;
- Materials from the Georgian Parliamentary Commission on Abkhaz issues;
- Materials prepared by the UN needs assessment for Abkhazia.²

The UN mission report is the most reliable of these sources, though it is now somewhat dated. However, economic analyses and extrapolations (expert assessments) still capture some of the financial, economic and social processes taking place in Abkhazia and South Ossetia despite shortages of more reliable information.

3. ECONOMIC SITUATION IN THE CONFLICT ZONES

Two separatist conflicts – between Georgia and Abkhazia and South Ossetia – will be analysed within the framework of the current research. Currently, both conflicts are frozen under a ceasefire enforced by Russian peacekeepers under the aegis of the CIS. Both conflict zones are economically and politically vital to Georgia. Their quickest possible settlement is of vital importance and Georgia’s overriding priority.



3.1 THE ECONOMIC SITUATION IN ABKHAZIA

With an area of 8,700 km², Abkhazia is situated to the northwest of Georgia and is equivalent to 12.5% of all Georgian territory of 69,700 km².

According to the 1989 census, 525,000 people, or 9.7% of Georgia's then population of 5.4 million people, lived in Abkhazia. Ethnic Georgians constituted 45.7% of the 1989 population (239,900 people); Abkhaz accounted for 17.8% (93,300)³; and other minority groups include Russians, Armenians, Greeks, Jews and others. The military action of 1992-93 led to the mass exodus of Georgians from Abkhazia, radically altering its demography. The UN estimates there are now only 180,000 people living in Abkhazia.

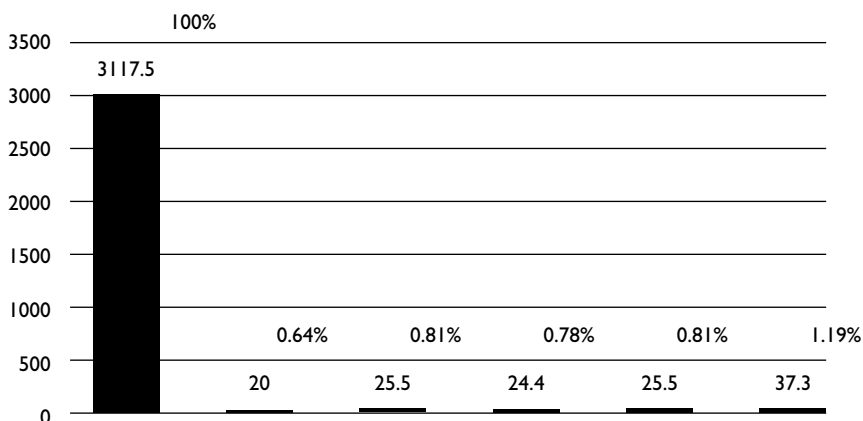
By rough estimates, Abkhazia's GDP in 2001 was around \$70-80 million, or \$350 per capita, compared with \$700 million in 1988. This figure is half the equivalent indicator for the rest of Georgia (see table 1).

TABLE 1. PRODUCTION VOLUME IN THE PUBLIC SECTOR OF ABKHAZIA, 1989-98

	1989	1994	1995	1996	1997	1998
Turnover (billions roubles)	2	46	128	130	149	224
Turnover (\$000,000)	3,117.5	20	25.5	24.4	25.5	37.3
Growth in comparison to previous year (%)	—	-99.4	27.5	-4.5	4.5	46.2
Production volume in comparison to 1989 (%)	—	0.64	0.81	0.78	0.81	1.19

SOURCE: UN NEEDS ASSESSMENT MISSION TO ABKHAZIA, MARCH 1998

CHART 1: CHANGE IN VOLUME OF PRODUCTION IN THE PUBLIC SECTOR OF ABKHAZIA, 1989-98 (\$000,000)



SOURCE: UN NEEDS ASSESSMENT MISSION TO ABKHAZIA, MARCH 1998

Abkhazia’s social services are in complete disrepair. Given the region’s massive unemployment, the population is dependent on subsistence farming and humanitarian aid for survival.

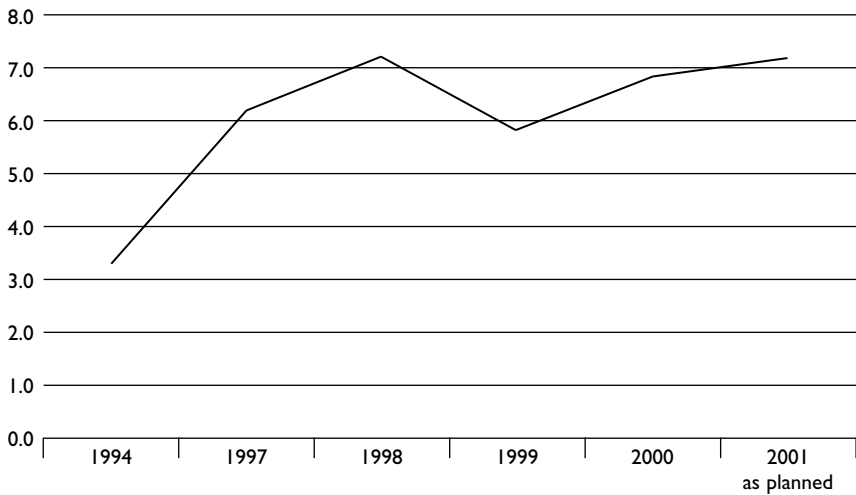
Budgetary expenditure is tightly constrained. Revenues equalled \$7.2 million in 2001. In per capita terms, budgetary expenditures amounted to around \$30 per person in the same year. Given its small size, state expenditure plays little role in people’s social or economic life.

TABLE 2. NATIONAL BUDGET OF ABKHAZIA IN 1995-2001 (\$000,000)

	1995	1996	1997	1998	1999	2000	2001	2002 (PLANNED)
REVENUE	4.94	5.55	6.10	6.2	6.3	7.2	7.2	8.9
EXPENDITURE	5.29	5.76	5.98	6.0	5.7	7.4	7.7	9.3
SURPLUS/(DEFICIT)	(0.35)	(0.21)	0.12	0.2	0.6	(0.2)	(0.5)	(0.4)

SOURCE: BUDGET OFFICE, PARLIAMENT OF GEORGIA

CHART 2. NATIONAL BUDGET REVENUES IN ABKHAZIA, 1994-2001 (\$000,000)



SOURCE: BUDGET OFFICE, PARLIAMENT OF GEORGIA

The official currency of Abkhazia is the Russian rouble. There are 15 functioning commercial banks in Abkhazia, though their total credit portfolio amounts to only \$4 million. Interest rates are very high at 5-10% per month. Private deposits are minimal and financial stocks come mostly from foreign, mainly Russian, sources.

Industry, like other branches of the Abkhaz economy, is in ruins. With few exceptions, factories do not function and those that do still work are on the brink of closure.

Logging shows some signs of activity and the authorities are making every effort to export timber products. However, lack of regulation in the industry is an environmental hazard and there is considerable deforestation.

Abkhazia's once-important food processing industry has practically ceased to exist. Bakeries are among the few enterprises in the sector that do continue to function. One significant exception is a plant producing fruit preserves, non-alcoholic drinks and mineral water, but even this enterprise faces huge problems. Of 23 tea-processing factories, only nine were operational in 2000 but none at full capacity. Overall tea production is estimated at 1.5% of its pre-war level. In 2000, Abkhazia produced 2,000 tonnes of tea, compared to 111,100 tonnes in 1989.

Electricity supply

Abkhazia receives electricity from the Inguri hydroelectric plant. The Inguri reservoir is situated on territory controlled by Georgia, but the plant and distribution transformer are located in Abkhazia. Following an agreement between the two, 60% of the electricity produced goes to Georgia while 40% is distributed in Abkhazia free of charge. Abkhazia also receives electricity from Russia.

Georgia's authorities provide valuable assistance to Abkhazia by paying for electricity delivered to the region either from Georgia or Russia (see table 3). Between 1993 and 2001, \$35 million of electricity was delivered from Georgia proper, while Inguri supplied a further \$110 million worth, a total sum amounting to twice Abkhazia's annual GDP. In addition, energy deliveries to Abkhazia from Russia added \$44 million to Georgia's external debt.

The Inguri plant employs mainly Georgians but its operations provide a rare example of peaceful cooperation between the Georgian and Abkhaz authorities. At present, it is being renovated as part of a €40m loan to Georgia from the European Bank of Reconstruction and Development.

The delivery of electricity to Abkhazia is a necessity since the latter can close the plant at any time. As a result, Abkhaz factories, the railway and the country's inhabitants pay next to nothing for the power they consume.

Transport infrastructure

The military conflict resulted in the devastation of the transportation network. Abkhazia's roads and bridges, unrepaired since the war, remain in ruins. There are four functioning seaports in Abkhazia: Sukhumi, Ochamchira, Gagra and Gudauta. Sukhumi has the greatest capacity. The region's main airport is located not far from Sukhumi in Gulripshi. It has an excellent runway and is equipped with automated landing instruments. The airport has the capacity to handle air freight, but this facility is presently not functioning. Most railroad stock was rendered unusable in the conflict. There

has been limited reconstruction, but the transportation of large amounts of heavy freight by rail is not possible at present. Passenger trains and small cargo services run from Sukhumi to Ochamchira and Sochi in Russia.

TABLE 3. ELECTRICITY SUPPLIED TO ABKHAZIA, 1993-98

Period	From Georgia		From Russia		Total electricity supplied, in millions of kilowatt hours (kwh)
	Millions of kilowatt hours (kwh)	Price in thousands of lari	Millions of kilowatt hours (kwh)	Price in thousands of lari	
1993-96	1,340.9	36,326.0	1,020.0	19,635.1	2,360.9
1997	530.7	14,741.3	136.6	4,193.5	667.3
Jan-July 1998	352.5	11,632.8	77.9	2,425.4	430.4
Total	2,224.1	62,700.1	1,234.5	26,254.0	3,458.6

SOURCE: 'GRUZENERGO' GEORGIAN STATE ENERGY COMPANY

Agriculture

Agriculture traditionally played the lead role in the economy. Tea, citrus and other multi-year, labour-intensive crops occupied more than 40% of land under cultivation. The conflict seriously damaged the region's potential for farming and animal husbandry. The destruction of infrastructure, a much decreased labour force, and the collapse of support structures and markets all contributed to the precipitous decline that has afflicted the sector since 1993.

Abkhaz agriculture was always oriented towards exports. Following the break-up of the Soviet Union, Abkhazia – and Georgia as a whole – lost its monopoly of the region's subtropical produce market. Sanctions on Abkhazia's foreign trade, introduced by the CIS in 1996, made a bad situation worse. Abkhaz produce, however, still finds its way to the Russian and Turkish markets. In 2001, almost the entire 4,500 tonne citrus harvest was exported to Russia. The use of agricultural land has severely declined and almost 60% of arable land lies fallow. The lack of seed, pesticide, fertiliser, fuel and functioning machinery has caused steep falls in output.

Forty per cent of Georgia's citrus plantations were situated in Abkhazia. Productivity has fallen drastically since the conflict and, if not reversed, the trend could irreparably damage the region's potential to cultivate subtropical fruits. Rehabilitation of plantations will require a major influx of capital investment.

Abkhazia has the potential to produce more than 100,000 tonnes of tea per year and this crop could play an important role in rebuilding the economy and providing jobs. From 111,100 tonnes of tea collected from 11,100 hectares in 1989, output has fallen to around 2,000 tonnes in 2001.

Livestock remain a significant part of the region's agricultural pattern though, at present, production only meets the population's subsistence needs. The

number of livestock and poultry has declined by 60% since 1989 and commercial animal production has died out.

The export of hazelnuts has become profitable and an important source of hard currency both for government and unofficial power holders. Collection points operate in many villages, and farmers have planted hazelnut trees on former plantations and on land abandoned by Georgian refugees. In Gali, the local administration expects every family to produce an average of 70-80kg of hazelnuts a year. Local militias answering to the local administration reportedly force farmers in Gali to sell their excess production at below market levels. Farmers from Gali sell their excess in Zugdidi, across the Georgian-Abkhaz border, but Abkhaz hazelnuts are also found in Sochi, Russia. Unofficial 'taxes' are levied on those heading across the frozen frontlines to Zugdidi or across the River Psou to Sochi. Abkhaz criminal gangs also extract money for the right to sell walnuts in Gali.

Those living farthest from Gali face the sternest conditions. With fewer possibilities to trade and no alternative commercial structure, the population lives primarily on vegetables, corn and beans.⁴

Tourism was for a long time the main source of employment and income for the Abkhaz. During the conflict and in the immediate ceasefire period, many hotels and other tourist facilities were ransacked and ruined. However, by comparison with other economic sectors, the resort industry is probably the best preserved. The number of package tours to Gagra in 2001 was 3% of the pre-war total and most tourists were Russians, many of them the families of CIS peacekeepers or troops stationed at Gudauta military base.

Foreign trade

Despite the CIS decision on 19 January 1996 to limit trade with the separatist government of Abkhazia, unofficial imports and exports remain substantial.⁵

The majority of transactions consist of one-time deliveries of goods paid for in cash or by barter, a practice that stunts the development of long-term business relationships. More orthodox financial transactions are not conducted and the banking system is poorly supplied with capital, preferring to focus on providing short-term credit at high rates of interest.

Abkhazia's leading exports are tea, citrus, tobacco, scrap metal, timber and hazelnuts. Grain, flour, sugar, butter, potatoes and fuel are its most common imports. In recent years, timber exports to Turkey have dominated total exports by value. About 60% of recorded imports are from Turkey, with the remainder from Russia. As for registered exports, Russia receives 54% and Turkey 45% (see tables 4 and 5).

TABLE 4. FOREIGN TRADE BALANCE OF ABKHAZIA (\$000,000)

	1996	1997	1998	1999	2000
Export	2.8	6.0	6.0	4	6.3
Import	4.8	11.6	14.0	5.7	11.3
Balance	-2.0	-5.6	-8.0	-1.3	-5.0

SOURCE: BUDGET OFFICE, PARLIAMENT OF GEORGIA

TABLE 5. PERCENTAGE OF PARTNER COUNTRY IN TRADE WITH ABKHAZIA

Percentage of partner country in total exports	%
Russia	54
Turkey	45
Other	1
Percentage of partner country in total imports	
Turkey	60
Russia and other countries	40

SOURCE: BUDGET OFFICE, PARLIAMENT OF GEORGIA

Gali region and Kodori Gorge

Two regions in Abkhazia are worthy of special mention. The first, Gali region, is still under Georgian jurisdiction despite its location well inside the Georgian-Abkhaz border. Gali's population is composed almost entirely of former Georgian refugees whose return to the region occurred spontaneously and without any social or legal guarantees. On 27 May 1998, a presidential decree established the office of the State Presidential Envoy to Gali region with the goal of coordinating the work of government agencies in the area.

At present, Georgian jurisdiction in the Kodori Gorge extends to only 18 villages or settlements, consisting of 630 families and 3,100 individuals living between the Klukhor pass and the village of Lata.

Since 1995, the government has provided assistance for the reconstruction of infrastructure, including the Chubur-Sakeni road. Educational and medical clinics have been renovated and the most urgent food needs of the population are being met. The Ministry of Post and Telecommunications was given special funds to extend radio, television and radio-telephone to the pass.

Seven people work on the gorge's electricity distribution system, which is of strategic importance because Georgia imports Russian electricity through the pass. This system includes:

- 10kw elevated line with a total length of 64.8km;
- 0.4kw elevated line with a total length of 116.54km;
- And 21 transformer stations with a total strength of 9,235kw.

Air connections to Kodori Gorge are complicated by Georgia's aged helicopters, which can only fly into the pass in good weather while easier air routes are controlled by the Abkhaz authorities. Only three-axle trucks can make their way by road into the gorge.

Unemployment is a major problem. Local production is at a standstill and the sawmill is closed. The area's timber industry could again be profitable, given proper investment. Development of the area's traditional income-generating activity, livestock rearing, is inhibited by bad roads and limited access to market.

Criminal activity is rife in Kodori Gorge, particularly in the narcotics trade. As well as local criminals, the area serves as a sanctuary for criminals from elsewhere in Georgia. The growth in serious crimes, such as banditry, armed robbery and murder, are cause for special concern. Between 1994 and the present, up to 60 cases of premeditated murder were recorded. The Georgian prosecutor's office does not maintain an office in the gorge and local police are understaffed.

The population possesses a large number of unregistered weapons, a fact that establishes the preconditions for criminality. However, the population has been forced to protect itself since 1994 when all military units were removed from the region as part of a ceasefire agreement. At present, Ministry of Interior troops patrol the gorge.

Abkhaz military forces are concentrated at the approaches to tunnels leading into Kodori Gorge and in the territory adjacent to the village of Lata. Russian peacekeepers are also posted around Lata while the territory to the north of Lata is controlled by Georgian Ministry of Interior troops. Marukh pass is protected by a division of Georgian border guards.

3.2 THE ECONOMIC SITUATION IN SOUTH OSSETIA

South Ossetia is located in northern Georgia on the border with Russia. The region occupies an area equal to 3,900km², or around 5.6% of total Georgian territory.

The economic situation in South Ossetia (Tskhinvali region) is among the most difficult in the South Caucasus. By some estimates, GDP is equal to \$15 million per year or \$250 per capita, a figure that places the region among the poorest countries in the world. Customs duties form the main source of revenue for the South Ossetian budget. In 2000, total revenue amounted to 48.6 million roubles (or \$1.7 million), of which customs duties made up 54.5%.

Most industry in South Ossetia is decayed and at a standstill. In 2000, the value of industrial production was estimated at 10.2 million roubles (\$333,000). With limited deliveries of power from Russia and Georgia, only the Tskhinvali lumber and mineral water plants function more or less regularly, albeit at 10-25% of capacity. The production of mineral water makes up over 60% of total industrial activity. Cottage industries partially satisfy the needs of the region's internal market. The region's irrigation system is in complete disrepair and badly needs renovation.

The minimum monthly pension in South Ossetia is 60 roubles (around \$2) and the minimum monthly salary 200 roubles (\$7), while the level of subsistence is estimated at 1,100-1,300 roubles (\$40). The current government has accumulated a large internal debt by withholding salaries, pensions and social payments.

Ossetian youth – most of whom are either self-employed in quasi-legal business or unemployed – face the future with narrow prospects. Over the last three years, only three of the 1,300 graduates from South Ossetia State University and 37 of 480 graduates of its technical colleges have found work in their chosen areas of specialisation. The majority of the region's 1,532 secondary school graduates are unemployed. The most sought-after professions are working for the 'power' ministries (security, police and military), highway patrol and customs. The unofficial income for a customs officer, for example, is around 1,200 and 1,500 roubles (\$40-50) per day.

Since 1992, the demographic situation has worsened dramatically. The total population shrank from around 100,000 people to 60,000 after the departure of most of the Georgian population and the migration of many Ossetians to Russia. According to some sources, the real number of Ossetians still living in the region may be much less. There are only 34,300 qualified voters according to the South Ossetian electoral commission, more than 60% of whom are middle-aged or elderly.⁶

The intensity of migration is due firstly to the extremely low standard of living. In addition to the expulsion of Georgians, there has been a mass movement of the labour force to North Ossetia and other regions in Russia in search of work. The best-educated and most employable portions of the population have left. Many of those who left South Ossetia for Russia are ready to become Russian citizens and stay there as permanent residents. Eleven settlements, sufficient to accommodate 900 families, are currently under construction in North Ossetia to house some of these economic refugees.

Crime is rampant, encouraged by poverty and political instability. Large sums of money are concentrated in the smuggling business, much of which is funnelled through Ergneti market, though some analysts estimate that only about 10% of fees collected actually end up in South Ossetia's budget. The remainder makes its way through illegal channels into the hands of different levels of the republic's power structure.

Widespread ownership of weapons also feeds crime in the region. The government's decision to legalise the possession of arms, already passed into law, played a particularly negative role in law enforcement. Separatists and criminal groups use the region as an arena for weapons trading, sometimes with the participation of Russia's peacekeeping forces.

South Ossetia is also a transit route for valuable Russian antiquities. In December 1999, a special Russian police unit set up in Rostov-on-Don to combat smuggling smashed a ring dealing in icons, church artefacts and other relics that ran from

Moscow to Georgia via Stavropol, North Ossetia and South Ossetia. In March 2000, customs officials from Stavropol interrupted the smuggling into Georgia of 172 Orthodox icons and artefacts by passenger bus.⁷

Economic growth requires the injection of significant sums of money, but investment is hampered by the unresolved conflict with Georgia. Without sources of energy and sufficient resources to pay for imported power, South Ossetia suffers from constant energy shortages. Debts to Russian energy companies amount to millions of dollars. The communication infrastructure connecting Georgia and Russia through Tskhinvali region is almost completely disused.

South Ossetia could possibly be included in the EU's TRACECA transport corridor project if it regularised its status in international law. Such a development would benefit the entire South Caucasus, and stimulate further investment from international organisations and private sources, including an increase in the transport of energy resources

4. THE NEGATIVE IMPACT OF CONFLICT ON GEORGIA'S ECONOMIC DEVELOPMENT

4.1 SMUGGLING

Smuggling is the secret movement of goods and other valuables across international borders to avoid customs controls. Smuggling has reached alarming proportions in Georgia, creating a highly organised transnational market in illegally traded goods, including narcotics and weapons. It is now so pervasive that it threatens the country's economic security.

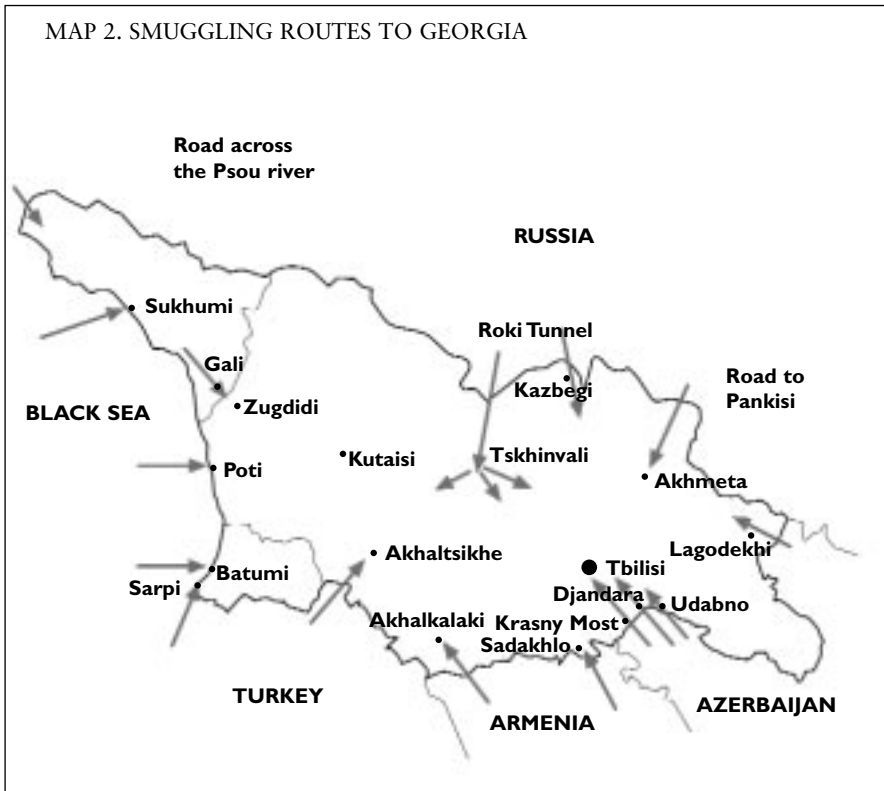
Contraband is smuggled to Georgia via many different routes but the conflict zones of Abkhazia and South Ossetia play the leading roles. There are many remote and winding roads outside the country's central areas where customs services and control points are more or less ineffective.

The most common routes used by smugglers enter Georgia from:

- Ergneti (uncontrolled territory in South Ossetia bordering Russia);
- Krasny Most (on the border with Azerbaijan);
- Abkhazia (bordering Russia on the Black Sea);
- Adjaria (bordering Turkey on the Black Sea);
- Poti (on the Black Sea);
- Akhaltsikhe (bordering Turkey);
- Kazbegi (bordering Russia);
- Lagodekhi (bordering Azerbaijan);
- Dzhandara (bordering Azerbaijan).

This far-from-exhaustive list makes clear the multitude of routes available to smugglers. Petroleum products and other contraband goods are imported in different volumes from barrels and bottles to trucks and tankers.

In 1997, Georgian exports to Russian amounted to only \$78.7 million of goods, according to Georgian statistics.⁸ But the Russian customs service recorded imports of \$148 million – nearly double that figure. In the same year, Georgia recorded over \$126 million in imports from Russia, while Russia recorded \$144.5 million in exports to Georgia.



A comparison between Georgian data on trade with Russia with analogous data from the IMF, based on Russian figures, is also revealing. Between 1996 and 2000, Georgian export figures account for only 77% of IMF's statistics. For imports, Georgian figures are on average 20% higher than Russian figures during the same period. In 2000, Georgian data recorded \$68.1 million in exports to Russia while the Russian statistics used by the IMF recorded \$77 million in imports from Georgia. More important is the data variation on Georgian imports from Russia in 2000. According to Georgian sources, \$90.2 million worth of goods were imported, but only \$42 million is recorded in the

IMF data. The difference between these two figures is a massive \$48.2 million. Such large discrepancies can only be explained by disorganisation within Russia's customs service. A similar trend was apparent in 2001 (see table 6). Georgia registered official exports to Russian worth \$73.5 million and official Russian imports worth \$91.3 million. Russian statistics for the same year registered official exports to Georgia of \$138.8 million and imports from Georgia at \$164.1 million.

TABLE 6. COMPARATIVE STATISTICS OF GEORGIAN EXTERNAL TRADE ('MIRROR' COMPARISON) WITH 10 OF ITS LARGEST PARTNER COUNTRIES, 2001 (\$000,000)

	Export		Import	
	Georgian State Statistical Department data	Partner country data	Georgian State Statistical Department data	Partner country data
Russia	73.5	138.8	91.3	164.1
Turkey	68.7	112.0	105.0	146.2
USA	9.5	27.6	27.8	118.8
Germany	7.9	8.3	69.1	75.9
United Kingdom	22.9	24.6	25.1	27.6
Azerbaijan	10.6	11.1	73.1	91.7
Switzerland	15.6	16.2	14.0	15.5
Ukraine	11.7	12.3	49.5	53.8
Italy	8.6	8.9	25.5	28.8
Turkmenistan	28.9	30.3	17.6	19.7
Total from 10 partners	257.8	390.2	498.2	742.3
Other countries	62.2	62.8	185.9	185.9
Total	320.0	453.0	684.1	928.2

SOURCE: STATE STATISTICAL DEPARTMENT

Unaccounted, untaxed exports to Russia from Abkhazia and South Ossetia rose due to the unilateral introduction of visa requirements for Georgian citizens that were not applied to residents of the two breakaway territories. The new visa regime encouraged the export of counterfeit Georgian products that are typically popular in Russia – notably wine and mineral water – and flooded the market with cheap substitutes of lower quality. Georgian producers selling into Russia's large market faced new difficulties. Simultaneously, it is through the breakaway regions – and their citizens – that the bulk of unregistered trade items are trafficked into Georgia. Both have become de facto 'free-trade zones' for contraband flows that destabilise Georgia's internal market. Legal importers simply cannot compete with untaxed imports from Russia.

Despite the CIS decision to limit economic cooperation with Abkhazia,⁹ official

and unofficial bodies in Russia, and its regional leaders flagrantly do business with the separatist government. The CIS embargo required member states:

- Not to conduct trade, economic, financial, transport and other operations with Abkhazia without the agreement of the government of Georgia.
- Not to establish official contact with representatives of quasi-government agencies in Abkhazia, their representatives or members of its military formations.
- Not to support the separatist government, nor to establish with it political, economic or other unions, and not to provide economic, financial and military aid.

Numerous violations of these restrictions by Russia have made Georgian-Russian relations difficult. Despite the sanctions, the Russian administrations in Northern Caucasus work intensively with the Abkhaz authorities. In July 1998, the Russian Duma passed a motion that obliged the president to take unilateral action to change cross-border and customs relations on the Abkhaz section of the Georgia-Russia border, effectively abolishing the CIS sanctions and related UN decisions. In the past two years, Russia has implemented the Duma's motion.

The removal of sanctions with no genuine advance in the peacemaking process will not bring the conflicting parties any closer to one other. Since the motion was implemented, Russian investment in Abkhazia has risen steadily, forging financial and material interests by both Russia's state and private sector – not to mention military-political interests – that could turn into serious hurdles for Georgia's territorial reunification.

Georgia used the only means at its disposal to counter Russia's violations of its bilateral and multilateral agreements on Abkhazia. On 5 December 2002, parliament adopted a provision obliging the government to contest Russia's application for membership of the World Trade Organization (WTO) if it continued to violate its international undertakings on Abkhazia.

Parliament itemised the following problems created by Russia:

- Ignoring the CIS agreement of 19 January 1996, specifically the clauses making unlawful economic cooperation with separatist entities in Georgian territory and the use of Abkhazia ports.
- Discrimination against Georgians in Russia's new visa regime, which gives special treatment to citizens of Abkhazia and the Tskhinvali region.
- Violation since 9 October 1993 of the Georgian-Russian agreement on border control points, and the resulting smuggling that negatively affects both countries.
- The creation of artificial trade barriers to Georgian and transit trade goods at the unified Russian-Georgian customs post at Verkhny Lars-Kazbegi.

- Illegal detention of transit goods destined for Georgia.
- Tax levies taken from trade groups, as foreseen in article 3 of the agreement ‘On the principles of levies of indirect taxes on exports and imports of goods (and services) between Georgia and Russia’, from 10 July 2001.
- Lack of protection of Georgian trademarks and geographical place names on Russian territory.
- The Georgian parliament resolved that the government should raise the above points in bilateral and multilateral negotiations on Russian entry to the WTO. In the case of an unsatisfactory response, or the lack of concrete guarantees within the framework of Russia’s accession agreement, Georgia would oppose Russia’s entry into the organisation.

Another aspect of Russia’s unneighbourly relations is the restoration of the railway link between Sukhumi and Sochi without prior agreement of the Georgian government, a move that further contributes to illegal trading.

As a full member of the WTO, Georgia is conducting negotiations on Russia’s entry into the organisation with the goal of resolving economic difficulties between the two countries and creating conditions for the entry of Georgian products and services into the Russian market.

Smuggling via Tskhinvali region (Ergneti market)

There is considerable evidence of the existence of large-scale smuggling operations between Georgia and Russia via South Ossetia. From Ergneti market, located close to Tskhinvali, large volumes of contraband flood the Georgian market with a negative impact on the country’s economy. Petroleum and other products imported from Russia through Roki tunnel are unloaded at terminals not far from Tskhinvali, from where they then enter Ergneti market. The products are then traded and enter Georgia’s internal market without paying customs duties because of corruption in the Georgian administration.

This has resulted in a peculiar situation. On the one hand, goods enter Georgia without proper registration or payment of customs fees and taxes. On the other hand, the same goods end up in the hands of Georgian owners who did not bring the products in illegally, but purchased them in Georgia and merely transported them from one part of the country to another, again without paying duty. South Ossetia, its customs, tax and police services cannot (and often do not want to) detain and register smuggled goods entering Georgia illegally from Russia. Criminal groups also participate in the traffic.

According to Georgia’s Ministry of Tax Revenues, more than 150 vehicles travel from Ergneti market to Tbilisi each day, bringing contraband goods worth a total of 500,000 lari (around \$250,000), making for a total of 200 million lari (\$100 million) worth of untaxed imports. This figure does not include the petroleum and diesel fuel delivered from the same terminals near Tskhinvali and

distributed throughout the country. The cash that enters Tskhinvali in payment for such products represents a significant financial outflow from Georgia.

There are three markets in the village of Ergneti. The first, according to unofficial sources, is controlled by well-placed Georgian and South Ossetian officials.¹⁰ According to the Finance Ministry, South Ossetia serves as the transit route for most items smuggled into Georgia. Fuel, tobacco products, flour, grain and other food products are all smuggled into Georgia through Ergneti at a cost to the national budget of 5-6 million lari per month (\$2.5-3 million). The largest share of 3 million lari (\$1.5 million) is due to the illegal import of petrol and cigarettes.

Heroin has been entering Georgia through the conflict zones for years, though the quality and cost of the narcotics are low. Some information suggests that the amount passing through Ergneti is probably only half that entering from Azerbaijan. Three Ossetians control most of the gun and drug smuggling trade in the region, much of which is carried out in collaboration with Russia's peacekeeping forces. Local residents, who prefer anonymity, say Georgian administrators and police protect the traffickers.

Clan-controlled smuggling in Abkhazia

Illegal economic activity has recently sprung up in the small strip of land that runs along the River Inguri from the Black Sea to Jvari and separates Abkhazia from Georgia. Shipments are run over the main bridge over the Inguri, as well as more hidden crossing points. Illegal cigarettes, landed in Sukhumi by foreign (mostly Turkish and Russian) ships, are transported to the Georgian city of Zugdidi from where they are distributed throughout the country. Georgian foodstuffs and other agricultural products are transported back to Abkhazia for illegal export. According to the Ministry of Tax Revenues, around 4.5 million packs, or 9,000 crates, of cigarettes enter the market from Abkhazia every month, making a total of 108,000 crates each year.¹¹ Since one crate retails at around \$159, Georgia sends the equivalent of \$17.2 million a year to Abkhazia to finance its illegal cigarette purchases. The growing role of narcotics, which enter Abkhazia from Turkey, has added a new element of danger to trade across the Inguri.

The security services in Gali region, commanded by the Abkhaz security service in Sukhumi, also function as its police force. There are five control points in the villages of Diakhazurga, Saberio, Samakvalo, Tagiloni and on the main bridge over the Inguri where security services monitor the ceasefire line. There are also two customs control points in Tagiloni and at the Inguri bridge, run by departments of the security services, that extort payments from citizens transporting goods across the border.

According to Georgia's Ministry of State Security, Abkhazia's leadership control all the most profitable businesses, including tourism, illegal logging, the smuggling of oil, petroleum and cigarettes from the Viceroy tobacco factory. The Viceroy factory in Gudauta has been completely renovated with Bulgarian equipment and 14 Bulgarians provide technical help.¹²

Contraband cigarettes, red wine and citrus fruits, are also smuggled from Abkhazia to Russia. Police officials in Mingrelia and the Abkhaz government-in-exile control the Georgian connection in these deals. Lately, the trade in stolen cars has also become profitable. As in South Ossetia, the business is partially fed by the growing narcotics trade.

Despite differences in nationality and their historical grievances, the criminal groups engaged in smuggling have clearly established a common language, and Russian peacekeeping troops also play a role by reportedly arranging transport and security for smuggling operations. In some cases, contraband is known to have been transported on vehicles belonging to peacekeeping forces.

Smuggled petroleum products

The revenue lost through the smuggling of petroleum products is one of the main causes of Georgia's budget deficit. Tackling rampant corruption in this sphere is one of the country's leading fiscal challenges. Tax revenues would grow by 30% if the government collected the appropriate tax on petroleum and its by-products (see table 7). According to the PA Consulting Group,¹³ the government could realise up to \$250 million in revenue each year from taxes on gasoline and petroleum products. Just two products, gasoline and diesel, make up 75% of this sum, or \$186 million. In 2001, petroleum taxes generated revenues of only \$50 million.

The Parliamentary Budget Office estimates that Georgia consumes 80,000 tonnes of petroleum products – 50,000 tonnes of petrol and 30,000 tonnes of diesel – each month. Were all that fuel fully taxed, the budget would receive 327 million lari (around \$163 million) each year (204 million lari from petrol and 123.6 million lari from diesel) – or nearly three times what the budget currently receives from taxes on all petroleum products (petrol, diesel, kerosine, fuel oil and oil).

According to the Finance Ministry, smuggled petroleum enters the country mostly from South Ossetia (Ergneti), Abkhazia and Azerbaijan (from Krasny Most, Lagodekhi and Jandara). Oil products are cheaper in neighbouring countries, creating favourable conditions for smuggling.

The Ministry of Finance calculates that around 5,000 tonnes of petroleum enter illegally from Ergneti market every month, equal to 6% of total consumption and 12% of smuggled fuel. Most is brought in by train or unregistered vehicles.

Petroleum is imported by ship from Russia to Abkhazia, from where it is transported across the River Inguri into Georgia. According to the State Department of Secret Services, gasoline is also shipped in railway tankers belonging to the Russian peacekeeping forces. Petrol and diesel are also brought in by rail and sea through Sukhumi and Ochamchira. Overall, Abkhazia imports more than 8,000 tonnes from the Russian Federation each month, the majority intended for resale in Georgia. The trade in petroleum products from Turkey adds a further 1,000 tonnes to the monthly total.

Other importers of smuggled fuel resort to falsification to retain competitiveness. They import less expensive admixtures and blend them with cheap petrol to raise the octane level and inflate the price, because this substance is taxed at a lower rate. The health danger of such fuels, especially for teenagers, is well known.

Another method of smuggling is the illegal sale of cargo marked for transit. The volume of fuel entering the market this way has reached great proportions, especially for petroleum products imported from Azerbaijan.

TABLE 7. ESTIMATED GEORGIAN CONSUMPTION OF PETROLEUM, DIESEL FUEL AND LIQUID GAS, 2000

Source	Petrol (tonnes)	Diesel fuel (tonnes)	Liquid gas (tonnes)
PA Consulting Group	650,000	400,000	75,000
World Bank	600,000	432,000	18,000
Barents Group	621,000	432,000	n/a
Avia Fuel Service	440,000	n/a	n/a
Budget Office, Parliament of Georgia	600,000	360,000	n/a
Customs Department, Georgia	132,000	60,000	n/a

SOURCE: BUDGET OFFICE, PARLIAMENT OF GEORGIA

Smuggled grain, flour and sugar

Grain and flour are mostly smuggled from Russia and Turkey (see table 8). According to some estimates, Georgian consumption of sugar amounts to about 180,000 tonnes a year, but only 40% of that amount is reported and taxed when crossing the border. The remaining 60% enters the market as contraband. In 1999, only 75,800 tonnes of imported sugar were reported to customs in 1999, with a total value of \$15.8 million.¹⁴

TABLE 8. IMPORTS OF GRAIN AND FLOUR, 1997-2000 (TONNES)

	1997	1998	1999	Jan-July 2000
Grain	305,811	218,273	169,935	111,257
Flour	121,655	109,056	85,991	38,661

SOURCE: CONCLUSIONS OF THE TEMPORARY PARLIAMENTARY COMMISSION FOR THE STUDY OF THE REASONS FOR FINANCE AND BUDGET CRISIS, PARLIAMENT OF GEORGIA, TBILISI, 2000

Illegal exports of timber products

Timber exports from Abkhazia have grown year on year. About 50,000m³ of wood products were exported in 1999, including rare and prohibited species. According to the data available, the following amounts of timber were exported from two regions alone, Gagra and Gudauta:

TABLE 9. TIMBER EXPORTED FROM ABKHAZIA, 1997-2002 (CUBIC METRES)

Year	Volume
1997	24,000
1998	30,000
1999	39,503
2000	50,000
2001	57,000
2002	63,430

SOURCE: BUDGET OFFICE, PARLIAMENT OF GEORGIA

However, the above data do not capture the total volume of timber exports. Exports in 2003 are expected to reach 80,000m³ of timber¹⁵ with a price range of \$100-125 per 1m³.

Turkish citizens are active in the export trade, and regular shipments leave Ochamchira and Sukhumi twice a week. Third countries are also involved. One Spanish company is logging in Bzyb', having invested up to \$4 million in its logging operations. There are five manufacturing shops in Bzyb' with a combined capacity of around 4,000m³ of quality parquet flooring for export to Turkey and Spain. Forests in Gali and Tkvarchel regions are also being intensively worked.

In Georgian and foreign expert opinion, the scale of forest cutting in Abkhazia has begun to disrupt the region's environmental balance (logging was forbidden in Soviet times). But the export of timber is an important source of income for the self-declared republic.

Smuggled cigarettes

If tax on cigarettes were paid in full, Georgia's budget would receive an additional 140 million lari (\$70 million) per year at least.¹⁶ In recent years, the revenue generated by cigarette tax has actually fallen (see table 10). In 1999, revenues from cigarettes amounted to \$31.1 million compared to \$13.1 million in 2000, \$14.9 million in 2001 and \$16.9 million in 2002. Around 75% of the nation's cigarette business occurs in the shadow economy.

The source of most of Georgia's smuggled cigarettes are its breakaway territories. The majority is smuggled from Ergneti market, the main supply for Tbilisi, but large amounts also come in from Abkhazia and Adjara. Contraband plays a disproportionately large role in sales of the filterless cigarettes smoked by around 35% of consumers.

The importance of smuggling in Abkhazia is demonstrated by the strict control maintained over the trade by highly placed officials and clans, particularly the clan of V.Ardzinba,¹⁷ which controls the factories in Sukhumi and Gudauta that produce the Marlboro, Marlboro Medium and Astra brands.

Illegally imported and locally produced contraband tobacco often ends up in Gali region, from where small groups smuggle it over the River Inguri to Zugdidi via the 301st post of Russian peacekeeping troops, the bridge in Rukhi and the fords at Shamgona and Napadu. In most months, more than 500-600 crates of smuggled cigarettes enter Zugdidi, either by car or in public minibuses.

In addition to organised smuggling rings, small-scale carriers move cigarettes from Gali to Samegrelo, their ultimate goal being to sell their goods on the right bank of the River Inguri. Around 150 cartons of Viceroy cross the river every day. Viceroy are also smuggled into Abkhazia from Turkey by ship, and deliveries of Parliament and Donskoi Tabak cigarettes enter from Russia. Occasionally, shipments are sufficiently large to influence pricing in Georgia's consumer market.

TABLE 10. REVENUES FROM TOBACCO PRODUCTS, 1997-2002 (MILLION LARI)

	1997	1998	1999	2000	2001	2002
Local production			4.2	0.8	15.3	18.0
Imports			58.7	25.1	15.1	18.5
Total	27.5	13.8	62.9	25.9	30.4	36.5

SOURCE: EXCISE DUTY SERVICE, MINISTRY OF FINANCE, GEORGIA

Illegal shipping and smuggling

Maritime shipping – or smuggling, as defined by the CIS and international strictures on trade with Abkhazia – accounts for 60-70% of the republic's export and import operations. The ports of Sukhumi, Ochamchira, Gagra and Gudauta are all functional, although only Sukhumi can handle large vessels.

Sukhumi formerly specialised in passenger traffic, reflecting its importance in regional tourism. In the 1980s, an average 1.3 million passengers passed through Sukhumi every year, although around 86% of this traffic occurred between May and October. Nonetheless, about 190,000 tons of freight arrived each year.

At that time, shipping accounted for 24 times less freight than railways and 79 times less than that hauled by truck. In terms of passenger transport, sea routes accounted for 2.3 times fewer passengers than railways and 8.3 times less than car, bus or other motor vehicles. Railways and motor vehicles played a much larger role in the life of the Caucasus at that time. Now, the situation has reversed with the majority of Sukhumi's port activity involving freight.

The depth of Sukhumi port is only 3.5-7 metres and it is poorly defended from the open sea. Two tower cranes are functioning, but there is a shortage of equipment for loading containers, and the port's railway is defunct. Two warehouses have been built to meet local commercial needs. The port in Ochamchira, which formerly serviced military needs, is perhaps better outfitted than Sukhumi.

Abkhazia has established close contacts with trade partners in Turkey, Russia, Romania, Moldova, Ukraine, Italy and Spain. Fish, scrap metal, coal, citrus and timber are among the products exported by sea.

The main imports are petroleum, diesel, industrial products, grain, flour and mineral additives, mainly purchased from Russia, Turkey and Romania. A large proportion of these cargoes is destined to be smuggled to Georgia.

Ships heading for Abkhaz ports do so in defiance of international restrictions on trade with the self-declared republic. From 1999 to 2003, the coastguard of Georgia's Border Protection Department has detained over 40 ships for illegal trading of one kind or another. In 2002, 11 ships were detained for smuggling in Georgian waters, including one illegally exporting timber, five illegally fishing, two smuggling scrap metal, one importing lubricants, one smuggling cigarettes and illegally exporting coal, and one exporting other products (see table 11).¹⁸

On 31 July 2003, the Turkish ship *Selim 1* was officially auctioned in Tbilisi after the expiry of the legal period for appeal or the payment of fines for illegally shipping goods to Abkhazia. The Turkish liner *Shakir Baba 3* was auctioned in June 2003 on the same grounds. It was purchased by residents of Poti for 133,400 lari (\$66,700).

In 2003, the coastguard arrested seven ships for different illegal activities in Georgian waters near Abkhazia and a further eight ships' captains were given official warnings. In the first half of 2003, such arrests brought 548,000 lari (\$274,000) to the state coffers and a further \$250,000 is expected by the end of the year.¹⁹

TABLE 11. ILLEGAL SHIPPING CAUGHT BY DEPARTMENTS OF THE STATE DEPARTMENT FOR THE PROTECTION OF THE STATE BORDERS OF GEORGIA IN THE PORTS OF THE ABKHAZ AUTONOMOUS REPUBLIC AND COASTAL WATERS, 1999-2002

#	Description of incident	Date of Capture
1	The vessel <i>Mitkhad Eregly</i> , flying under a Turkish flag, was boarded in a raid near Poti. Inspection determined it was carrying timber materials from Sukhumi port.	26 June 1999
2	Sailing under a Turkish flag, the seiner <i>Capitan Bezat</i> was apprehended unlawfully fishing 22 miles from the Cape of Kodori.	18 July 1999
3	Sailing under a Turkish flag, the seiner <i>Gustom Olgu</i> was detained unlawfully fishing 22 miles from the Cape of Kodori.	18 July 1999
4	The Russian tanker <i>Fortuna</i> was detained in Poti during a border check. Inspection revealed that the vessel illegally entered the port of Sukhumi three times and delivered 1,464 tonnes of petrol and 997 tonnes of diesel from Russuniversaltorg to the Abkhaz Marine Shipping company.	28 December 1999
5	The Russian cargo ship <i>Strontz</i> was detained during border controls. Inspection determined that the ship had entered Sukhumi, illegally crossing the Georgian-Russian marine border. The detained ship was carried 3,900 tonnes of scrap from Sukhumi to Georgia. The owner of the ship was the company Abkhaztorgresource.	12 March 2000
6	Sailing under a Turkish flag, the seiner <i>Abal Balik Chilik</i> was detained for poaching fish in Georgian territorial waters and illegal transportation of passengers.	28 April 2000
7	Sailing under a Turkish flag, the seiner <i>Shakir Reys 2</i> was detained for illegally crossing the Georgian border and poaching of 31 tonnes of anchovy.	12 March 2001
8	The Ukrainian vessel <i>Vega</i> was detained for illegally entering ports in the Abkhaz autonomous republic. Inspection of documents revealed that the vessel had realised a delivery of scrap metal from Sukhumi to Turkey.	11 May 2001
9	Sailing under the Turkish flag, the vessel <i>Ilidisi 1</i> was detained illegally crossing of the borders of Georgia with a shipment of illegal coal from Sukhumi. The ship had delivered 60 tonnes of non-customs-cleared filter cigarettes to Abkhazia and loaded 917 tonnes of coal.	11 September 2001
10	Sailing under an Estonian flag, the dry-cargo ship <i>Ira</i> was detained for illegally entering ports in the Abkhaz autonomous republic. The ship had delivered various consumer products to Sukhumi.	3 August 2002
11	Sailing under a Turkish flag, the seiner <i>Sheker Baba 3</i> was detained for illegally crossing the border of Georgia and poaching six tonnes of fish.	18 November 2002

SOURCE: STATE DEPARTMENT FOR PROTECTION OF THE STATE BORDERS OF GEORGIA

Unregulated fishing

Turkish fishing boats catch between 630 and 740 tonnes of fish per year in Abkhazia's Black Sea waters with a minimum commercial value of \$300,000. This catch includes:

- Whiting: 400 tonnes at \$0.35 per kg;
- Surmullet: 100-150 tonnes at \$0.50 per kg;
- Anchovies: 100-150 tonnes at \$0.20 per kg;
- Plaice: 30-40 tonnes at \$3.00 per kg.²⁰

The Turkish companies, Konev Ltd. and Kiyak Kardeşler, which have signed agreements with Abkhazia's economics ministry, dominate the fishing and fish export markets. Turkish fishing boats often use illegal methods that do permanent damage to the region's fishery.

Export of scrap metal

The export of scrap metal has grown into a sizeable business. Under privatisation, the former managers of state-owned companies (so-called 'red directors'), or those close to them, became owners of the firms they used to run. The new management is not always interested in regenerating these companies, preferring to dismantle the machinery and capital stock, and export the steel and other metals as scrap. The trade has proven very profitable for exporters – though prices in Georgia are often below world levels – and encouraged a steep growth in the theft of other precious metals, including power lines, gas pipelines, water and sewage pipes, and even graves and statues.

The growth in the business can be gauged from Georgian statistics. The value of exported scrap amounted to \$2.4 million in 1995, \$600,000 in 1996, \$1.6 million in 1997 and \$1.8 million in 1998. Since 1998, the volume of exports has shot up, due to privatisation and the revoking of certain export taxes. In 2000, exports stood at \$54.8 million and more than \$56 million in 2001. Scrap metal's contribution to exports has similarly expanded. Scrap accounted for 1.6% of exports by value in 1995, 10.7% in 1998, 16.6% in 2000 and 17.6% in 2001. In recent years, scrap has become Georgia's single largest export. Although the export of scrap is strictly regulated by existing legislation, unregulated and unregistered exports from Georgia, mostly through Batumi and Poti ports, undoubtedly continue.

The stripping of obsolete factories in the breakaway territories deserves special mention. The majority of Abkhaz enterprises no longer function and most of their assets have been disassembled and the metals exported. According to the State Department of the Secret Services, the majority of scrap is exported through Sukhumi and Ochamchira but a portion is still shipped via Batumi and Poti with the connivance of local officials and criminal groups. The looting of

graves has also been documented in Abkhazia, with the aim of collecting marble, aluminium and other materials.²¹

Up to 100 large maritime shipments of scrap are made each year from Georgia. According to available data, the peak year was 1999 with 40,000 tonnes of precious metals and 32,000 tonnes of non-precious metals. The volume of Abkhaz scrap exports has steadily fallen as sources become scarcer.

Drug routes and weapons trade

The influence of the mafias that control the drugs trade in Abkhazia has expanded at the same pace as the area used for cultivating narcotic crops. Unemployment and poor living standards have created conditions favourable for the growth of the drug business and the recruitment of larger numbers of people to drug-related crime.

Abkhaz criminal groups have divided the illicit economy into specific spheres of influence. Groups from western Abkhazia control the smuggling of fuel, food and tobacco products into Georgia, as well as participating in the delivery of drugs to Russia. Groups from Gagra, largely Armenian, are involved in domestic narcotics production. Groups from Gudauta control the export of drugs. Chechen groups have set up in eastern Abkhazia, Sukhumi railway station and along Abkhazia's main roads, specialising in 'business' initiatives and the transport of cargo through the Georgian-Abkhaz border.

Drugs are exported from Abkhaz ports on fishing boats, their access being virtually unhindered due to the weakened state of Georgia's coastguard. Railway and vehicle transport are also used, as well as the remote passes between Abkhazia and the Karachaevo-Cherkessia republic in Russia's northern Caucasus.

Drugs produced in laboratories in Abkhazia are smuggled in specially constructed secret compartments across the River Psou, which marks the Abkhaz-Russian border. These exports are destined for Krasnodar, Rostov and Volgograd in southern Russia, as well as Ukraine and Moldova.

Drug smuggling along this route is almost completely controlled by Armenians in Abkhazia and southern Russia. Shipments, which are seasonal, are usually made between September and March. Demand in southern Russia, Ukraine and Moldova is largely satisfied by drugs from Abkhazia. Latin American cocaine and heroin from Central Asia are both transported through Abkhazia en route to the Russian and European markets. High ranking officials in the Russian military figure prominently in the trade, which makes use of Gudauta military airport. The drug route from Russia to Turkey also runs through Abkhazia, using Turkish shipping as its chief means of transport.

So profitable are the established smuggling routes that only a negligible proportion of Abkhaz drugs enter the Georgian market. Abkhazia's

leadership is in a difficult position with regard to the narcotics industry since allies of organised crime are already in key government institutions and the administration is no longer in a position to take decisive measures. Georgian officials and police are disturbed by the growth in the drug trade since Georgia's inclusion in the Eurasia transport corridor could be jeopardised if its transport network is used to traffic narcotics.²²

The illegal weapons trade runs in tandem with Abkhazia's drug business and uses the same routes. According to Georgian sources, explosives and arms shipped into Abkhazia by boat from Turkey are then transported to the Russian republics in North Caucasus, with a portion remaining in Abkhazia.

4.2 KIDNAPPING AND HUMAN TRAFFICKING

Kidnapping awakens very specific fears in Georgia and has attracted a significant amount of international press attention (see table 12). It should be noted that the kidnapping statistics also include numerous cases of abductions of women for marriage, which is something of a Caucasian tradition. For example, 28% of all abductions in 2000 were marriage-related and they made up 44% of cases in 2001 and 2002. Such cases, as a rule, are all solved. However, numerous kidnappings have as their aim ransom, or the exchange of prisoners with an opposing group. Georgian partisans, Abkhaz police and military, and criminal groups often resort to this variant. There were 34 kidnappings with ransom demands in Abkhaz territory in 2000, 37 in 2001 and 28 in 2002. By contrast, a total of 65 people were taken hostage in 2000, 61 in 2001 and 48 in 2002 (see table 13).²³ During the same period (2000-02), 122 persons were killed.

TABLE 12. STATISTICAL DATA ON ABDUCTIONS IN GEORGIA, 1992-2002

Year	Registered	Solved	% of cases solved
1992	37	22	59.5
1993	89	25	28.1
1994	43	29	67.4
1995	59	37	62.7
1996	74	50	67.6
1997	61	53	86.9
1998	29	26	86.7
1999	29	23	79.3
2000	32	25	78.1
2001	23	16	69.5
2002	28	20	71.4
Total	504	326	64.4

SOURCE: MULTIPLE AUTHORS, CRIMINOLOGY AND THE LAW ENFORCEMENT SYSTEM, TBILISI, 2002

TABLE 13. HUMAN RIGHTS VIOLATIONS ON ABKHAZ TERRITORY, 2000-02

Type of violation	2000	2001	2002
Firearm-related deaths	36	65	21
Attacks by bandits (with robbery)	23	101	119
Injured during physical violence and threats	12	38	42
Abducted (for ransom)	34	37	28
Destruction of private property (by arson or explosion)	7	32	43
Hostage taking	65	61	48
Armed ransacking of buses	11	5	14
Unlawful detainment	36	47	28
Threatened by retribution	5	4	9
Killed by landmines	2	5	18
Injured by landmines	-	2	17

SOURCE: INTERIM COMMITTEE OF THE PARLIAMENT OF GEORGIA ON ABKHAZ PROBLEMS

There are also cases in Gali region of people being used as slave labour. Underage girls from Abkhazia, as well as women from Russia, are trafficked to Turkey for the purpose of prostitution. Victims are divided into groups of 10 and registered as 'housekeeping staff' on Turkish ships. The number of persons trafficked in this way amounts to hundreds.

4.3 TRADE IN STOLEN VEHICLES

One of the commonest forms of criminal activity is car theft, particularly in Tbilisi, with the aim of reselling the vehicles back to their owners. The majority of cars are taken to South Ossetia or Abkhazia. Following the payment of ransom, the cars are returned, while the rest are smuggled to Russia. According to the Georgian Ministry of the Interior, 206 cases were registered in 2001, of which 158 vehicles –76% of the total – were returned to their true owners. But the true number of stolen cars is probably higher, since not all cases are reported and victims often try to resolve the problem through informal channels.

4.4 ILLEGAL COAL EXPORTS

Private Turkish companies that export coal to Turkey primarily work the mines in Abkhazia. Ada Madencilik San Ltd signed an agreement in April 2000 to mine the Khudzga pit in Tkvarcheli that foresees the extraction of a total of 100,000 tonnes. Another Turkish firm, Kara Elmas Ltd, is involved in the Tkvarcheli coal deposits. At the end of 2001, it renovated a coal enrichment plant in Tkvarcheli on the lower plateau that uses coal from the Khudzga pit. Barashan, another Turkish firm, has also invested in the Tkvarcheli 'mining

directorates'. Since June 2002, Tamsash has been extracting coal from the Dzhit deposit on Mount Khodzha.²⁴ Representatives of these firms have expressed the hope that the Abkhaz government will permit them to expand their activities. In their opinion, it could be possible to extract around 1,500 tonnes per day.

4.5 AN ILLEGAL SERVICE INDUSTRY: TOURISM IN ABKHAZIA

The Abkhaz government sees the development of tourism as the main spur to economic development. To this end, the travel agency Rusaltur opened a Moscow office in 1999 and work began renovating Abkhaz resorts with public money. Renovation has been conducted at resorts at Lake Ritsa, Gagra and Pitsunda. Priority was given to resorts in western Abkhazia or close to Russia because tourists consider Gudauta, Pitsunda and Gagra safer than other areas.

There are currently 10 Abkhaz tourist companies and agencies in Moscow. According to official figures, 25% of the revenue generated by tourism is spent strengthening the region's armed forces. The following vacation facilities have been appropriated and rented to Russian companies or institutions:

- Musera pension, rented by the Beryozka (Birch Tree) tour company in Cheboksary, northern Russia;
- Tkvarcheli Hotel in Sukhumi, rented on a 49-year lease to Kogovtarant tour company in Cherkessk;
- Agudzera pension, rented to the Youth Centre of Nalchik, Kabardino-Balkaria;
- Hotel Armenia in Gagra, rented to one of the Moscow agencies of the Russian Ministry of Defence;
- Arabika resort in Gagra (formerly belonging to the Litfond), rented to the city administration of Aksay in Rostov region;
- The Abkhazia resort in Novyi Afon, rented to the State University of Kabardino-Balkaria.

The Hotel Ritsa was also rented to Chegem 2000 on a 49-year lease. Under the terms of the contract, the company had to renovate the property in 2003. Amrit and M.I.F. Ltd also won tenders for resorts in Amra and Kolkhida.

According to Abkhaz statistics, around 20,000-25,000 people vacationed in Gagra in 2001. The government makes widespread use of tourism to influence prominent figures in Russia, some of whom are offered free vacations in exchange for political or diplomatic support.²⁵

Growing Russian investment in Abkhaz resorts represents a significant expansion of influence in the region and could be seen as a de facto attempt to integrate Abkhazia into the Russian economic sphere. Russia could choose at critical moments to use its economic control over Abkhazia to achieve wider strategic goals in the South Caucasus.

4.6 ILLEGAL PRIVATISATION OF PROPERTY IN ABKHAZIA

Russian companies and individuals have also acquired control – at almost symbolic prices – of property, resorts and companies previously owned by Georgians expelled from Abkhazia. Under a two-phase programme drawn up in 1995 and 1996, smaller enterprises were first privatised, followed by the sale of larger companies. Profitable enterprises and resorts remain in state hands.

On 20 March 2002, the Georgian parliament issued a declaration on privatisation in Abkhazia that complemented previous rulings issued on 10 March 1994, 17 April 1996 and 1 April 1998. According to these declarations, all legislative acts or executive decrees not in keeping with Georgian legislation or judicial norms were declared invalid and illegal, including all decisions and deals violating the right of state ownership.

According to the law ‘On the Illegal Privatisation of State Property and the Private Property of Refugees and Forcibly Displaced Persons in Abkhazia’, adopted by parliament on 20 March 2002:

- Georgia should ask the UN, OSCE and other responsible international institutions to record all cases where the government of Abkhazia expropriated state property and the private property of refugees and internally displaced persons (IDPs), and develop corresponding suggestions for countering the situation.
- The executive of the Georgian government, together with the legitimate government of Abkhazia (i.e. the government in exile) and with the participation of the UN, OSCE, the Council of Europe and other international organisations, shall design measures to protect the property rights of refugees and IDPs.
- Georgian police forces should study cases of expropriation and the privatisation of state property and property belonging to refugees and IDPs by the Abkhaz authorities.
- The Georgian authorities should inform the government of any country whose citizens or companies establish trade and business operations with Abkhazia that all acts of the separatist government are illegal.

Throughout Abkhazia, especially in areas formerly settled by Georgians, refugees’ moveable property and real estate has already been ‘privatised’ by others using non-legislative means. Hotels, resorts and other property in Sukhumi, Gagra, Pitsunda, Novyi Afon, Gudauta, Gulripshi and Ochamchira were sold or given to persons originating from other countries. By 2001, it was estimated that over 1,000 pieces of real estate and other property had been privatised.

4.7 INTERNALLY DISPLACED PERSONS AND REFUGEES

According to the UN High Commissioner for Refugees (UNHCR), more than

272,000 IDPs lived in Georgia at the end of 2000, 96% of whom came from Abkhazia. In 1996, the figure was 282,000, suggesting that many had since migrated abroad. Of this number, 27% were children, 17% elderly and 56% of working age. The majority live in Samegrelo (42%), Tbilisi (33%) and Imereti (12%). In recent years, a large proportion of the IDP population has moved to the urban areas. For example, the number of displaced in Tbilisi grew from 40,000 in 1997 to 90,000 in 2001.²⁶

Significant amounts of the budget are spent on refugees. The Ministry for Refugee Affairs and Resettlement receives annual funding of 57.2 million lari (\$27.6 million), or 6.3% of total annual expenditure, compared to the Ministry of Defence, which absorbs 37.1 million lari (\$17.9 million), or 4.1% of the total budget. Refugee-related expenditure is almost equal to spending on education (32 million lari) and health (34 million lari) combined.

IDPs also receive assistance from local budgets. The Tbilisi municipal budget provides IDPs with free access to the metro and other public transport, a concession amounting to 8.2 million lari, or 5% of the city's budget.

Around half the refugee population lives in private housing, with the remainder housed in former hotels, resorts, schools, factories and company premises. According to the UN Children's Fund (UNICEF), most IDP children live in collective public housing.²⁷ The maintenance of housing for refugee children, especially those living in public housing, is a serious problem since they live in multi-family buildings with inappropriate sanitary facilities.

A survey by the ICRC in May 2000 showed that IDP families, especially in public housing, were more vulnerable than the local population vis-à-vis employment, wages, land ownership and living conditions.²⁸ According to the World Bank publication, 'Georgia Poverty Update', 'the level of poverty among internally displaced persons is a third higher than that among the local population'.²⁹

The majority of IDPs live near the Abkhaz border in Samegrelo and Imeretia where they retain close contacts with their former homes. Some regularly return to work their lands in Gali region.

4.8 PERSPECTIVES ON ECONOMIC COOPERATION BETWEEN THE CONFLICTING PARTIES

A number of basic positions exist on the issue of developing economic relations with the conflict regions:

Close relations

According to this view, close economic relations should be established as quickly as possible, including the signature of joint business projects, Georgian investment in Abkhazia and Tskhinvali region, the expansion of economic ties with other regions of Georgia and the renovation of rail, road and air links.

Supporters of this position regard the status quo as merely preserving the

conflict in a frozen state. Government attempts to reach a final settlement in the past 10 years have come to nothing and only serve to demonstrate the need for new approaches, including closer economic relations with the breakaway regions. The development of shared interests between Georgian, Abkhaz and Ossetian businesses will eventually lead to a convergence of political positions.

Supporters of closer economic relations argue that Georgia's passivity has allowed Russian and Turkish businesses to dominate the conflict zones economically. Despite growing interest in the development of official and legal business relations, the current situation forces businessmen to cooperate on illegal, or openly criminal, grounds.

Cooperation as capitulation

Opponents of the above position believe that the development of economic ties, the lifting of sanctions and opening of transport and communication channels will only entail the complete loss of these territories and their full integration into the Russian Federation. Georgian government support for renewal of economic relations, it is argued, would trigger a massive wave of Russian investment in the conflict zones. Given the pro-Russian orientation of both regions, competition between Russian and Georgian capital would leave the majority of their economies in Russian hands which – the supporters of this view believe – will be tantamount to Abkhazia and Tskhinvali region being 'swallowed' by the Russian Federation. The presence of Russian businesses in the two regions, in their view, is evidence that this process is already underway (see section 4.6). Officially sanctioning the intrusion of Russian capital would make the re-establishment of Georgia's territorial unity impossible.

The opening of rail and road corridors from Russia to Armenia through Georgia, moreover, would create difficulties in Georgia's relations with Azerbaijan, which is neither politically nor economically desirable. Furthermore, Georgian participation in the reconstruction of the Abkhaz and South Ossetian economies is impossible without the participation of the displaced population and their return to their homes.

Moderate positions

A number of compromise positions exist between these two more radical approaches. A common thread running through them all is that reconstruction and development of the conflict regions' economies, the establishment of trade ties and the lifting of sanctions should be dependent on the separatist regions reaching a final political settlement with Georgia's central government. Such an approach foresees:

- The lifting of sanctions on condition that the displaced are allowed to return;
- The opening of rail and road links on condition that the mandate and deployment of Russian peacekeeping troops is altered or abolished;
- The sanctioning of direct trade and commercial relations between the conflict

regions and Russia, Turkey and other countries on condition that Georgian border guards and customs officials control the international borders.

As should be apparent from earlier sections of this paper, business relations between the opposing sides in the Abkhaz and South Ossetian conflicts are close and multifaceted, but almost completely illegal. These relations are for the most part built on the transport of smuggled goods. As a result of interviews with different participants in the conflict, as well as analysis of existing materials, the authors have come to a rather interesting conclusion.

On the one hand, illegal economic relations between Georgia and Abkhazia, but especially between Georgia and South Ossetia, have led to a narrowing of positions and cooperation between different sides of the conflicts. These relations act as an informal guarantee that fighting will not be renewed. On the other hand, changes in the status quo and the fight against illegal business are not in the interests of the main economic players, including senior representatives of regional and central government, as well as criminal elements. They are largely satisfied with the ceasefire situation, and do not stand to gain from a final settlement of the conflicts.

In transitional economies where reforms have been frozen or unsuccessful, a number of experts have noted that incomplete reform plays into the hands of certain economic players who are able to exploit the instability to enhance their profits and operations. Further reform and the establishment of functioning institutions threaten their sources of income. Such economic actors – who already comprise a new social stratum – will do anything to ensure the maintenance of existing tensions.³⁰

In the authors' opinion, this is a fair analysis of the economic aspects of the separatist conflicts in Georgia. The lack of a final settlement guarantees the incomes of certain sections of society. The paradox is that the deeper the (unregulated) economic and business relations between the conflicting sides, the less interest there is in a political solution to the conflicts. The close ties that exist between business and government structures strengthen and support this conclusion.

Interviews with representatives of regional government in Georgia revealed that regional, as well as central, governments do not welcome economic cooperation and actively forbid such relations. At the same time, government representatives unofficially confide that such relations are expedient and are actively pursued.

For example, it is common knowledge that Gori region's economic interests in Tskhinvali are closely tied to Ergneti market. The owner of a poultry factory in Gori admitted that he uses the less expensive feed purchased at Ergneti market. In his opinion, using more expensive feed would lead to his business closing and an end to production. There are many similar examples in Georgia.

In private conversation, one of the leaders of a district adjoining Tskhinvali noted that close economic links – and warm personal ties – exist between the conflicting sides and that these relations are mutually beneficial. At the same time, the respondent felt that closing Ergneti market (which in his opinion will

never happen) would lead to a renewal of hostilities and that anyone who tried to legalise the market's activities – by opening the trade to regular taxation, taking control of certain spheres from different groups or shifting relations in favour of the state – 'will say goodbye to his life within a week'.

The interview supports the assertion that illegal economic ties only serve to delay the search for a political solution. This conclusion may not seem logical at first. The closer the economic cooperation, the easier it should be for different parties to reach political agreement. But the situation in Georgia demonstrates that illegal economic ties, which support continued instability, hinder the search for a political solution. From this it follows that the only economic relations that will support a final settlement are those, which are official, fully legal and accompanied by political agreement between the conflicting parties. The deepening of illegal economic relations makes a political settlement harder to reach.

Perhaps it would make more sense to begin with small-scale, socially oriented and mutually beneficial pilot projects at the interface of economy and ecology, agriculture and the arts.

5. CONCLUSION

This paper examined the influence of economic factors on the prospects for the settlement of existing conflicts in Georgia. To this end, the paper:

- Analysed the economic situation in the conflict regions, South Ossetia and Abkhazia;
- Evaluated the impact of the conflicts on the Georgian economy, as well as the regions themselves;
- Examined the main forms of economic ties between Georgia and the conflict zones, namely smuggling routes and mechanisms;
- Defined the positions of different central and regional actors in Georgia who profit from the status quo and are not interested in a political settlement;
- Analysed the perspectives and conditions for deepening economic relations between the conflicting parties, and their potential role in conflict settlement.

The authors have come to the following conclusions based on analysis of the available statistics and analytical materials, as well as interviews conducted during trips to the conflict zones:

- The frozen conflicts have caused significant political and economic harm in the form of increased state expenditure to meet the needs of displaced persons, increased danger to political stability, the blocking of transport routes, disruption of regional economies, and so on.

- Georgia's economic development, improved socio-economic conditions and the formation of civil society are rendered more difficult without a peaceful settlement to the existing conflicts.
- Despite the fact that economic relations between the conflicting sides are mutually profitable, the lack of a political solution, insecurity, mutual distrust and other unavoidable consequences of armed conflict hinder the reconstruction and development of the conflict zones. The elderly, disabled and other vulnerable populations are in an especially difficult situation and are completely dependent on humanitarian aid.
- The massive scale of emigration, demographic imbalance, distortion of social, gender and age structures, and the loss of the most employable portions of the population are causes for great concern. Gali region deserves special attention. Continued political instability and the absence of security guarantees keep Georgian returnees from taking entrepreneurial initiative, actively participating in economic life or enjoying basic social services. Added to this are the discriminatory policies of the Abkhaz authorities that make it difficult for children to receive education in Georgia, although Gali is exclusively a Georgian region. Such a position intensifies animosity between the conflict parties and lowers the chances of finding a mutually acceptable solution. It also plays into the hands of radical Georgian politicians, who promote military means as a way of winning Abkhazia back, and undermines more moderate politicians or civil society organisations that are trying to build bridges between the conflicting parties.
- Relatively well-developed economic relations exist between the conflicting sides, but they are largely illegal and mostly involve smuggling. Representatives of central and regional government, as well as criminal organisations, participate in this illegal trade, utilising the post-conflict chaos to:
 - > Trade in smuggled petroleum products (mainly through South Ossetia). Lost revenue from petrol, diesel and other petroleum goods is one of the main causes of Georgia's chronic budget deficit. Corruption and unrealised taxes in this sphere have become the main fiscal problem in recent years. If the state successfully collected taxes on petroleum products, budget revenues would increase by 30%.
 - > Evade taxes on cigarettes and tobacco products. In Georgia, 75% of all trade in cigarettes circumvents taxation. The reason for the existence of such a large black market is the smuggling of cigarettes from the conflict regions.
 - > Illegally trade in timber. Illegal logging and timber exports are growing at a phenomenal rate in Abkhazia, including valuable and endangered species.
 - > Export scrap metal. Recent years have seen a significant rise in scrap metal exports, including the wholesale dismantling of factories in the conflict zones. The majority of enterprises in Abkhazia are defunct and a large part of their equipment is exported to Turkey as scrap through the ports of Sukhumi and Ochamchira. Part of this trade is routed

through western Georgia with the connivance of local officials and criminal groups for export from Batumi and Poti. In some instances, Georgian graves in Abkhazia have been pillaged for scrap aluminium, other metals and marble, similarly for export.

- > Smuggle food products. Unregistered and untaxed shipments of grain, flour, sugar and other food products enter Georgia from Russia and Turkey.
- The de facto government of Abkhazia is trying to develop foreign economic relations, mostly with Russia and Turkey, ignoring the interests and property rights of the displaced Georgian population. The unlawful privatisation of property belonging to refugees and the attraction of foreign investment increases disagreement with Georgian authorities, making a political settlement more difficult.
- Georgia, Russia and the entire region have interests in the restoration of communication routes through Abkhazia and South Ossetia. The reopening of such corridors will discourage illegal trade, narrow the influence of criminal groups and create barriers to the further development of the drug trade. Commercial trade relations between Georgia, Russia, and the countries of the South Caucasus will quickly develop. Increased traffic will encourage the development of tourism, increase foreign investment and establish conditions for more stable economic development.
- The majority of the revenue generated by economic activities in Abkhazia goes towards military expenditure. Without political settlement, the development of economic cooperation and increases in regional incomes will directly benefit the military potential of the separatist government.
- Russia's active economic expansion in Abkhazia serves as a mechanism for strengthening its hold over the entire region, as well as the de facto integration of Abkhazia into Russia's economic space. At any given time, Russia can use its economic dominance of Abkhazia to realise its strategic goals elsewhere in the region.
- The movement of large volumes of smuggled goods through Ergneti market in Tskhinvali – and the resultant loss of revenue through customs duties and other taxes – is a main cause of Georgia's chronic budget deficit.
- The current, illegal forms of economic cooperation with the conflict regions have a destructive impact on Georgia's economy and state security.
- Limiting the shadow economy in favour of the development of legal business may become one of the most important forms of cooperation between Georgia, Abkhazia and South Ossetia.

On the whole, the development of economic relations between the conflicting parties will accelerate conflict settlement only when such relations are legal and

transparent, and when there is a parallel structure for settling political issues. These, specifically, are: the return of refugees and their participation in the region's economic life; the departure of Russian peacekeeping forces and a ban on their interference in economic activities; and a compromise agreement on the status and rights of Abkhazia and South Ossetia.

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CHAPTER FIVE

Economic development prospects in Abkhazia and the concept of regional cooperation

YULIA GUMBA AND TAMAZ KETSBA

1. INTRODUCTION

Abkhazia is situated in north-western Caucasus and is bordered by the River Psou to the north, the River Ingur to the south, the Black Sea to the west and southwest, and the Caucasus mountains to the northeast. With an overall area of 8,700km², it is slightly smaller than Cyprus, but has a population larger than Luxembourg, Liechtenstein or Malta.

As indicated in Chapter 4 of the current Constitution, Abkhazia is composed of the following historic lands: Sadz, Bzyp, Guma, Dal-Tsabal, Abjua and Samyrzakan, which contain the districts of Gagra, Gudauta, Sukhum, Gulripsh, Ochamchira, Tkvarchal and Gal districts; and the cities of Gagra, Gudauta, Novyi Afon, Sukhum, Ochamchira, Tkvarchal and Gal.¹

Abkhazia's natural and geographical setting favours the development of subtropical farming and tourism. During the Soviet era, the resort towns of Sukhum, Gagra, Gudauta, Novyi Afon and Pitsunda were highly popular, and sites such as Lake Ritsa were famous throughout the world.

Most of Abkhazia's territory is covered with forest, and it is rich in valuable species, including chestnut, yew, oak and box, as well as medicinal, fruit and melliferous plants. Timber stocks amount to 103 cubic metres.² Alpine meadows are used for summer pasture.

The Georgia-Abkhazia war broke out on 14 August 1992. Ten thousand Abkhaz died and many more were wounded in one of the cruellest conflicts to follow the break-up of the USSR. Since the defeat of the Georgian forces and their retreat, Abkhazia has functioned as a de facto independent state.

The country suffered a colossal economic collapse as a result of both the war and the disintegration of the Soviet Union. Towns like Sukhum, Tkvarchal and Ochamchira were severely damaged, entire villages destroyed and a vast quantity

of equipment and transport vehicles (buses, cars, ships and planes) was seized and taken to Georgia. Almost every resident suffered from the general looting.

After military action halted in November 1993, negotiations on a peace settlement began in Geneva under the aegis of the UN in cooperation with Russia and the OSCE. An assortment of documents was signed in 1994 that created the legal basis for further conflict settlement, but no final solution has been reached in the 10 years since.

The Georgian and Abkhaz sides define the main outstanding issues differently. Their positions are sufficiently firm to have created a stalemate in the negotiation process.

TABLE 1. GEORGIAN AND ABKHAZ POSITIONS IN THE CONFLICT

Georgian priorities	Abkhaz priorities
<ul style="list-style-type: none"> • Determination of the political status of Abkhazia • Facilitation of the return of refugees 	<ul style="list-style-type: none"> • Establishment of a basis for future relations between Georgia and Abkhazia • Agreement on mutually acceptable security decrees and the creation of instruments to prevent future conflict • Ending of economic sanctions and the economic rehabilitation of the region

Official attitudes to the conflict differ greatly. Georgian and Western writers often refer to it as Abkhazia's war for independence although, for the Abkhaz, separation was the result, and not the cause, of the war. The Abkhazian government's original intention was not independence, but to defend the country from an attacking army that threatened both its autonomous status and the survival of its people, according to a now notorious declaration by Georgian General Giorgi Karkarashvili.

That is why the conflict immediately took on the character of a national war for liberation, as described by Paye and Remacle as well as other authors.³ In addition to the grievances openly aired during Mikhail Gorbachev's *perestroika*, Georgian-Abkhaz relations are burdened by different interpretations of the two nations' historical relations with one other, differences deeply rooted in the past.

Experts and politicians refer to the Georgian-Abkhaz conflict, like many others in the South Caucasus, as a 'frozen conflict' and the continuation of the current situation contains a strong potential for renewed confrontation. Frozen conflicts also present obstacles to political, economic, social and other reforms. For reforms to be sustainable and long-term – and these are precisely the kind of reforms needed in societies going through prolonged economic and political crisis – stability and security must be guaranteed, but such conditions are incompatible with frozen conflicts. In addition, analysts have noted the serious socio-economic difficulties afflicting Abkhazia because of sanctions. The UN and OSCE's approaches

toward Abkhazia and NK differ significantly, particularly in the area of sanctions. In Abkhazia, an ‘embargo that targeted the Abkhaz side exclusively, was all-encompassing: the only exception was humanitarian aid – in a situation comparable to the one in Iraq and Serbia after the war ... As opposed to the embargo resolutions on Abkhazia, the ones on NK were formulated in generic terms and specifically concerned only arms and ammunition’.⁴

A successful peace settlement requires the bases of internal support for such a settlement to be identified. As is evident from experience of non-official, or ‘Track 1.5’, Georgian-Abkhaz dialogue within the framework of confidence-building measures, no amount of activity by external peacekeepers can compensate for the lack of internal premises for a settlement. Projects for successful peacebuilding must grow from the conflicting societies themselves and need to become part of their nation-building projects, and their efforts to achieve self-development.⁵

If Western countries face the continued task of sustaining a high standard of living for their people, and the countries that emerged from the break-up of the Soviet Union are focused on solving the problems of transition, then Abkhazia faces a very special situation. Having survived a devastating war and terrible human and material losses, Abkhazia continues to face external economic and political pressure.

The armed conflict coincided with an economic transition in Russia that was characterised as ‘shock therapy’. Since Abkhazia’s economy is 70% dependent on Russia, this had a critical impact on the new republic.

The Russian rouble, the de facto currency in Abkhazia, quickly shed its value and inflationary forces took their toll. Additionally, Russia introduced a new currency to replace Soviet coins and bills in 1993. After the war, the Abkhazian national bank subsequently collected more than 100m ‘old’ roubles in a currency exchange exercise that it could not ultimately complete. If industrial production in Russia fell from 30-65% in the mid-1990s, depending on region, industrial production in Abkhazia decreased 10 times more – and, in certain industries, by 20 to 50 times. Many firms simply halted production. The majority of the working population was left jobless. A large proportion left to find work in Russia to feed their families. Many state-owned organisations delayed salary payments for up to 10 months. The value of pensions decreased to 2,500 roubles in 1994 (\$2.5). Criminality soared and remains prominent today.⁶

Economic development was further hindered by the sanctions introduced by the CIS on 19 January 1996, which are still in force. Abkhazian passenger and cargo ships have faced an embargo since October 1995. Before that, in December 1994, Russia banned men aged from 16-60 from crossing the River Psou into Russia. A 20% value-added tax on goods exported to Russia also had negative effects on commerce.

The Abkhaz regard the CIS trade restrictions as sanctions. In their view, this blockade not only retards economic development, it damages negotiations on a

final settlement with Georgia. There is still trade with Turkey across the Black Sea, with Russia over the River Psou and even with Georgia across the bridge over the River Ingur, but production is weakly developed and the majority of the agricultural wealth of this fertile land is wasted, since ‘economic as well as political isolation has produced a siege mentality and a need for self-sufficiency that hinders not only compromises, but also contacts in general’.⁷

2. CONSEQUENCES OF THE WAR: ECONOMY AND PEOPLE

The Abkhazian economy suffered great damage as a result of the Georgian-Abkhaz conflict. A special commission was established to evaluate the damage caused to the national economy in current prices, as well as to evaluate the cost to damaged capital according to the type and nature of industries, adjusting figures to the levels of 1 January 1995. These figures were then converted into US dollars at current exchange rates.

TABLE 2. DAMAGE TO ABKHAZIA'S ECONOMY DURING THE WAR OF 1992 -93

Types of objects	Amount in \$000,000s
Architectural monuments, scientific research institutes, universities and colleges	1,400
Fuel and energy systems	2,120
Transportation infrastructure	2,150
Construction industries	480
Agribusiness	610
Communications and television infrastructure	400
Private property (housing)	150
Housing and community services sector	80
Educational facilities	70
Plants and factories	250
Health infrastructure	300
Trade infrastructure	100
Household services	50
State offices, resorts and other government property	400
‘Absoyuz’ consumers’ cooperative facilities	300
Other	2,440
Total	11,300

SOURCE: FEYZBA, Y. AND O. SHAMBA (2002) NATIONAL ECONOMY OF ABKHAZIA,

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Much of the remaining productive capital is outdated. Due to long-term under-investment in the maintenance and renewal of energy and transport infrastructure, there is a high risk of collapse and accident. In addition, many of Abkhazia's factories were built during Soviet times for Georgian workers and did not take into account the current context.

By the end of the war, it was clear that the old economic system was in ruins. While Abkhazia was fighting, other regions of the former Soviet Union had begun their transition to market economies. Abkhazia faced the task of surviving, feeding its people and getting the economy running again. Economic transformation requires intense and fundamental changes that often lead to a breakdown in the traditional way of life, drastic decreases in living standards, growing inequality, a high level of unemployment and a worsening demographic situation.⁸

The social environment was extremely hard in the early post-war years, due to delayed payment of salaries and pensions, declining living standards, polarisation of the population and low levels of social service expenditure. The situation was aggravated by a lack of budgetary resources and tax collection problems.

2.1 AGRICULTURE AND PROCESSING

One third of the land surface of Abkhazia experienced military action during the war. Georgian army units occupied over 200 collective farms, livestock operations and other agricultural ventures in Gali, Ochamchira, Gulripsh, Sukhum and Gagra districts, most of which were subsequently pillaged and burned.

Abkhazia's agro-industrial sector now faces difficult times. The fall in production continues, the capital base has not been renewed in more than a decade and asset-stripping is evident in all economic spheres. The situation has been made worse by the collapse of previous economic ties and the trade blockade.

Large areas covered by citrus and tea plantations were destroyed in heavy exchanges of artillery fire. The amount of arable land has decreased by 17,000 hectares, orchards by 13,500 hectares and hay fields by 100 hectares. Meanwhile, the amount of grassland and fallow fields grew by 2,500 hectares. The figures for fields sown with industrial and vegetable crops also grew, but productivity has decreased by 18.3 centners per hectare for grain, 173 centners per hectare for citrus and 33 centners per hectare for tea.

The production of tea and tobacco was particularly important for the economy in the Soviet era. Tea-processing factories in Gali and Ochamchira districts sent their produce to packaging factories throughout the USSR. Tobacco was also processed at factories in Sukhum, Gantiadi, Gagra and Ochamchira. The Sukhum tobacco factory was particularly well known for its quality.

Since the war, budgetary expenditure on agriculture has been relatively significant (\$1.83 million in 1999 and \$1.35 million in 2000), but production units owe the government more than 3 million roubles (\$107,000). The problem in repaying debts is rooted in the current low quality and high production costs of Abkhaz tea and tobacco.

Factories producing essential oil in Tamish (Ochamchira district), Babushara (Gulripsh district) and Gali used to supply perfumeries in the USSR with their products.

The amount of land under cultivation decreased significantly both during and after the war. In the post-war period, the cultivation of tung trees, mulberries, grapes and vegetable oil plants has all but ended. In the pre-war years, the area under vineyards, predominantly in Gudauta, Sukhum, Gulripsh district and around Gagra, exceeded 6,500 hectares. In Bombori (Gudauta district) there was a specialised vinery.

Bays and bamboo were among other subtropical plants grown for trade. Areas under fruit (pears, apples, peaches, plums, persimmons, figs, pomegranates and others) in Sukhum, Gal and Gagra districts amounted to 12,500 hectares. Kiwi, geranium and basil were also grown.⁹

Today Abkhazia is self-sufficient in vegetables (except onions and potatoes), fruit, meat and dairy products. Cabbage and potatoes have replaced tea and tobacco on many former plantations. There is good potential for developing winter vegetable production on an industrial scale. Mild winters, more than 200 sunny days per year, and a large number of thermal springs, especially in eastern Abkhazia, provide favourable, year-round conditions for farming of many kinds.

Private animal husbandry has assumed new prominence over the last year. Previously, commercial dairy farming only existed in Gagra district, but the number of livestock in the public sector has fallen by 75%. It is also worth noting that the adequate supply of food products can be explained by the drastic reduction in the urban population following the expulsion of the Georgians.

During the war the agricultural industry lost an equivalent of \$8.7 million in crop farming and an equivalent of \$0.8 million in cattle-breeding.¹⁰

TABLE 3. AGRO-INDUSTRIAL COMPLEX IN EASTERN ABKHAZIA (GURLRIPSH, OCHAMCHIRA, TKVARCHAL AND GAL REGIONS) AS OF JANUARY 2003

Region	Number of enterprises	Form of ownership			Activities	Number of staff	Number of agricultural machinery units
		private	state	rented			
Gulripsh	19	5	13	1	Vegetable crops, citrus, livestock raising, horticulture, fruit processing, juice production	756	52
Tkvarchal	14	-	14	1	Tea, citrus, tung	708	34
Ochamchira	45	9	22	14	Tea, tobacco, vegetable farming, livestock, food processing		
Gal	3	-	3	1	Citrus	268	34

SOURCE: MINISTRY OF AGRICULTURE OF ABKHAZIA

The absence of an approved plan for reforming and developing Abkhazia's agro-industrial potential has delayed the introduction of a number of basic legal codes on state regulation, the status of cooperatives, state support for small businesses, land tenure, and so on. The process of rehabilitation, it should be added, unfolds against a background of destroyed linkages between sectors. New ones, defined by market rather than administrative forces, are being left to the agricultural enterprises themselves.

2.2 TOURISM AND RECREATION

Before the Soviet Union collapsed, there were more than 100 recreation centres, public dacha and tourist resorts in Abkhazia, with a capacity to accommodate 40,000 people.¹¹

TABLE 4. LOCATION OF SPAS AND RESORTS IN ABKHAZIA IN 1985, BY REGION

City or region	Under local administration	Under USSR or Georgian SSR administration	Total
Sukhum (city)	4	10	14
Gagra and surrounding area	12	32	44
Tkvarchal (city)	1	-	1
Sukhum region	1	4	5
Gulripsh region	1	6	7
Gudauta region	12	15	27
Ochamchira region	1	3	4
Total for all Abkhazia	32	70	102
As % of total	31.3	68.7	100

SOURCE: MINISTRY OF AGRICULTURE OF ABKHAZIA

TABLE 5. PROSPECTS FOR DEVELOPMENT OF RESORTS IN ABKHAZIA (IN THOUSANDS OF BEDS)

Resort, area	1980	1990	2000	Future prospects
1. Gagra City Council	19.4	33.3	51.0	76.0
Leselidze tourist complex	3.6	7.0	11.0	14.0
Gagra-Pizunda complex	15.8	26.0	40.0	62.0
2. Gudauta region	9.0	13.5	29.4	51.0
Ritsa-Avadkhara complex	0.5	1.5	9.5	10.0
Gudauta complex	5.4	7.6	15.4	22.0
Novyi Afon tourist complex	4.0	4.5	10.5	19.0
3. Sukhum and Sukhum region	7.4	9.2	22.0	22.0
4. Gulripsh region	3.5	5.5	25.0	48.0
5. Ochamchira region and the city of Tkvarchal	1.1	2.5	8.8	68.8
Zolotoye Runo tourist complex	0.4	0.7	1.7	48.0
Ochamchira tourist complex	0.7	1.8	7.1	20.0
6. Gal region	0.7	0.7	3.8	58.0
Total for Abkhazia	42.0	65.0	140.0	307.0

SOURCE: MINISTRY OF AGRICULTURE OF ABKHAZIA

Abkhazia's tourist and recreational facilities suffered major damage during the Georgia-Abkhazia conflict. Out of 125 spas, hotels and resorts 90 were destroyed during the armed conflict; an additional 13 are in need of significant renovation.

TABLE 6. CONDITION OF THE ABKHAZIAN TOURIST INDUSTRY, AS OF 2003

Number of functioning tourist facilities, of which:	36
State-owned	2
Rented	33
Privately owned	1
Number of beds in tourist facilities	5,000
Number of employees	2,000
Occupation during the 2002 tourist season	23.8%

SOURCE: ABKHAZ MINISTRY OF TOURISM, 2003

Most of the pre-war tourist infrastructure, including around 12,000 hotel beds, was allowed to decay and has begun slowly to recover after 1999. In that year, 7,500 tourists visited Abkhazia, a figure that rose to 25,000 in 2000 and 160,000 in 2003.¹² A number of pensions and resorts have been partly, or entirely, privatised as new sources of investment emerged to rebuild the tourism infrastructure. However, major modernisation and much greater investment will be required if Abkhazia is to attract international customers.¹³

2.3 ECOLOGY

The conflict impacted upon Abkhazia's economy and environment in many different ways. In addition to the direct damage outlined above, there have been secondary effects on the environment. The population is forced to cut down trees for fuel, plough slopes that are subject to erosion, maintain excessive livestock, overfish and overhunt just to survive. As a consequence, people are destroying the very ecosystems that are the basis of their livelihood. Environmental sustainability is undermined and many valuable plants face extinction. The secondary impact of conflict is observable in a growing number of areas.¹⁴

TABLE 7. ENVIRONMENTAL IMPACT OF MILITARY ACTION IN ABKHAZIA

Type of impact	Consequences	Scale*	Duration**	Environmental and economic losses
Shell craters, trenches, blindage, other defensive works	Damage to topsoil, ground water and water flows; destruction of lower soil layers; defoliation	I	3	Changes in the lie of the land; erosion and impoverishment of soil and biodiversity
Actions of troops, tanks, aviation, etc	Compacting of ground and destruction of topsoil, defoliation, fuel leaks and noise pollution	II	3	Pollution of topsoil, atmosphere and water
Landmines	Removal of agricultural land and forests from normal crop rotation; drastic decline of recreational use of landscapes	III	3	Impossibility of agricultural work; human and animal deaths
Artillery and other bombardment	Creation of wastelands and areas littered with the remains of weapons	II	3	Destruction of topsoil stability, tree cover, plants and animals; changes in the lie of the land established conditions for erosion
Occupied territories	Defacement of urban landscapes, nature reserves, etc.	I	3	Destruction of traditional relations between people and nature. Destruction of national economy and infrastructure

SOURCE: MINISTRY OF TOURISM, 2003

Notes: *Scale of problem: I – local, II – regional, III – global;

**Duration: 1 – short-term, 2 – medium-term, 3 – long-term.

In addition to these threats to Abkhazia's environment, Georgia's Supsa oil terminal, which was opened in 1999 to transport Azerbaijani oil to Western markets, is considered to have the capacity to pollute a large area of the Black Sea basin.

2.4 POPULATION AND SECURITY

The majority of the Georgians in Abkhazia left the country during or after the conflict. Similarly, many thousands of Abkhaz were internally displaced, fleeing the regions that suffered most.

The future of these IDPs and refugees is one of the most acute issues facing negotiators in the search for a permanent settlement. According to the UN

Observer Mission in Georgia (UNOMIG) and CIS peacekeeping forces, a total of 60,000 refugees had returned to Gali region by 2003.

The rehabilitation of the areas in Abkhazia that suffered directly from fighting, an increase in their inhabitants' standard of living and a plan for the region's socio-economic development should be among the priorities leading to any future political settlement. Success in resolving these issues would be a positive factor in the peacemaking process.

As mentioned, post-war Abkhazia faces serious economic challenges, the largest of which is the CIS embargo that has resulted in a drastic decline in industrial production. Under such conditions, agriculture cannot develop, it can merely provide for local consumption. The agricultural situation is worsened by the large number of landmines, which make farming impossible in large areas of Gali and Ochamchira districts. According to the UK demining NGO, Halo Trust, there are more than 60,000 landmines in Abkhaz territory.

The transition to a free-market economy has been accompanied by a polarisation of the population based on income and an increase in the number of those in need of assistance.

In addition to the destruction of productive and industrial infrastructure, the war had a serious impact in the urban and regional centres. Villages that were in the path of the violence suffered even greater damage. There are few state-run kindergartens left, and schools and medical facilities lack the most basic necessities. Abkhazia's only retirement home, in Kamany, Sukhum district, has also closed.

The difficult socio-economic situation is apparent in public perceptions of the most serious obstacles to a political solution of the Georgian-Abkhaz conflict. According to a survey in 2002, the public views the main factors blocking the development of Abkhazia as:

- Lack of settlement to the Georgian-Abkhazia conflict – 42%;
- Lack of democratic experience – 26%;
- Economic isolation – 21%;
- Existence of clan structures – 21%.¹⁵

The low level of security is another factor impacting negatively on the normalisation of Georgian-Abkhaz relations. Since the end of open warfare in 1993, there have been episodes of serious military confrontation, such as occurred in Gali in May 1998 and Kodor Gorge in October 2001. Diversionary and sabotage activities continue in other areas in the security zone on the border between Abkhazia and Georgia. As a result, law enforcement staff, soldiers and private citizens in Abkhazia, both ethnic Abkhaz and Georgians (Mingrelians), continue to be killed and injured.

3. MAIN TRENDS IN ECONOMIC DEVELOPMENT IN ABKHAZIA

Apart from war damage and continuing tensions with Georgia, the economy of Abkhazia, in common with all post-Soviet states, experiences negative factors that further impede rehabilitation, such as:¹⁶

- Weakness and corruption in the executive authorities;
- Lack of transparency and a corresponding lack of social involvement in decision making on vital reforms;
- Underdeveloped party system;
- High level of shadow economy;
- Underdeveloped democratic institutions;
- Lack of a long-term reform strategy.

Analysts emphasise that the financial system that came into being after the Georgia-Abkhazia war implied a system of taxation, mandatory social payments, and a debit and credit system at both republican and municipal levels that simply do not meet the needs of a market economy.¹⁷

Unlike Georgia, which receives unprecedented financial, expert, consultative and other assistance from Western governments and international financial institutions, Abkhazia has been left to its own devices. It has to solve its problems in an environment of sanctions and political pressure from the international community. The sanctions make absolutely no contribution to resolving the political conflict, but they exert negative influence on development in the region due to the unintended stimulus they give to the growth of the parallel or shadow economy.

The current paper required an assessment of the level of development and effectiveness of economic systems in four focus regions – Tkvarchal, Gulripsh, Ochamchira and Gali. The main difficulty in identifying solutions to existing problems is the total lack of material and technical resources, aside from labour. Balanced development across an entire economic system needs to take into account numerous factors influencing the creation and effective functioning of the agro-industrial complex even in this small region.

Research for the paper generated a substantial amount of statistical information in the four focus regions. The direction of any economic development, in general, will be dictated by the need both to enhance balanced, systemic approaches to the agro-industrial complex and to broaden their social impact, which in turn will alleviate social tension.

The following characteristics of the Abkhazian economy determine the direction of its development:

- Specialisation in resort and tourism services, and the concentration of non-industrial resources in this sphere;
- Subtropical agriculture production and the large number of workers employed in the sector;
- The mountainous nature of agriculture, characterised by the low levels of technology and mechanisation;
- The small size of enterprises in regional industry;
- The seasonal character of the two leading economic sectors, agro-industry and tourism, and also the subsidiary branches of food processing and services due to peaks and troughs in the number of annual tourist arrivals.

Modernisation and growth in agro-industry and tourism will form the basis for developing an Abkhazian economy that is orientated towards integration with other states in the South Caucasus. But the reconciliation of national and regional economic interests will not be feasible without first overcoming the negative consequences of the Georgia-Abkhazia conflict. Accelerated rehabilitation would be enhanced if Abkhazia were extended assistance by the international community, which has a genuine interest in region-wide economic integration and stability. Carefully strategised, such assistance would help to change a society that has lived through war and reduce the likelihood of renewed violence.

4. ECONOMIC INTEGRATION OF THE SOUTH CAUCASUS REGION AS A FACTOR IN SECURITY AND CONFLICT TRANSFORMATION

The collapse of the Soviet empire and the ensuing flare-up of many of its inherent ethnic and political conflicts radically changed the traditional economic ties and geopolitical map of the post-Soviet world. The South Caucasus, in particular, faced violent disintegration since the conflicts drew dividing lines across the region. Many researchers have pointed out that the policies of international organisations involved in conflict resolution have proven largely ineffectual due to an excessive focus on the political constituent of such conflicts, their underestimation of the value component of Caucasian conflicts and international demand for short-term results.

International measures of enforcement, including sanctions and an unbalanced approach to the conflicting parties, as well as strong geopolitical competition in the South Caucasus, have helped to create a dangerous deadlock in the peace process, both in local conflicts and the region as a whole. This stimulated Russian and Western experts to consider a 'new logic' of conflict resolution that included the factor of unrecognised states. Russia

began building a new system of national security on its southern borders with Armenia and Iran, with unrecognised states contributing important elements of balance and stability. Meanwhile, Europe offered unrecognised states membership of international organisations like the OCSE, in a limited format and outside the issue of international recognition.¹⁸

In Abkhazia, which has a clear orientation towards Russia¹⁹ as the only guarantor of its security, analysts are also studying models of regional consensus and cooperation. Some are examining the potential benefits of integration as an indirect means of conflict resolution, possibly based on supranational models of integration, without alienating Abkhaz public opinion, not just about Russia and the Caucasus but Europe as well.²⁰

What is most important is the creation of a genuine Caucasian integration model on the foundation of its participants' horizontal economic ties (this could become a more effective format for future discussions of the region's most serious political conflicts). This contrasts strikingly with the interim model of South Caucasus society in the Stability Pact for Caucasus, whose Belgian developers maintained as a precondition the current international and political hierarchy of the conflicting parties.

The proposal to use the institutional mechanisms of the OSCE and EU to create a Caucasian integration model, as well as the enrolment in these organisations of Russia, the US, Turkey and Iran where possible, offers some advantages. For the Abkhaz people, the most important issues are security²¹ and demographic distortions in Abkhazia. In this regard, the format would need to provide at least three levels of security guarantees for the conflicting parties (international, general Caucasian/regional and local/bilateral), and to open up opportunities to look for a balance of interests of the leading geopolitical actors.²²

These theoretical projects, which are gaining support among Caucasian experts, emphasise the economic priorities of regional cooperation, which requires a new and more pragmatic approach by conflicting political elites to the issues of stability and economic development in the region.

In fact, several existing regional structures initially emerged as political coalitions, such as GUUAM (Georgia, Ukraine, Uzbekistan, Azerbaijan and Moldova), significantly reducing their chances of gaining the confidence of their regional neighbours. That is why joining the efforts of all the regional participants, both recognised and unrecognised, in a single framework, might be a more effective way of working, despite the objections of the recognised states.

A positive signal in this regard was the unexpected comment by Georgian President Mikhail Saakashvili during a recent visit to Moscow that Russian investment in Abkhazia was welcome, irrespective of progress in resolving the Georgia-Abkhazia conflict.²³ While Abkhazia insists on its independence, it has participated many times in projects that are essential for its economy, as well as Georgia's (for example, the Ingur power station). Thus the basis

for cooperation between conflicting countries could become purely economic issues, separated from political conflict resolution.

Conversely, when economic cooperation or promises of international economic aid were obligatorily tied to political bargaining over the principle issues of conflict resolution (which Abkhazia has experienced many times), no political progress ensued and there was increased distrust toward the international peacebrokers. Economic sanctions and international isolation, favouring one party in the conflict to the detriment of the other, have proven equally ineffective as instruments of pressure.

Such instruments, moreover, created conditions for the rise of shadow or openly criminal businesses in the border regions, including Gali where illegal raids by armed Georgian irregulars overlap with the activities of criminals, fuelling the possibility of large-scale military actions or political provocations. The legalisation of the cross-border trade (which is based on smuggling goods to and from Georgia) is possible only with commitments from both parties, as well as regional and international guarantees. It would help to alleviate tension in this strategically important part of Abkhazia and optimise future political process.

Georgian attempts to restrict trade between Turkey and Abkhazia by detaining Turkish vessels has had dubious economic impact, but negatively affects public opinion since it is common knowledge that it is the Abkhaz people, and not the government, that is worst effected. Georgia's negative information campaigns (portraying Abkhazia as a hotbed of drug traffickers and Islamic terrorists) have had a deleterious affect on the peace process and economic cooperation. Attempts to distract international attention from the Pankisi Gorge (where such problems may genuinely exist) and to convert it into repressive measures against Abkhazia testify to the lack of constructive pragmatism in Georgia's long-term vision of conflict resolution. Regrettably, international organisations demonstrate a biased approach in practice, representing the political interests of only one party to the conflict, though some recent reports question the effectiveness of economic sanctions and raise the need for the full-scale rehabilitation of Abkhazia.²⁴

Financial investment (as opposed to political repression and economic sanctions) in zones of frozen conflicts could achieve the following:

- Become a factor of influence for the international community in preventing future military actions and create a secure background for the political peace process;
- Become a vector of more liberal public sentiments;
- Become a factor of genuine economic development and cooperation that circumvents political disputes;
- Encourage a growing interest and responsibility by the conflicting parties in the avoidance of future armed conflict.

Working out a pragmatic concept of economic development for conflicting communities in the South Caucasus on the basis of its economic interests requires the leading international organisations to adopt a committed motivating role, both financial and political. These organisations have to create the political background and legal framework to implement local, regional and trans-regional economic projects, irrespective of success in the political negotiations of the conflicting parties.

Economic integration could create new legal norms of relations, such as an international ban on the use of armed force, the lifting of sanctions and the creation of pan-Caucasian legislation in the spheres of economy and economic competition. With this approach, it becomes feasible to work towards a collective negotiation system modelled on the EU to transform conflict-generating relations into more civilised economic and political competition.²⁵ This, in turn, would make it possible to transform the conflict-generating relations of the external actors, which could be more directly involved in working out a model of regional consensus. Economic integration would also make it possible in future to synchronise democratic reforms in local regional units with a view to establishing a common legal space.

Regional economic integration as a factor in conflict transformation and the creation of a pan-Caucasian, democratic space is probably not the fastest-acting recipe against war and violence, but it seems to be the most reliable in the long term.

The restoration of disrupted transport routes is the most important of the stabilising trans-regional projects, since it is the single biggest factor in the region's economic disintegration. An urgent issue is the restoration of the Russia-Abkhazia-Georgia-Armenia railway and the restoration of air traffic,²⁶ as well as alternative transportation routes for Caspian energy resources that take into account the interests of Russia, the West and the participants themselves. In addition to the BTC pipeline, several new ones are being discussed, including: Baku-Supsa-Odessa-Brody-Plotsk-EU; and an option to connect the western arm of Baku-Supsa and the northern arm of Tengiz-Novorossiysk, which would run through Abkhazian territory (Novorossiysk-Sukhum-Supsa) to the Turkish port of Ceyhan on the Mediterranean.²⁷

From the point of view of stability and interdependence, it would be beneficial to discuss the economic division of labour in the region based on the potential and features of its constituent political-geographical subjects (production and transportation of energy resources, environmentally clean agricultural products, tourism, etc.).

A common regional concept of economic development presupposes a balance of national economic concepts especially in the light of the fact that they are still being determined in many states. The support of international

organisations for national development programmes is important both in theory and practice, and could be implemented through targeted investment and the sharing of expertise.

Analysis of the negotiation processes and the ethnic and psychological climate of the conflicting parties in most of the conflict zones in the South Caucasus does not tend towards optimistic conclusions. Numerous factors, both objective and subjective, predetermine the existing status quo, which is the situation of frozen conflicts. Under such conditions, the establishment of an organisation that specialises in issues of regional economic cooperation could be a working mechanism to help 'warm up' zones of frozen conflicts by providing support to local agencies for economic development and democratic reform.

Similarly, strong support for democratic reform and civic initiatives in zones of local conflict is a necessary precondition for the economic development of individual communities in line with the regional economic objectives of the 'new logic'. Cooperation and balance between individual Caucasian communities (including conflicting ones) in the region as a whole is the key challenge for a regional organisation of economic cooperation which, in the long term, could help to stabilise political processes.

5. CONCLUSION AND RECOMMENDATIONS

The following recommendations for economic renewal in Abkhazia are based on the specifics of its agro-industrial sector and are geared towards the completion of market reforms. Above all, they seek to remedy some of the worst consequences of a war that was fought on Abkhaz territory:

- A policy of state subsidy to purchase surplus produce from farmers is needed to stimulate production. Such a system existed in the Soviet times and might be reintroduced in Abkhazia.
- The poor condition of transport communications in eastern Abkhazia must be a priority in reconstruction planning. Often there are no regular connections at all between villages and regional centres. The condition of roads and bridges in most settlements – and between them – is pitiful, with the exception of the highway connecting Sukhum to Gali, which has been repaired.
- It is necessary to review the economic logic of maintaining the large, Soviet-built factories that require the delivery of large volumes of fruit, vegetables and other agricultural products for processing. Downsizing these enterprises into small, more technologically flexible firms may prove more sensible economically.

- International agencies currently focus a disproportionate amount of their efforts in eastern Abkhazia, while it is obvious that socio-economic conditions in the rest of the country are only moderately better. A similar imbalance can be seen in a comparison of foreign aid to Georgia and Abkhazia. Georgia accommodates 150,000 refugees from Abkhazia, but its territory and infrastructure were largely unaffected by the conflict. Abkhazia also has a large population of IDPs. Its economic and social infrastructure was more drastically affected, yet it receives minimal international assistance in reconstruction and economic reform.

Abkhazia faces numerous difficulties in attempting to formulate a new strategy of economic development. The most important considerations are:

- International isolation and economic sanctions;
- Lack of democratic experience and reform, including in the sphere of the economy, and a lack of legislation to shape reform;
- Lack of international support for the democratic process in Abkhazia;
- Unresolved Georgia-Abkhazia conflict and the disruption of regional boundaries.

In spite of these factors, the dominant social and political trends in Abkhazia are converging towards democratic institutions, integration with the international legal space, rise of civil society and a network of civil groups that do not depend on government funding or ideology. We are witnessing the formation of conditions that favour the active and effective interaction of various sectors of Abkhaz society.

However, economic development is lagging behind the evolution of political and democratic institutions, and this does not promote the rise of socially responsible businesses, including those that might be interested in charity and peacekeeping.

Socially responsible businesses could play a significant role in resolving local conflicts because business interests rule out unstable zones and require a totally integrated space. Abkhazian NGOs could create institutions, such as agencies for economic development or democratic reform, with a mandate to work towards a specific set of goals.²⁸ The following could be among their main aims:

- Approach donors to support projects in small, socially responsible business;
- Support democratic reforms, especially in the sphere of economic legislation;

- Provide education on human rights, conflict resolution and small business development;
- Provide analyses, forecasts and recommendations on the political and economic situation, as well as peacekeeping.

An integrated approach to the work of such an agency will also promote long-term cooperation in all sectors of society, as well as dialogue between government, political and business elites, and civil society.

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- ² *ibid.*
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- ¹⁶ United Nations Development Program, op.cit.
- ¹⁷ Feyzba, op. cit.
- ¹⁸ Coppieters, B. (2002) 'Federalism and conflict on the Caucasus' (Moscow, Russia: Moscow Carnegie Center, Working materials), p. 49.
- ¹⁹ Russia's popularity grew considerably after it granted citizenship en masse to the population of Abkhazia, which is unable to move around without passports. There has also been a surge in Russian investments in the resort industry.
- ²⁰ Tania, op. cit.
- ²¹ From the Abkhaz point of view, Georgia has been the biggest threat to its national identity throughout the 20th century: militarily (1918-21, 1992-93); legislatively (downgrading

Abkhazia to a Georgian autonomous region); culturally (closure of Abkhaz schools, renaming localities, repression of cultural figures); and demographically (a massive relocation of Georgians to Abkhazia in Soviet times reduced the national population to a minority on their own territory). Georgia's post-war policy is also interpreted as repressive and ultimately nationalistic (Gal in 1998, Kodor in 2000, sanctions, terrorism, etc.).

²² Tania, L. (2003) 'Strategy options in Georgian-Abkhazian conflict resolution' in *Central Asia and the Caucasus*, 5(29). p. 55.

²³ *Free Georgia*, 12 February 2004.

²⁴ *The UN Needs Assessment Mission to Abkhazia* in 1998, which included a World Bank representative, drew the following conclusion: 'Trade restrictions could have far-reaching consequences in terms of psychology and give rise to the sentiment of isolation, which would enhance political positions at the expense of economic integration. In the Mission's opinion, relaxing the restrictions could promote peace and create a more favourable climate for the negotiation process.' p.8.

²⁵ Tania, op. cit.

²⁶ The UN Needs Assessment Report concluded: 'the main airport ... can function all year round ... It is equipped with the best system of air traffic control and modern air navigation systems for an entirely automatic landing in the region... could become both a passenger and freight port for the entire region' p. 23.

²⁷ Lakoba, S. 'A view from Japan: Will "Rose" of Georgia join the Red Book?', *Nuzhnaya Gazeta*, 2 March 2004.

²⁸ In our opinion, the need for this kind of institution exists in many conflict-ridden regions.

SECTION THREE

PERSPECTIVES ON THE INFORMAL ECONOMY

CHAPTER SIX

Economy and conflict in South Ossetia

VAKHTANG DZHIKAEV AND ALAN PARASTAEV

1. INTRODUCTION

Before the establishment of the Soviet Union, South Ossetia was part of Tbilisi *gubernia* of the Russian empire and one of the most economically backward regions of the country. The South Ossetian Autonomous Region was created in 1922 within the Soviet Republic of Georgia. The *oblast* was formed from the administrative regions of Dzhava, Znauri, Leninogorski and Tskhinval, with Tskhinval as its capital.

South Ossetia covered 3,800km², or 5.4% of the surface area of the Georgian Soviet Socialistic Republic. It now borders the Russian Federation (the Republic of Northern Ossetia-Alania) in the north; the Georgian regions of Dusheti, Kazbegi, Sachkhere and Oni regions in the east; and the Georgian regions of south Kaspian, Gori and Khashuri in the west. All its territory is located on the slopes of the Main Caucasian Ridge.

According to the 1989 census, there were 99,100 inhabitants in the autonomous region, of whom 70% were Ossetian, 20% Georgians and 10% who belonged to other nationalities. Ossetians are the titular nation. Tskhinval, a city of 42,900, is the autonomous region's administrative centre. South Ossetia's population – 58% of which live in rural areas – constituted 1.9% of Georgia's total population in Soviet times.

South Ossetia contributed only 2% to Georgia's total GDP. According to Georgian statistics, it had the lowest index of all the republic's regions, though in fact the *oblast* was superior in terms of its mineral and raw material resources, as well as recreation potential. Industrial production was concentrated mainly in Tskhinval and Kvaisa village in Dzhava region. Mechanical engineering, metalworking, food processing, light industry and the timber industry were well developed in Tskhinval, while Kvaisa was a source of lead and zinc.

Conditions are also favourable for crop farming and cattle breeding. Cattle breeding was traditionally the main branch of agriculture.

There were two predominant forms of transport in South Ossetia, railway and car. The majority of the roads were built along the rivers. Difficult geographical conditions still determine the development of the transport system. The only railway was opened in 1940, but it stopped functioning in 1989 after the outbreak of the Georgia-Ossetia conflict.

Considering the *oblast's* mountainous character, vehicles play a very important role in South Ossetia's economy. The Transcaucasian turnpike is the main artery for transporting passengers and cargo, and around 90% of all local business is connected to this road.

2. CAUSES AND HISTORY OF THE GEORGIAN-SOUTH OSSETIAN CONFLICT

The current confrontation between South Ossetia and Georgia may seem to be a normal phenomenon in modern history, saturated as it is with such intrigues. Both sides are simple people with a strong sense of self-respect and an awareness of historical catastrophe, even as they face the start of the third millennium.

All known conflicts between Ossetians and Georgians in the course of their 2,000-year co-existence were preconditioned by internal and external, political and economic, factors. To a large extent, this most recent conflict can be attributed to the discrepancies and mistakes in inter-ethnic relations committed during the Soviet era.

The separation of nations that had lived together for centuries was painful in the extreme. Economic, political, cultural and family ties were destroyed, leading to violent conflict between national minorities and majorities. In such situations, a minority's desire for independence becomes justifiable, while such a separatist aspiration is unthinkable to the majority, which uses every effort to preserve its territorial integrity.

Perestroika, which began in the USSR in the mid-1980s, did not resolve the problems that its architects set it. In many ways, it speeded up the processes that led to the disintegration of the Soviet Union with the internecine wars that resulted in suffering for many peoples in a previously united country. Non-titular nations in the Union's republics were particularly hard hit.

Perestroika in Georgia unleashed a movement directed at ensuring national dominance in all areas of public life, including politics, economics, demographics and the social sphere. The Georgian nationalist movement, which was bent on withdrawing from the USSR and establishing a nation-state, actively cultivated hostile policies toward 'non-indigenous' nations, a category into which the Ossetians naturally fell.

In May 1989, an information war was launched against South Ossetia. The mass media and public rallies introduced into popular consciousness the image of the Ossetian as an enemy of the Georgian, leading to demands for abolition of the South Ossetian Autonomous Region.

Given the *oblast's* lack of legal defence, an Emergency Session of the Soviet of National Deputies of the South Ossetian Autonomous Region was convened to reorganise the region into an autonomous republic within the confines of the Georgian Soviet Social Republic (SSR). South Ossetia turned to the Georgian SSR Supreme Soviet for approval, assuming this move guaranteed the territorial integrity of Georgia and, in the event that Georgia left the Soviet Union, South Ossetia would still have constitutional guarantees of its continued status as an autonomous republic within Georgia.

On 18 November 1989, the Presidium of the Supreme Soviet of the Georgian SSR rejected the Emergency Session's decision without providing any legal reasons. In so doing, the Georgian SSR parliament ignored the possibility of maintaining the peace with Ossetians within Georgia's national borders. Instead, Georgian leaders encouraged their parties to hold a 'popular rally' in Tskhinval. Georgian aggression against South Ossetia began on 23 November 1989.

On that day, the 'Roundtable' bloc, headed by Zviad Gamsakhurdia, who went on to become Georgia's first democratically elected president, organised a march on Tskhinval of thousands of militants from the Georgian national movement to resolve the 'nationality problem'. The President of the Republic, Givi Gumbaridze, and other government and church dignitaries walked at the head of the rally.

The crowd was not allowed to enter the city, but a military blockade, pogroms, murder, torture and violence against Ossetians soon followed. After the events of 23 November and the repression that followed, the South Ossetians declared their intent to remain within the USSR should Georgia attempt to withdraw from it.

Georgia did withdraw in 1990, and the South Ossetians declared their independence on 20 September 1990, according to the norms and regulations of international law – the law on self-determination – in an attempt to preserve their autonomy and identity. In response, some 6,000 Georgian policemen and criminals – who had been released from Georgian prisons and quickly donned military uniform – descended on Tskhinval before dawn on 6 January 1991 and captured most of the city. The Georgian authorities acted with the express agreement of the Soviet Ministry of the Interior.

A large-scale, military aggression was launched against South Ossetia and its people that lasted more than a year and a half. Ossetians hoped the violence would end after the fall of the Gamsakhurdia dictatorship in January 1992 and the rise of his enemies. However paradoxical it may seem, the war actually took on a more violent character after President Eduard Shevardnadze assumed power

and Georgia acceded into the OSCE. Regular military units were sent to South Ossetia and the Republican Guard utilised heavy military equipment.

According to the Joint Control Commission – a Georgian-South Ossetian panel established as part of the process of negotiation – more than 1,000 people were killed, 1,700 wounded and 100 disappeared as a result of the Georgian aggression. Over 100 Ossetian villages, as well as entire quarters of Tskhinval and Znaur, were burned and destroyed. Thousands of South Ossetians lost their homes or became refugees. Around 100,000 people took refuge in North Ossetia, across the Russian-Georgian border. The losses in terms of ecological damage were also dramatic.

All of Georgia's actions between 1989 and 1992 are viewed in South Ossetia as aggression against the Ossetian nation, which had exercised its right to self-determination and declared its independence.

The territory of the autonomous region was divided into two zones, with one part controlled by Georgia and the other by the South Ossetians. Parts of Leningor, Znaur and Tskhinval regions remain under Georgian jurisdiction while the rest, including the city of Tskhinval and all of Dzhava region, remain under Ossetian control. Znaur, Leningor and Tskhinval regions are considered conflict zones.

Four-sided negotiations on the South Ossetian problem, involving Georgia, South Ossetia, Russia and North Ossetia, began in Dagomis on 24 June 1992. The conflicting sides agreed on a ceasefire and the creation of a corridor to separate them. The Dagomis Agreement brought an unsteady peace to the territory of South Ossetia.

A new stage in the history of the two nations began after the Dagomis Agreement and the arrival in South Ossetia of CIS peacekeeping troops. Efforts to foster ties between the two peoples replaced military action, but the settlement process has moved forward with difficulty and only the Joint Control Commission prevented it hitting a complete dead end. Periods of active political engagement to bring the two sides closer are followed by periods of inaction in which both sides display a complete lack of understanding of one another. A large number of problems remain to be resolved before steps can be made in the direction of stabilisation.

Historical experience shows that the consequences of ethnic conflict linger for more than one generation.

Other destabilising factors that hamper the peacemaking processes are social disunity, political uncertainty in Georgia and South Ossetia, as well as unfavourable economic conditions.

The process of negotiation was put on hold again recently. Four-sided meetings are held from time to time with the goal of settling the conflict, but the Georgian and South Ossetian positions are directly opposed and mutually exclusive of each other. New paths must be found to speed up the process of settling the conflict.

3. POLITICAL AND ECONOMIC CONSEQUENCES OF CONFLICTS FOR UNRECOGNISED STATES

The fall of the Soviet Union led to the formation of 15 newly independent states, each of which has been an active and recognised member of the international community over the past decade. However, a number of state-like formations on the territory of the former Soviet Union that declared an independence they were able to defend militarily also marked 10 years of sovereignty in 2001, although they are still internationally unrecognised. These include Abkhazia, NK, Transdniestria and South Ossetia. In 1999, Russia – at its second attempt – managed to deny Chechnya's demand for independence, though the war in the North Caucasus continues unabated.

Ceasefires in the Transdniestria and Georgia-South Ossetia conflicts were reached in 1992, and in the NK and Georgia-Abkhazia conflicts two years later, but political settlement is still absent on the Dniester and in the mountains of the Caucasus. In the meantime, these unrecognised republics have acquired the attributes of real states – from constitutions and cabinets to police and military forces. They have consolidated structures of government and management, and regularly hold elections for government office. Despite this, power remains in the hands of a few clans. Economic systems – in an extremely truncated manner – have been created in Abkhazia, Transdniestria, NK and South Ossetia that provide for the survival of most of their residents, while simultaneously creating the conditions for enriching criminal organisations. Despite the lack of recognition, the self-declared republics actively participate in international exchanges. Over the years, their representatives have continued to maintain dialogue with the governments of the states from which they tried to secede, their former imperial masters – which returned in the form of a peacekeeping force – and with international intermediaries, including the UN and OSCE.

The external situation of the conflict regions is relatively stable. They have achieved their immediate objective of independence, and the absence of recognition has not created insurmountable obstacles to the maintenance of external ties. Snuffing out regional and ethnic independence through military means is not within the power of the central governments of Azerbaijan, Georgia, and Moldova. Attempts to find military solutions ended more or less catastrophically. At the same time, continuing tensions represent a threat to stability in the entire region. Under certain conditions, the frozen conflicts could again be transformed into 'hot' military conflicts. In 2000 and 2001, Georgian-Abkhaz tensions reached dangerous levels. On the other hand, even as the ceasefire is maintained, the same unrecognised breakaway regions are infiltrated by criminal business activities – from weapons smuggling to drug trafficking, including sales to terrorists. For all these reasons there is a need for a political solution on the basis of compromise.

A series of civil wars has spread throughout the region since the dissolution of the Soviet Union, particularly in the South Caucasus. These wars often pursued economic rather than military goals, and groups fighting in them often gave priority to their own economic interest: in the Caucasus, this often amounts to marauding. The growing impoverishment of people caught up in the conflicts is notable when compared to the flourishing of their former neighbours in the USSR whose main motivation has been the accumulation of capital under new ownership structures. In fact, the conflicts in the South Caucasus took place between the poorest regions of the former Soviet Union and have now become part of their daily economic realities. The analysis of ties between conflict and economy at the outbreak of the South Caucasus wars is not the prime goal of this study, which focuses instead on the current economic situation and its influence on future development of frozen conflicts in the South Caucasus.

4. OBSTACLES TO JOINT BUSINESS IN THE GEORGIAN-SOUTH OSSETIAN CONFLICT ZONE

At a socio-economic level, with the development of market structures and the rate at which the main economic indicators fall, the South Ossetian economy can be said to be in severe crisis. The main reasons for this crisis are:

- The loss of economic ties with Georgia and other post-Soviet republics;
- The undefined, legal status of the Republic of South Ossetia;
- The destruction caused to South Ossetia's economy by earthquakes and the Georgian-Ossetian conflict;
- The migration of qualified specialists to Russia.

South Ossetia's economic problems are largely the consequences of the Georgian-Ossetian conflict and may be divided into economic (destruction due to military action, low living standards and the lack of social protections and assistance) and social-psychological (a lack of faith in tomorrow, a lack of any sense of future possibilities and chronic stress caused by expectations of renewed fighting).

Simultaneously, living through conflict has created a special entrepreneurial character and formed a specific type of economic psychology among South Ossetians that allows them to adapt to the realities of economic change.

Structural reform of production is problematic since the climate is not conducive to investment due to heightened risks in the conflict zones. The formation of a more conducive investment regime is of the highest priority in terms of economic development. The socio-economic environment further complicates an unfavourable situation in the labour market. Unemployment among youth has hit 70% and the young have become potential recruits for criminal groups due to the frozen conflict situation.

In a context where the Caucasus has become a zone of competition between world powers wishing to consolidate their positions in the region, special attention needs to be paid to the development of entrepreneurship and business through external economic ties.

The following are external factors that can play either a negative or positive role in settling the Ossetian-Georgian conflict through business and economic development:

- The Republic of South Ossetia, a de facto independent country, remains an administrative unit of the Republic of Georgia in the eyes of the Russian Federation, other CIS countries and the international community. This drastically limits South Ossetia's external economic ties to other states on an inter-state basis, which in turn makes it difficult to attract foreign capital at a time when this capital has become a vital factor for economic reconstruction. Until the legal status of the Republic of South Ossetia is determined, external economic ties should be established through entrepreneurs in South Ossetia and closer business ties with Georgian businesspeople.
- The political and economic problems of South Ossetia and Georgia cannot be decided in isolation from the political and socio-economic conditions in the North Caucasus as a whole, particularly in North Ossetia-Alania, the natural corridor that connects South Ossetia to the Russian Federation. Any military, political or ethnic conflict in the republics of the North Caucasus that might eventually involve North Ossetia-Alania could hamper the delivery of needed products and materials, with negative influences on the shared business of the conflicting sides.
- The continued threat that military might could be used to decide the 'South Ossetian question' keeps Georgian and South Ossetian businesspeople from making the kind of long-term investments that create jobs and stable economic growth. Instead, they concentrate on trade. This constant and most serious of external factors in turn poses obstacles to the narrowing of positions between the conflicting parties.

Given the current economic and political situation, the development of business projects between the conflicting parties could tie the economic interests of both sides and create a stimulus for stabilising the political situation.

Businesspeople – Georgian as well as Ossetian – approached the authors of the current research with ideas for joint projects. In the authors' opinion, the creation of joint business structures requires detailed analysis and preparatory research. The practice of joint, cross-border economic projects, in particular the creation of small businesses in the Ossetian-Ingush border zone within the Russian Northern Caucasus, shows that the creation of structures where

representatives from both sides work together are not usually viable and quickly collapse due to internal conflicts. It is more rational to create companies on either side of the conflict on the condition that their normal functioning requires them to cooperate with their counterparts across the border; for example, a mill on Georgian territory that cooperates with a bakery in South Ossetia. Under conditions of an extreme shortage of electricity and its high cost, it makes sense to employ a similar model involving electricity mini-stations.

South Ossetia's border predicament with both Georgia and the Russian Federation opens additional possibilities for the development of business through a free economic zone. International experience demonstrates that the main issue in such zones is the creation of conditions for tax-free or discounted business. The creation of a free economic zone would take on special importance for South Ossetia, which is rich in natural resources.

A free economic zone could be created in the Znaur region of the Ossetian-Georgian conflict zone (Lopan Gorge) where one village is under Georgian jurisdiction and the next under South Ossetian. This could be the first stage of the economic integration of South Ossetia and Georgia and serve in the future as a main mechanism for mutually beneficial, economic cooperation.

The authors consider that the organisation of such cooperation on economic issues is the most important step toward discouraging a renewal of military conflict.

5. RESEARCH DESIGN

The aim of the current project is to research the ties between economics and conflict in the context of the Georgia-Ossetia conflict. The work of the research group living in one of these regions, South Ossetia, was dedicated to researching the options for post-conflict settlement on the basis of economic cooperation. The conflict hit the population of the two ethnic communities very hard and led many to the brink of absolute poverty.

In the study, the researchers refrained from taking up the positioned formulations of either side in the conflict. Economic activities that continued throughout the conflict were examined. Economic possibilities that appeared during the course of the conflict – and their impact on the conflict – were of special interest. In the current work, theoretical analysis was tested against a sizeable amount of quantitative statistical data, which is generally difficult to collect given the lack of transparency in the economic mechanisms in the region. It is hoped that the research will help to develop economic and political strategies for the conflicting sides.

The South Ossetian research group analysed the existing situation and suggested a variety of methods for resolving problems. These suggestions could

be useful if there is sufficient political will in Tbilisi and Tskhinval to implement them. The research group also hopes to contribute to the discussion of the problem of post-Soviet, ethno-territorial settlement, though the decisions, in the end, must be taken by the Georgians and Ossetians themselves.

In the middle of the first decade of the 21st century, Georgia and South Ossetia can either create the conditions necessary for the long-term settlement of the problems between them or the opposite, leading to new outbreaks of violence and conflict. In this situation, efforts by committed but uninvolved specialists to suggest the elements needed to reach a settlement could prove useful. At the risk of repeating what has been said already, it should be underlined that the disposition of these elements – the building blocks of peace – is up to the parties directly involved.

Research questions

- What is special about the economic situation in the South Caucasus against the background of the frozen conflict? What are these specific traits based on?
- How does the economy of the Republic of South Ossetia currently function?
- How should the level, intensity and trends of economic cooperation between Georgia and South Ossetia, and its influence on the conflicts, be evaluated?

The research examined ties between business and conflict in South Ossetia in two areas:

1. *South Ossetia's financial system*: the researchers analysed the South Ossetian economy in general, its financial indicators and its banking system in order to identify which areas of business are dominant. In the course of the research, it became clear that the majority of business is concentrated in border trade. The second area of research is devoted to this.
2. *The phenomenon of Ergneti market*: a surprising economic mechanism formed on the Georgian-South Ossetian border in the post-conflict period that accounts for the lion's share of the South Ossetian economy in terms of economic figures, employment, money flows, GDP, state budget and so on, and also influences the economy of the South Caucasus as a whole. For this reason, the influence of Ergneti on the economy of the bordering areas of Russia, Turkey and Iran was also investigated. This mechanism is described in detail along with its peculiarities of form and function. The researchers explain how these aspects of the economy influence the conflict. Having described the current situation, an attempt is made to forecast the possible directions for the further evolution of the conflict.

6. RESULTS OF THE RESEARCH

6.1 THE NATIONAL BUDGET OF SOUTH OSSETIA

The financial sphere in South Ossetia is the focus of the present research, specifically the following questions:

- From where does South Ossetia collect finances and how does it spend its budget resources?
- How is social protection and assistance provided to South Ossetian citizens?
- How are South Ossetia's governing structures financed?
- How do the above influence the possibilities for solving the conflict?

It was decided to analyse the budget in order to identify which areas of business contribute the most. A drastic impoverishment occurred during the post-conflict period, and providing the population with social security, food, water, electricity and gas are of primary importance. There are limited possibilities for small business, and the majority of jobs are in the public sector (doctors, teachers, workers in state-owned companies), making the timely payment of salaries essential. The Russian rouble is the main currency throughout South Ossetia.

South Ossetian budget expenditures were planned to be 154.4 million roubles (around \$5.5 million) in 2003, with a 23% deficit, the best result for the entire post-conflict period. Revenues were estimated at 124.64 million roubles (\$4.5 million). Even a 1% increase in inflation has a huge effect on the budget since the salaries and standard of living of South Ossetia's citizens directly depend on it. An increase in the budget deficit lowers private investment and, as a result, slows the rate of economic growth. It should not be forgotten that one rouble invested by the government brings much less profit, and therefore much less economic effect, than the same rouble invested by the private sector. On the other hand, the experience of leading economic powers has demonstrated that fiscal policy can help overcome economic crisis.

Thus, the level of expenditures, income and taxes play a leading role in determining the economic condition of the Republic of South Ossetia, the scale of production and the number of jobs in the post-conflict period.

The difference between the government's income and expenditure, and particularly the manner in which the deficit is financed, has equally serious consequences for the republic's macroeconomic situation.

To begin with, the income and expenditure of the state budget should be examined (data taken from official sources).

TABLE 1. BUDGET REVENUES OF THE REPUBLIC OF SOUTH OSSETIA IN 2003

Group, sub-group and source of incomes	Amount (in thousands of roubles)	Amount (in \$)
Incomes from Taxation	82,161	2,934,000
Value-added tax	27,936	997,715
Including VAT on products imported into South Ossetia	24,700	882,144
Excise	450	16,100
Vodka and liquor licences	450	16,100
Tax on corporate profits	791	28,250
Capital gains tax	-	-
Income tax from physical persons	5,213	186,180
Income tax withheld by legal persons	2,509	89,610
Income tax withheld from the income of legal persons	2,704	96,580
Taxes on foreign trade activities	41,882	1,500,000
Customs duties	40,300	1,440,000
Customs fees	1,582	60,000
Tax on the use of natural resources	79	2,830
Land tax	939	33,540
Land tax on agricultural land	838	29,930
Land tax on urban and suburban land	101	3,610
Land tax on non-agricultural land	-	-
Property tax	282	10,100
Property tax on legal persons	120	4,300
Property tax on physical persons	152	5,430
Tax on inherited property and gifts	10	370
State duties	425	15,200
Duties on cases before the Arbitrage and Supreme Court of the Republic of South Ossetia	20	720
Duties on cases brought before general courts	39	1,400
Duties on notarial, registration and other actions	366	13,100
Fees for commercial rights	2,024	72,300
Taxes on gaming sector	-	-
Licensing fees	540	19,280
Republic licensing fees	300	10,720
Local licensing fees	240	8,600

Migration duties	1,600	57,150
Income from awarding patents	-	-
Other taxes and miscellaneous incomes	-	-
Non-tax income	37,283	1,335,000
Income from rental of state property	1,657	59,180
Rental of land for agricultural use	67	2,400
Rental of urban and suburban land	-	-
Rental of land for non-agricultural use	133	4,750
Miscellaneous income from other rental of state property	1,457	5,250
Income from the sale of state property	21	750
Payments from the sale of publicly owned organisations (businesses)	-	-
Income from the privatisation of apartments	21	750
Income from the sale of productive and non-productive state capital and other machinery	-	-
Income from confiscations, immobile or other property transferred to state ownership	-	-
Administrative fees	600	21,430
Fines collected by vehicle services (besides fines)	300	10,715
Administrative fines and other sanctions, including vehicle services fines	300	10,715
Fines collected from physical persons convicted of crimes	-	-
Other non-tax incomes	35,005	1,250,000
Incomes from accompaniment of transport	3,000	108,000
Cancellation of credits from the budget	8,120	290,000
Including previously released	5,000	180,000
Pension fund	1,000	35,715
Income from for-pay services and other services	6,385	230,000
Income from paid quarantine services	1,500	54,000
Financial transfers without compensation	15,000	540,000
Income of the road fund	5,200	185,000
Tax on use of roads	100	3,580
Tax from the owners of transport vehicles	300	10,715
Fees on the exploitation of republican importance	4,800	171,000
Total incomes of the budget of the Republic of South Ossetia	124,644	4,452,000

SOURCE: MINISTRY OF ECONOMY OF SOUTH OSSETIA

TABLE 2. BUDGET EXPENDITURES OF THE REPUBLIC OF SOUTH OSSETIA FOR 2003

Article of expenditure	Amount (in thousands of roubles)	Amount (in \$)
Civil servant expenditures		
Salaries	45,198	1,615,000
Pension and benefits	4,924	175,000
Administrative expenses	14,444	520,000
Business travel	2,221	80,100
Training	528	18,860
Scholarships	1,726	61,650
Food	4,108	147,000
Medical supplies	1,362	48,645
Equipment and inventory	10,006	358,000
Uniforms and linen	2,298	82,100
Social support		
Social support for veterans of the world war two	100	3,575
Assistance to families of the deceased and wounded	150	5,358
Social assistance payments, including:	13,969	499,000
<i>Pension and benefits (non-workers)</i>	12,909	462,000
<i>Unemployment payments</i>	400	14,290
<i>State social assistance to the poor</i>	520	18,572
<i>Organization of soup kitchens</i>	140	5,000
Holidays and special events	671	24,000
Government policies and programmes		
Fund to support small businesses	800	28,580
Receipt of licences	94	3,358
Support of youth policies	500	17,850
Support for returning refugees	100	3,575
Loans	14,600	522,000
Presidential demography programme	200	7,142
Program for the development of the Ossetian language	200	7,142
Organisation of military service	30	1,100

Repairs and maintenance

Renovation and construction	12,208	436,000
Upgrading facilities	2,372	84,720
Residential housing renovation	600	215,000
Repair and maintenance of roads	6,430	230,000

Budget and finance

Government reserve fund	800	28,580
Creation of state reserves	3,000	108,000
Credit return	3,100	110,715

Information and publicity

Sporting events	728	26,000
Payment of typographic services	652	23,100
Public events staging expenditures	120	4,285
TV broadcasting	14	500
Acquirement of production	200	7,142
Book production	77	2,750
Book publishing	310	11,100

Other

Payment of external security services	268	9,570
Reporting forms	1,294	46,215
Bank service fee	57	2,040
Special expenditures	173	6,180
Expenses based on fee collection	2,740	97,860
All other expenditures	30,978	1,110,000

Total expenditures	153,372	5,480,000
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SOURCE: MINISTRY OF ECONOMY OF SOUTH OSSETIA

The basis of the republic's fiscal policy and the real activities of the South Ossetian government can now be examined.

Composition of revenues

These figures are included to demonstrate which sources are dominant in the formation of South Ossetia's budgetary income. The entire planned income for 2003 amounted to 124.64 million roubles. If the sources of this income are analysed, then the line items that are directly or indirectly related to the transit of goods through the republic can be highlighted (see Table 3 below).

TABLE 3. COMPOSITION OF REVENUES

Type of revenue	Amount in thousand roubles	Amount in \$
VAT on imported goods	24,700	883,000
Customs fees	41,882	1,495,000
Migration fees	1,600	58,000
Escort of vehicles	3,000	107,000
Income of the Road Fund	5,200	185,000
Total	76,382	2,728,000

SOURCE: MINISTRY OF ECONOMY OF SOUTH OSSETIA

The fact that almost 62% of South Ossetia's budgetary income comes from the functioning of the TransCam transportation corridor connecting Russia, South Ossetia and Georgia is clear. Is this a lot, or a little? For comparison, let us examine income from taxes on legal entities – 791,000 roubles (\$28,250, or 0.7% of budgetary income), or tax on physical persons – 5.2 million roubles (\$187,000, or 4.2% of budgetary income). From these figures, it is clear that the budget is hyper-dependent on income from the Russian-South Ossetian-Georgian transit traffic.

Budget expenditure and deficit

The data show just how limited South Ossetia's budgetary revenues really are. It should be underlined that at least 35,000 people – more than a third of the population – are dependent on the budget, most of them government employees. The average salary in South Ossetia is no more than \$10 per month, meaning people lead a lowly existence.

Special attention needs to be paid to the way in which South Ossetia finances its budget deficit, which equals 23% of total revenues. There should be a relatively simple solution to the problem: either decrease spending or increase revenue. However, as noted earlier, the Republic of South Ossetia does not have the option to decrease its outlays, much less make serious cuts, due to the large share of the population that is dependent on the budget. The only remaining

option is to increase revenues. Reserves within the republic are non-existent (as will be demonstrated in the review of the banking sector). Given the political risks, investment is practically impossible. The only option left is to borrow. Over the course of the last five years, the only source from which it can borrow has been the government of the Russian Federation, determining the political direction followed in Tskhinval.

The structure of the South Ossetian budget is such that the budget is highly dependent on the functioning of the TransCam highway. This dependence has specific political risks in that either Russia or Georgia could strengthen border controls. If this happened, the economic collapse of South Ossetia would be a real possibility, doubtless resulting in the intensification of the conflict. The current state of the South Ossetian budget, in other words, does not encourage the search for a permanent political solution to the conflict, but actively contributes to keeping it in its current frozen state.

6.2 THE BANKING SYSTEM IN SOUTH OSSETIA

Events over the last 10 to 12 years have influenced banking activities and the financial market of South Ossetia. The unstable political and economic situation, huge declines in production and disruptions in monetary flows mean that dozens of commercial, organisational and private depositors have lost their money.

The deepening economic crisis and high rates of inflation have also caused serious damage to South Ossetia's credit and monetary systems. Mistaken economic policies, including separate, unforeseen bank operations, have worked against the interests of clients and shareholders. One example of such actions is operations with fake credit notes conducted in the mid-1990s.

As a result, the banking system has been denied the possibility of having its resources participate in the financing and provision of credit to the productive sectors of the economy. Banks are practically without capital.

The National Bank of the Republic of South Ossetia is the only bank in South Ossetia that really functions under current conditions. All others – and there were five in the final years of the USSR – have virtually ceased operations. Since the National Bank began operations in 1997, it has undertaken the measures necessary to increase its capital, increase shares and attract additional resources as much as conditions allow.

Lack of mechanisms for bank regulation

The fact that effective and adequate regulation is needed by the banks themselves is often forgotten. Clients look on such a regulatory system as an additional guarantee of the safety of their accounts and a necessary element for establishing trust. The lack of regulatory mechanisms also inhibits the entry of foreign banks into the republic's financial market.

The main problems in the development of the banking system are the following:

- Low level of banking capital;
- Significant volume of credits not repaid, resulting in the major part of assets being devalued and immobilised;
- Overdependence on the national budget as the only source of the National Bank's assets;
- Imperfections in current banking legislation and lack of the finalised legislative aspects of banking activity.

These problems increase the effect of negative external and internal factors to a significant degree. The lack of an adequate banking system postpones for an indeterminate period the development of a viable economical model along European lines and contributes to the maintenance of the current state of the Ossetian-Georgian conflict.

The problems of the National Bank stem from the inadequate attention paid to the need to create a balanced structure of assets and fixed liabilities, directly influencing liquidity.

The unsatisfactory level of management has led to a worsening of the financial state of credit organisations. In general, the outflow of qualified personnel drastically affects all branches of the economy. With only a few exceptions, those that are able to find work abroad do their utmost to leave the republic.

The creation of a proper legal basis for banking activities remains unfinished, and an adequate legal and normative basis for the activities of credit organisations is still needed.

The current laws on banking are not professional and do not meet the needs of economic development. The law 'On the National Bank of the Republic of South Ossetia' and 'On banks and banking activities in the Republic of South Ossetia' contain internal contradictions. Additionally, the statutes of these organisations do not meet the textual requirements of the law. The normative acts regulating a two-level banking system are extremely unsatisfactory and in need of numerous legislative corrections.

The government and the National Bank need to reach agreement on the principle directions in which the banking system should develop, discussing a complex of measures aimed at creating a developed banking sector and increasing its attractiveness. This current situation is connected with the necessity of centralisation and increased capitalisation, at least in terms of the National Bank.

To solve this problem, it is necessary to:

- Provide for the narrowing of general legal rights of credit organisations to the conditions characteristic of a market economy, taking into consideration the unresolved nature of the conflict with Georgia.
- Consider the conditions necessary for the functioning of commercial banks in the framework of a reformed banking system. In this regard, it is necessary to draft a concept paper outlining the policies of the Republic of South Ossetia in relation to banks, determining the role of the National Bank and the entire legal field of banking activities.

The amount of resources dedicated to the functioning of the National Bank depends on the Ministry of Finance, the main source of financial resources for the productive sectors of the economy. As far as the base capital of the National Bank is concerned, it is not clear on which figures it was based or the exact amount of government participation. The formation of the National Bank's capital fund must be reviewed with an eye to its organisational and legal bases.

The National Bank can hardly be considered an ordinary bank, taking shape as it did in a situation where monetary and credit policy were subordinated to a high degree of uncertainty and economic crisis, characterised by drastic decreases in production and increasing budgetary deficits. The effectiveness of future monetary policy will depend on the ability to put the banking system in order so that it functions properly, including the speed and reliability of a system of payments that involves the implementation of modern banking technologies and instruments for completing money transfers.

In any case, the current situation needs to be corrected. The centralisation of capital and increased bank capitalisation are necessary, and should move forward in a reasonable fashion. Together with the liquidation of banks unable to meet their obligations, it will be necessary to preserve the survival and functioning of the banking system, giving banks the possibility to provide basic services to the economy. These reform measures should result in the retention of the market orientation of the banking sector, and the creation of legal and normative regulations for banking activities. At the same time, further improvement of the legal framework of banking activities is needed to increase the effectiveness of banking sector reform, mainly through the formation of adequate legislative and normative bases regulating the activities of credit organisations.

According to current regulations, the minimum amount of capital needed to start a credit organisation is 4 million roubles (around \$150,000). Today, the base capital of the National Bank amounts to only 680,000 roubles (around \$25,000) and it will only be able to meet the minimal regulations based on reinvesting its own profits in nine or 10 years. In other words, there is no way that the National Bank can do without financial help from the government.

One criterion for evaluating the scale of the banking system's participation in the economy is the level of monetisation, or the level of trust the population has in banks as a place to store their savings safely. One of the main priorities of economic policy must be the creation of conditions for sustainable economic growth on the basis of the large-scale attraction of long-term credit and investment in the South Ossetian economy.

The National Bank cannot receive income from monetary emissions as there is no separate currency to emit. Nor does it have the ability to conduct its own monetary, credit and exchange rate policies. For this reason, there is no possibility of seeking and using credits from the Central Bank of the Russian Federation to support the liquidity of South Ossetia's banking system. In addition, it should not be forgotten that the National Bank functions under the special conditions dictated by an unregulated political situation. In this regard, there are no objective criteria for solving the problems facing the National Bank. All current solutions are dictated by the republic's political direction and its goal of joining the Russian Federation. For example, the National Bank could otherwise have a correspondent account at one of the territorial sub-units of the Russian Central Bank and not in one of the commercial banks in Vladikavkaz, which would offer the possibility of regular, legal monetary emissions from the Russian Federation, and not exceptionally as is now the case. Nor would the National Bank have to conduct currency import and export operations through the customs office at Nizhny Zaramag in accordance with rules established for foreign banks, which saddles the National Bank and its clients with additional customs and other expenses.

The establishment of a correspondent account, as well as the status of an authorised bank of the Russian Federation, would create favourable conditions for clients of the National Bank wishing to work in the banking sector, giving them the possibility of conducting payment operations with the help of modern banking technologies at a minimal cost in terms of time and money. It would be desirable to find a way for the main financial operator in South Ossetia to join the unified banking system of the Russian Federation, and not cut the thin thread tying the economy of South Ossetia to the growing Russian economy, as well as to the outside world.

The above analysis has two important findings:

1. The budget of the Republic of South Ossetia is directly dependent on customs revenues and VAT on imported goods;
2. The republic's financial institutions are in no position to support stable economic growth. Over the past couple of years, banks have provided credit mostly to commercial and purchasing operations characterised by high entrepreneurial and credit risks, leading to significant loss of liquidity.

South Ossetia's economy is based on the transport and flow of goods across its territory. Most successful businesses are connected with the delivery of goods from the Caucasus and Middle East to the north or, in reverse, from Russia and other CIS countries to the south.

6.3 THE PHENOMENON OF ERGNETI MARKET

Analysis of the economic mechanism known as the Ergneti market included a search for answers to the following questions:

- Why did the South Ossetian economy develop precisely in this manner in the post-conflict period?
- Why did the border and transit trade become the republic's leading business, a trend that is not waning, but clearly tending towards further growth? What are the risks attached to this situation?
- Does this kind of economic development assist in overcoming the current conflict or not?

To answer these questions, it is necessary to describe Ergneti market as it originally developed and as it exists today. Trade deals between the two conflicting sides – Ossetians and Georgians – developed spontaneously on neutral territory between Tskhinval and Georgian-controlled villages of the Gory region after the declaration of the ceasefire and the posting of peacekeepers in 1993. These commercial contacts grew from the necessity of surviving in the regions caught up in the conflict.

At that time, the Georgian economy faced a difficult crisis. The dissolution of the USSR and the cutting of economic ties with other former Soviet republics led to the collapse of Georgia's main industrial firms, a difficult energy crisis (due to cooling relations with Russia) and growing impoverishment of the population. The disruption of traditional flows of energy between Russia and Georgia made the smuggling of fuel – petroleum, natural gas, diesel – super-profitable. Normal profits for such contraband between 1993 and 1997, according to a source that took part in them, averaged between 250-300%. Such high levels of profitability led the first deals to be closed, despite the risks associated with conducting business in the conflict zone.

The large number of mixed marriages in South Ossetia prior to the conflict helped these initial entrepreneurs to make and retain their Ossetian-Georgian business contacts on the basis of friendship and family ties. Ossetians bought up fuel from bulk dealers in the adjacent Russian regions and delivered it to the Georgian border, where further deals were struck with their Georgian counterparts. The main location for the meeting of buyers and sellers was a small property close to the Tskhinval-Tbilisi highway, near the village of Ergneti.

A second flow of goods, in the opposite direction from south to north, was also concentrated in Ergneti market. These flows are described below in chronological order:

- In Soviet times, Georgia was a large exporter of agricultural products to markets in what became the Russian Federation. After the dissolution of the Soviet Union, transport connections between the two countries were cut by local conflicts. The Ergneti market initially facilitated trade in Georgian produce, notably tangerines, apples and dried fruit.
- Consumer products, such as clothing, household appliances, electronics and vehicles were also delivered to the then unsaturated Russian market.
- One area of trade came from stripping the equipment and capital from South Ossetian firms constructed during Soviet times. Sometimes it was sold in its original state, but more often as scrap metal.
- From 1996 onwards, alcoholic drinks were smuggled from Georgia through South Ossetian territory. The Republic of North Ossetia-Alania became Russia's largest source of spirits in the early 1990s and, by the middle of the decade, it accounted for at least 35% of all spirits sold in Russia. Initially, Ukraine had been Russia's largest supplier of spirits for the production of brand-name vodkas but, after relations worsened in 1996, North Ossetia replaced it by supplying raw liquor that had transited through South Ossetia. This marked a very important period for the new republic since the trade was valued at no less than \$60 million per year. According to South Ossetia's Department of Investment, the profits of South Ossetian 'firms' in the trade amounted to \$270 million over 3.5 years. Given South Ossetia's instability, however, most of the profit flowed out to Russia and other countries. By 1999, changes in the market made the trade unprofitable and the transit of Georgian spirits to Russia practically ceased.

From 1999 onwards, the main direction of trade has been from north to south. Border traders do not always take their products to Ergneti in a physical sense, but the transaction of trade flowing through South Ossetia mainly takes place in the market, whether the products are present or not. Most importantly, prices are determined at the market. This is why the authors have called the Russia-South Ossetia-Georgia border trades the 'phenomenon of Ergneti market', though this is far from being the only reason.

Main market activities

In 1999, Ergneti market, with a few minor exceptions, took on the structure and appearance that it has today. The market's layout in its current form should first be reviewed (see map 1).

The hardest part of the research was determining, at least approximately, the volume of each product traded through South Ossetia (largely equal to the trade

volumes on Ergneti market). The general lack of transparency of the market, the illegal importation of products from Russia and Georgia, traders' reservations about disclosing their true volumes and bureaucrats' limited knowledge of what really happens at Ergneti has created an information vacuum that the researchers had to address. In the end, key information was gleaned from the following sources:

- Interviews with market traders;
- Interviews with South Ossetian bureaucrats whose work relates to Ergneti market;
- Interviews with employees of the Customs Service of the Republic of South Ossetia;
- Interviews with employees of the Highway Service of the Republic of South Ossetia;
- Consultations with business contacts who are active, or used to be active, in the relevant areas.

The upper and lower limits of possible trade volumes for different products were obtained by comparing all of the different responses, as outlined below (the figures given represent monthly volumes for any given product).

BOX 1. GOODS FLOWING FROM NORTH TO SOUTH

Different brands of petroleum

This is one of the main items traded on the Ergneti market and has been actively traded since the market began. The amount of petroleum flowing through South Ossetian territory is affected by different factors, from seasonality to the varying moods of the Russian and Georgian governments. According to our estimates, the average monthly turnover of gasoline was somewhere between the following limits:

Min: 2,800 tonnes per month, worth at least 25.2 million roubles, or roughly \$840,000.

Max: 3,400 tonnes per month, worth at least 37.8 million roubles, or \$1.26 million.

Diesel

The same conditions affecting petroleum flows apply to diesel fuel. The fact that diesel is often passed off as more expensive petroleum explains its larger volume:

Min: 4,000 tonnes, worth at least 28 million roubles, or \$950,000.

Max: 6,000 tonnes, worth at least 42 million roubles, or \$1.45 million.

Wheat

Georgia is largely dependent on deliveries of Russian wheat due to the low transport costs through South Ossetia:

Min: 1,500 tonnes, worth at least 9 million roubles, or \$300,000.

Max: 3,200 tonnes, worth at least 19.8 million roubles or \$660,000.

Flour

The proportion of flour to the overall trade volume is less than that of wheat, but is still significant:

Min: 1,200 tonnes, worth at least 12 million roubles, or \$400,000.

Max: 2,500 tonnes, worth at least 25 million roubles, or \$850,000.

Natural gas

The transit of natural gas (condensate gas) through South Ossetia has grown over the past five years. Georgian demand was around 3,000 tonnes per month in Soviet times:

Min: 420 tonnes, worth at least 2.3 million roubles, or \$72,800.

Max: 800 tonnes, worth at least 4.2 million roubles, or \$140,000.

Cigarettes

One of the most profitable businesses on Ergneti market. Estimating the value of the cigarette trade is difficult since it is one of the least transparent and most monopolised areas of trade. Also, the direction of the trade has changed a number of times due to fluctuations in the Georgian and Russian markets. Today, the main flow is from north to south. Estimates are based on the fact that up to 15 truckloads of cigarettes were registered each month by South Ossetian customs officials in 2003. Most cigarettes are pirated on contracts with illegal producers.

Min: turnover around 27 million roubles, or \$900,000.

Max: turnover of up to 60 million roubles, or \$2 million.

Mixed fodder and fertiliser

South Ossetian officials include these products in a single category for purposes of registration at the borders and it is difficult to separate out the exact volumes:

Min: 3,000 tonnes, worth at least 10.8 million roubles, or \$360,000.

Max: 4,000 tonnes, worth at least 14.4 million roubles, or \$480,000.

Goods for servicing of motor transport

Despite imports of vehicles from the West, the majority of vehicles in Georgia are still Russian. Georgia imports all sorts of spare parts, tyres, etc.

Min: 32 million roubles, or \$1.1 million.

Max: 37 million roubles, or \$1.25 million.

Food products

Due to sizeable differences in estimates, the researchers resorted to monitoring the market in person. They counted around 100 wholesale traders who continuously work at the market. In conversation, it was revealed that the minimum volume necessary to guarantee profitability was around 250,000 roubles per month. Profitability is normally considered to be in the range of around 400,000 roubles per month. Extrapolating from these figures, the researchers estimate trade volumes to be:

Min: 25 million roubles, worth approximately \$850,000.

Max: 40 million roubles, worth approximately \$1.35 million.

Domestic and industrial goods

Georgia imports a wide variety of domestic goods from Russia. These include household appliances, implements, and cardboard and fibreglass packaging materials that are valued for their low cost, though their quality is also superior to more expensive Western counterparts. There are only a small number of traders in such items, making it easier to estimate the monthly volumes:

Min: 12 million roubles, or \$400,000.

Max: 15 million roubles, or \$500,000.

Construction materials

Due to Georgia's strong dependence on Russian construction materials in Soviet times and to the lack of sufficient domestic production, trade in construction materials is very active. The trade volumes are estimated at:

Min: 20 million roubles, or around \$670,000.

Max: 26 million roubles, or around \$870,000.

Hides of large horned livestock

Cattle hides are a valuable commodity at Ergneti and many are sold on to Georgia, Turkey, Greece and further abroad. In 2003, the volume of hides flowing through the market each month was 8.5 million roubles, or around \$280,000.

South-north

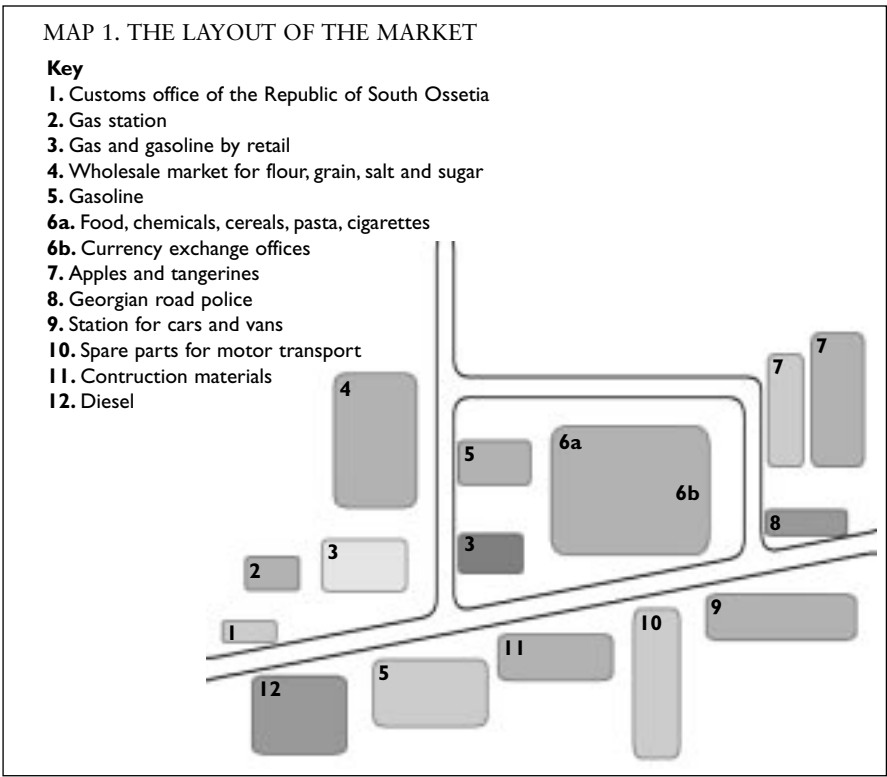
Since the decline in spirits exports to Russia, south-north trade flows mostly involve agricultural produce such as oranges, apples, pears and greens from Georgia, Turkey, Azerbaijan and Iran. It is relatively difficult to present monthly averages for these sales since the business is clearly seasonal. Nonetheless, \$15 million worth of agricultural produce were exported to Russia in 2003 according to South Ossetia’s Customs Services, the equivalent of \$1.25 million per month.

Finally, there are a number of products not included in the above list because, though they appear on the market with some frequency, they are not constantly available. Such goods are, nonetheless, traded and affect general price levels.

Based on these figures, it is possible to make the estimates for the volume of the market as a whole: the monthly volume ranges between \$8.4 million and \$11.1 million, and the annual volume, correspondingly, from \$100.8 million to \$ 133.2 million.

How the market works

Political realities have created paradoxical forms of border trade between Russia, South Ossetia and Georgia. The plan for how the market works is outlined in map1 below.



There are three points here of interest to the present research project:

1. The majority of cargoes cross the Russian-South Ossetian border illegally. This is due to Russia's customs policies, on the one hand, and to traders' absolute lack of awareness of their rights under Russian customs codes, on the other. In part, Russian customs agencies directly seek to hide such information. The high level of corruption among all Russian agencies that have some connection to the Russia-South Ossetia-Georgian highway should also be noted. Russian customs try to keep the 'informal' prices paid on the illegal flow of goods at below official rates. This provides further incentives for traders to import illegally.
2. The second point concerns the situation inside South Ossetia. Given the republic's over-dependence on transit, South Ossetian police and other government structures constantly monitor what happens on the main transit corridors. These 'power ministries' react very negatively to attempts by other South Ossetian agencies to extract bribes from the flow of cargo across the republic. For this reason, it is easier for businesspeople to pay the official customs at one place and be 'safe', as it were, throughout South Ossetia, rather than pay the relevant agencies at every stop along the way. Due to this, the flow of goods through South Ossetia can be considered quasi-legal.
3. Finally, there is the South Ossetian-Georgian border crossing. Almost all goods entering Georgia from Ergneti do so illegally. There are a number of reasons for this:
 - Because South Ossetia is an unrecognised republic, Georgia does not officially recognise the existence of a border. At the same time, no documents issued in South Ossetia are recognised as legitimate on Georgian territory. All cargoes crossing the border are illegal from the get-go.
 - Georgian bureaucrats are highly corrupt. Though all players in the game realise that trade between South Ossetia and Georgia is 95% illegal under Georgian legislation, they also acknowledge the large amount of trade and business involved.
 - The lack of elementary knowledge among market participants of their rights and the potential to legalise trade. People have become accustomed to giving bribes and cannot imagine other ways of conducting business.

MAP 2. SMUGGLING ROUTES IN SOUTH OSSETIA



Influence of the market on the Georgian-South Ossetian conflict

South Ossetia exists as an independent state, but is not internationally recognised and has all the problems related to this status. South Ossetia is slowly but surely rebuilding a standard of living connected to state construction and economic activity. The only life-line connecting the republic to the outside world is the Transcaucasus Highway, which is the main source of budgetary income for the state.

A large proportion of refugees from South Ossetia and internal regions of Georgia would like to return to their places of origin, but have settled in North Ossetia and other parts of Russia because of the difficulties in providing a decent standard of living in their communities of origin.

There is overall immigration from South Ossetia, albeit weak, due to the low standard of living and the lack of clear prospects for a resolution of the political status of South Ossetia. At the same time, research demonstrates that practically the entire population is against any form of association with the Republic of Georgia.

Ergneti market is the only economic mechanism that has demonstrated its ability to thrive in the post-conflict period. The conflict created unique conditions in the Caucasus and neighbouring areas. The market is characterised by a large flow of goods which are legal only in terms of South Ossetian laws and norms, but are up to 90% illegal in Russia and Georgia. This situation is quite unstable in political terms, but it also works as a price-setting mechanism for the entire Caucasus and serves a function integral to the region's economic development. The transit of almost any type of goods from north to south, or south to north, finds a demand at Ergneti market.

Although the market constitutes the lion's share of the South Ossetian economy, it is in no position to provide for the region's stable economic growth for the following reasons:

- The political situation is not conducive to the reinvestment of profits from the market in the South Ossetian economy. Most capital leaves South Ossetia for Russia and further abroad.
- A huge proportion of the finance circulating the market ends up in the hands of Russian and Georgian customs, and other officials in the form of bribes.
- South Ossetia reaps dividends from the market almost exclusively in the form of customs and other fees since the main traders are South Ossetian, Russian and Georgian citizens.

The following conclusions can be drawn from the above. Although Ergneti market is the dominant source of budget revenue for South Ossetia and is profitable for the entire Caucasus region, these very qualities also create conditions that support the current status quo and work against final settlement of the Georgia-South Ossetia conflict. The closure of the market by an executive order in Georgia or Russia could cause the collapse of the economy of the entire region and result in further escalation of the conflict. Under such conditions, it is vital to reduce the region's economic dependence on the illegal border trade.

7. MODELS FOR ADDRESSING CURRENT SITUATION

7.1 INTERNAL INVESTMENT IN SOUTH OSSETIA

The attraction of investment is of utmost importance to the South Ossetian republic's economic policies. Today there is no lack of projects requiring investment in as much as the region has a powerful economic mechanism creating and regulating supply and demand – Ergneti market. Practically everything sold on the market (especially products for direct consumption) could be produced locally. The problem lies elsewhere. Current sources of capital provide a weak resource base for the financing of projects. Banks are not in a

position to provide a significant volume of long-term credit, interest payments are too high, the budget does not have enough resources, and the financial position of most companies is similar. The selection of proper investment projects is therefore of special importance, given the limited financing available.

The return on investment, in the authors' view, is an insufficient criterion for determining which projects are worthy of investment. It is also important to know how long the new production facilities will work after the initial return on investment has been achieved. In most cases, decisions to invest are based on market dynamics. Investment projects in this case display a short-term, market-led character. If, as a consequence, new production ceases to be competitive, the existence of working capital is not maintained and the company reduces the scale of production, leading to disinvestment. It is important to understand that the growth of total investment volumes can be reached equally by minimising disinvestment. Investment growth can be very short-term and, as a result, quickly changes to stagnation when the market fills with competitors, and freed capital has difficulty in being put to effective use.

It could be argued that such a situation is completely normal – that scientific and technical progress dictates the necessity for continuous changes in economic structures. However, such arguments do not come close to discounting the problems associated with disinvestment.

Let us take a simple example. Say that, at a certain stage, there is a shortage of vegetable oil on the market. A number of small, vegetable-oil factories spring up and are profitable for some time. However, many will have to shut down over the medium term. Given the current competition in food processing, only large-scale operations with the ability to market their brands aggressively and continuously update their technology can survive. The appearance of such companies spells bankruptcy for an array of small producers. For the economy, this results in increased disinvestment. Therefore, investment totals over any given period of time need to take disinvestment into account.

For this reason, it is not the quantity of new investment – which as a rule only creates short-term production – that counts, but the coordinated formation of a competitive regional economy whose points of economic growth are confidently transformed into powerful production clusters. Given the importance of the latter condition, let us explore this in more detail.

7.2 PRODUCTION CLUSTERS

The leadership of different countries in the production of different types of goods is supported not by individual companies, but by a complex of technologically linked branches – clusters. In developed economies, branches of suppliers and branches of users are closely connected and represent relatively well developed, homogenised clusters in which certain firms try to create optimal, vertical-value chains in keeping with the different stages in the production processes: delivery of natural resources,

aggregators and specialised equipment, final production, distribution and the provision of services.

Such a cluster-led approach should find expression in a long-term programme for the development of the republic. The work remaining to be done in this direction is vast. First, large-scale research based on analysis of the industrial, scientific and technical, natural and human resource potential of the republic must be conducted with the aim of determining the appropriate areas of specialisation; that is, production clusters that South Ossetia intends to develop in the long term. It is precisely these areas that will determine the shape of its economy in 10 or 20 years time.

Business will orient its investment activities on the government's stated development goals, the picture that they provide of future economic structures in the region and its role in the overall division of labour. Businesspeople should have the opportunity to agree on their activities, with government plans expressed in published, large-scale research on long-term, regional economic development.

The market is driven by short-term gain. Investment will not be effective, given limited financial means, and the accretion of capital in separate, unrelated sectors that do not constitute a critical mass for the economy as a whole. Until such time as the government starts to promote effective industrial policies, important projects will be undertaken with a significant delay, or will remain unrealised. Important innovations will have an almost exclusively random character and be dependent on the energy and perseverance of individual entrepreneurs, who as a rule, will have to work independently to bring their ideas to fruition.

Former socialist enterprises could form an important part of production clusters in the making, though management issues remain contentious. There is a deficit of qualified managers able to put struggling enterprises back on their feet. More often, managers are appointed who have only their own personal gain in mind and who pursue their ends by asset-stripping. Even when finance is available for projects to rebuild Soviet-era firms, achieving results requires hard work by an experienced team of specialists to research: the current market situation of a given line of production; trends for future market developments; the position of competitors; their market niches; an overview of suppliers of equipment and technology; and so on. All this is not within the means of individual directors. For this reason, it is suggested that a type of 'brain trust' be created to assist firms in designing development strategies. Specialists of different backgrounds could be hired on a temporary basis, as and when needed. This should become the new philosophy guiding business development.

Currently, those responsible for representing the government's interests on boards of directors take passive positions, which should not be permitted. The reconstruction of companies requires unpopular decisions and the cutting of costs that no longer bring returns.

The formation and development of vertically integrated technological systems functions with law-like regularity. The competitiveness of the final product

depends on all branches in the production chain. For this reason, it is necessary that all the links be at approximately the same technological level. Cluster analysis suggests that the attraction of investment to each concrete branch cannot be viewed separately from the other, interlinked sectors in the cluster, but should be systematically developed within a cluster of vertically related sectors.

BOX 2. PRODUCTION CLUSTERS: EXAMPLES

The preparation of quality chicken meat requires not only space suited for rearing the chicks, but knowledge of the most modern technologies used, a factory for producing chicken feed with the right nutritional additives, processing and packing plants, and a developed system for transporting and marketing the final products under a widely recognised and respectable trademark. On the other hand, it is obvious that in a region with large crops of corn, branches dealing with the processing of corn should not only be maintained, but should expand their share of the overall economy. New products should be added to the list of finished products already being produced in South Ossetia (treacle, spirits, poultry). In particular, the production of sweet-corn conserves would offset the current import of such products. Such production would have a major implication for the region's economic specialisation and serve as a key branch for the creation of competitive clusters.

Firms in the region could constitute self-reliant technological chains, or become valuable sectors in inter-regional productive clusters. The successful functioning of a cluster as a whole, as well as its separate branches, would be determined by inter-regional cooperation between the region's businesses and governments.

The process of forming effective industrial clusters could be significantly speeded up with the help of goal-oriented, domestic and foreign investment. A national policy of attracting foreign investment should be developed in close relation with regional governments, which should be involved in the process of analysing potential clusters from the outset. The promotion of competing information and consultative resources for questions related to the structure of economic sectors, firms and potential partners in the republic with productive, scientific and technological or geographic potential, and other data is needed in order to attract potential investors. The most important equipment, progressive technologies and components could be purchased from international sources.

The planned and systematic formation of competitive productive clusters around key branches of the economy allows for the timely construction and strengthening of deficient links.

7.3 INVESTMENT VS. DISINVESTMENT

Spontaneous, chaotic investment could turn quickly into disinvestment (partially or fully). Changes in the saturation of markets lead to the worsening of market conditions for suppliers. Small producers will necessarily be absorbed by more powerful and competitive players that can then divide the market between them. The association of entrepreneurs desiring to work in specific branches with the goal of jointly realising more rational and larger investment projects is one way of avoiding such losses.

The result of investing only small amounts of capital will be inadequate production utilising outdated technology that owes its appearance to temporary market deficits in a given product.

The problem is that the shareholder system in the region does not currently function well as a means of accumulating capital. Nonetheless, this situation should serve as a stimulus to spur the executive organs of government into more effective action. The government has quite a few possibilities at its disposal: giving such a group of investors priority status; providing them with various forms of preferences and privileges (including guaranteeing loans and centralised distribution of resources from the budget's development strand); and the provision of information services in the areas of science, technology and marketing. The main issue is that the current problems require government understanding.

The creation of commercial and professional associations could similarly become a productive form of coordination between firms, mutually benefiting from the exchange of information and cooperation in defining their interests and plans for the future. The state could play an active role, participating in the process of the creation and functioning of such associations.

BOX 3. MINERAL WATER PRODUCTION

Let us examine the production of mineral water. The quality, purity and taste of South Ossetian mineral water is unsurpassed. The production of mineral water is composed of a mass of small bottlers, many competing with each other. It has long been recognised that there is a need to improve the business, through more active marketing, image formation and branding. Separate producers are unable to do this at present, and are unlikely to grow large enough to do so in the future. As a result, profits are limited by the underdevelopment of the branch as a whole. From this it follows that the creation of an association that would unite South Ossetia's mineral-water producers makes good sense. It could coordinate and facilitate the advancement of the interests of South Ossetian producers in markets throughout the Caucasus and abroad.

Small businesses have recently been the subject of much discussion. The government of South Ossetia has declared the development of this sector a priority for the region's economy. Judging by that declaration, the development of small business has almost attained the status of a strategic economic direction. In the opinion of the researchers, this issue deserves to be treated with a certain reservation. The development of small businesses should not be a goal in itself. Small enterprises in the area of commerce, restaurants and the provision of services need a minimum of interference from government. However, an overreliance on small businesses again puts the economy at the mercy of spontaneous market relations, leaving the economy with a primitive structure.

Financial assistance, decreasing state interference in small businesses and offering them privileges are important, but insufficient, measures. Business needs direction and the state should help enterprises form viable industrial clusters. Enterprises function effectively only as part of competitive productive clusters. Active clusters and clusters-in-the-making will support further development of existing and newly forming enterprises, and give them direction. Leading structures within the clusters act as the customers of SMEs and become a uniting link for them.

Small and medium-sized businesses form like satellites around large groups of companies and become their suppliers on world markets. For this reason the creation of clusters has a powerful effect on small business. Only such clusters, created with the help of the international community and including both Georgian and Ossetian enterprises, will reduce political risk in the region and facilitate the settlement of the current conflict.

7.4 BUSINESS DEVELOPMENT BETWEEN CONFLICTING PARTIES: SOUTH OSSETIA AS A POTENTIAL PARTNER

The economic value and geopolitical location of South Ossetia are two of the main factors behind Georgia's refusal to recognise the republic's independence. In terms of valuable minerals, mineral water and recreational potential, South Ossetia has huge possibilities for an effective economy, as geological survey data have fully demonstrated.

South Ossetia is rich in ore and non-ore mineral wealth. The region's metals include lead, zinc, silver, cadmium, manganese, iron, gold, nickel, molybdenum, mercury, chromite, tin and platinum. South Ossetia is also rich in non-valuable minerals, such as talc and barium, that could be of immense importance for the entire former Soviet Union. Currently, demand for non-metallic mineral resources is growing at a faster rate than other mineral wealth. The talc resources of Nauru region are the largest in the Caucasus. Talc is used as an additive in chemical, rubber, paper, perfume and cable manufacture. Its secondary uses are in the production of lubricants, casting,

cement, textiles and pencil lead, as well as plastics. South Ossetia also has one of the richest deposits of barium salts containing 97% sulphur-potassium barium. The high concentration of barium makes the deposits a valuable resource for salts with medicinal uses.

Non-metallic deposits have been studied and assessed in relatively close detail. Coalite is used as an ingredient for collecting chemical products and fire-resistant alloys in the production of ceramics. Quartz sands have been found around the village of Eredvi, which is under Georgian jurisdiction, as well as the villages of Tbet and Tselic in the Republic of South Ossetia. In Znauri region, there are large dolomites from which it is possible to extract hydraulic cement. In Soviet times, plans were drawn up to mine these deposits.

South Ossetia also has numerous deposits of stones used in construction, including granite, basalt, limestone, greenstone and others. Natural facing stones, such as volcanic sinter, marble and marbleised limestone, are also found. Sinter deposits are mainly located in Tskinval region. Production ceased as a result of the Georgia-South Ossetia conflict and three deposits are now in Georgian-controlled areas.

There are marble deposits in Znauri and marble was produced in all forms prior to the conflict. Mining deposits for materials to rebuild damaged homes and factories could be of significant importance. The joint development of deposits would support a quick settlement of the conflict.

In the course of research, many Ossetian and Georgian businesspeople expressed their interest in joint projects to produce construction materials.

TABLE 4. RESOURCES IN THE CONFLICT ZONES THAT COULD BE USED FOR THE DEVELOPMENT OF JOINT BUSINESS VENTURES IN THE PRODUCTION OF CONSTRUCTION MATERIALS

No.	Project	Annual production capacity
<i>Leninogorsk Region</i>		
1	A splitting and sorting factory for sand and gravel deposits at Sadzeguri	100,000 m ³
2	A cooperative for processing cattle hides	12,000 m ²
3	Ceramic production from deposits in Sadzeguri village	1 million pieces
4	Lime production in Korinta village	5,000 tonnes
5	A cooperative for the production of dried fruit	2,000 tonnes
6	Brick factory in Zakkori village	1 million pieces
7	Factory for the production of decorative finishing materials	20,000 m ² of mosaic tiles
8	Stone-processing factory on the Kanchaveti marble deposits	10,000 m ²
<i>Tskhinval region</i>		
1	Stone-processing in Vanat village*	50,000 blocks of tuff
2	Cement production	30,000 tonnes
3	Stone-splitting and sorting factory in Kurta and Kekhvi villages*	300,000 m ³ broken stones
4	Production of dried fruit	10,000 tonnes
5	Production of gravel at the Kvastali deposits and	
6	basalt deposits in Ambreti village	100,000 m ³
<i>Znauri region</i>		
1	Production of decorative finishing tiles in the village of Tselis	20,000 m ² of mosaic tiles; 10,000 tonnes of marble stone
2	Brick factory in Bekmar village	1 million pieces
3	Production of mosaic tiles on the Nagutnin deposits	30,000 m ²
4	Production of dried fruit	2 tonnes
5	Stone-processing factory working with quarried marble	50,000 m ² ; 40,000 tonnes of marble stone

*Note: Functional until 1989

8. CONCLUSION

No comparable, in-depth research into the South Ossetian economy has been conducted in the 12 years that have passed since the Georgia-South Ossetia conflict – the entire period of its existence as a republic. The authors view the present work as a first step to more extensive research of the problems touched upon here and the beginning of a long-term project. Research needs to continue using some of the same organisational methods, directly including the businesspeople and government officials who participate in economic processes.

The demand for programmes addressing ‘business and conflict’ was evident during the conduct of the field research, during the surveys and interviews, and in conversations with businesspeople and politicians. Defying all original expectations, the researchers were confronted with a special problem in collecting information. Businesspeople were most willing to share their views on the ‘co-existence’ of unresolved conflict and close business ties. In the words of one businessman, ‘the more business, the less conflict’.

In the course of conducting research, a number of businessmen and government representatives contacted the authors with finished business plans, the majority of which were – on the surface – joint projects involving both Georgian and South Ossetian participants.

However, problems of another type arose that the authors have been unable to resolve. They could be called ‘problems of current affairs’. Events change with such rapidity that the current findings managed to ‘age’ while the project was still being written up. Even as these lines are being written, the authors are finding on the Internet reports from Adjara that suggest events are not developing in the most positive fashion possible, and this may further influence the ‘frozen’ conflicts and economies throughout the Caucasus.

All this speaks in support of the fact that those seeking peace in the Caucasus need to be more active and, as the business saying goes, ‘time is money’.

The authors would like to thank all those who helped in the research and the South Ossetian officials who provided information and guidance, as well as those who supported the goals of the project.

CHAPTER SEVEN

The potential impact of Sadakhly market on the settlement of the Armenian-Azerbaijani conflict

TOGRUL JUVARLY AND ILHAM SHABANOV

1. INTRODUCTION

Economic relations between the conflicting sides of the Armenian-Azerbaijani conflict are interesting for a number of reasons. Firstly, such relations are an indication of the spontaneous processes resulting from economic transition, accompanied by impoverishment of the population. Real living conditions create incentives for people on either side of the frontline to engage in trade – often counter to the politics of the enduring conflict – as is the case with Sadakhly market on the border between the Azeri-populated part of Georgia and Armenia. But large economic interests are tied to, and in many cases even lead, these developments.

Obviously, a small border market cannot be isolated from the region's socio-economic realities. The era of subsistence economy has long since disappeared in the South Caucasus, and behind every market stands a group of wholesalers and large economic players within government. Sadakhly market is no exception. Although peasant-produced agricultural goods occupy an important place in the market, it also does a huge trade in goods with no direct relation to the peasant economy.

Secondly, the intensity of these economic relations, though realised on 'neutral' territory, are to a certain degree related to the intensity of the military stand-off between Armenians and Azerbaijanis. The authors suggest that the study of Sadakhly market and its development over time may serve as a means of 'measuring' the dynamic of relationships between the two parties in the Armenia-Azerbaijan conflict.

Thirdly, the analysis of Sadakhly cannot ignore the nuances of economic development in the 'mother' countries of the traders involved. Azerbaijan, to a large degree, has no need to buy anything from Armenia, which is why such trade

is perceived in Azerbaijan as ‘robbery’. These sentiments are understandable. Even Azerbaijan occasionally experiences energy crises: any information on the trade in oil products with Armenia, even if indirect and not sanctioned by official Azerbaijan, gives rise to a tide of agitated speculation in the press. Often it is characterised as support for an aggressor, although there is a strong element of naiveté in this image of a besieged castle without water and food that does not quite fit modern realities.

This image of the enemy prevails over pragmatism in the public discourse about trade between Armenia and Azerbaijan, even when conducted by private companies. Until the creation of the state tobacco monopoly, newspapers published reports about a certain Armenian mafia in the north that produced cigarettes and occasionally travelled to Azerbaijan on business. On another occasion, popular opinion was disturbed when Chrysler built a petrol station on the road to Baku airport. It was widely reported that the company was managed by an Armenian and that those who had allowed such a construction project were ‘sponsoring’ the return of Armenian capital at the very time that Azeris were being forced to leave Armenia. Finally, there have been numerous scandals over the import of Azerbaijani oil and fish products into Armenia. This occurred last year and was linked to the Caspian Fishing Company.

Since the beginning of work on the BTC pipeline project, media coverage has been devoted to the Greek contractor, CCIC, whose ‘entire management’ was portrayed as Armenian.¹ Such reports were never confirmed, and only one honorary chairman of the company actually had an Armenian name.

Sadakhly market is fortunate in that it is located in Georgia and not Azerbaijan, otherwise it would have already fallen victim to shifts in political mood and Azerbaijani public opinion. Indeed, even if it were deemed economically crucial, such a ‘free trade’ market could never exist in Azerbaijan. The frontlines spread over hundreds of kilometres, and shots are still exchanged that cost the lives of numerous soldiers. Most of the Azerbaijani territory occupied by Armenian forces is no longer used for civilian purposes and serves only as an area of military control. Despite the large areas of farmland occupied by the Armenians, NK (like Armenia itself) suffered an acute shortage of wheat last year. There is no farming at all on the depopulated land the Armenians call the ‘safety zone’ because so many of the fields are mined (the exact number is known only to Armenian commanders). This is not an environment suitable for establishing cross-border trade. The choice of Georgia as the site for an Armenian-Azerbaijani free-trade zone is perfectly natural, though it should be stressed there are few Azeri traders from Azerbaijan at the market. If they are present, it is usually as consumers.

To evaluate the role of this trade zone properly, we need to examine the advantages it brings to those living beyond the confines of Sadakhly. The role and significance of the market and its trade are controversial and open to dispute. But

its existence means that it needs to be taken into account, and it is reasonable to explore whether the market can bring some broader overall benefit.

Many populist nationalists believe that any economic contact with Armenia diminishes the patriotism of those engaged in it and might amount to 'betrayal' of one's country. In times of military conflict, however, such trading areas also serve as locations that facilitate the exchange of prisoners, grassroots negotiations and other potentially useful dialogues. In the event of a peaceful settlement of the conflict, it is precisely these economic 'contact points' that will help overcome syndromes of mutual hate in as short a time as possible.

A perfect example of the development of spontaneous markets was the one that appeared on the border of Eastern Slavonia during the Serbia-Croatia war. The Serbs who had fled, or been forced out of, their homes traded cigarettes, soap and other products with their former Croatian neighbours and this helped to re-establish person-to-person contact with one another. A more interesting fact, perhaps, is that the market enjoyed the full support of the UN Transitional Authority in Eastern Slavonia (UNTAES), and was protected by a contingent of peacekeeping troops.

2. HISTORY OF THE ARMENIA-AZERBAIJAN CONFLICT

The NK conflict broke out in the summer of 1987 when 75,000 Armenians signed an appeal to the Central Committee of the Communist Party of the Soviet Union for their region, then part of the Azerbaijan Soviet Socialist Republic (SSR), to be merged with the Armenian SSR. In autumn of the same year, the Russian economist, Abel Aganbegyan, tried to justify the unification of Armenia and NK with economic arguments. A wave of rallies and protests demanding the unification of the NK Autonomous Region with Armenia broke out all over Armenia.

By January 1988, the first few hundred Azeri refugees had begun to make their way to Azerbaijan from Armenia. On 16 February, the regional executive committee of the NK Autonomous Region adopted a decision declaring the region's secession from Azerbaijan. Twelve days later, a bloody continuation of the political conflict erupted in the city of Sumgait, Azerbaijan, with Armenians as its victims. Martial law was declared. Moscow's attempts to control the crisis were confused and had a conflicting character. The atmosphere during the first two years of the conflict was such that every rally, no matter its purpose, seemed like a breakthrough to freedom.

At first, the Armenia-Azerbaijan conflict seemed like a typical secessionist conflict, analogous to the conflicts in Northern Ireland and the Basque areas of Spain. In fact, the attempt by Armenians in NK to justify their right to secession in historical terms was unprecedented. Drawing on supposed historical

memories, Armenians propagated the idea of an Azerbaijani genocide against them. Every historical event was reconstructed as an argument in favour of secession, from the Armenians' 1,000-year history as a people and their uninterrupted residency in the South Caucasus, to the unrealised decision of the Soviet Caucasus Bureau for NK to unite Armenia with NK in 1923. Emotional appeals were falsely constructed on unfounded historical arguments.

The failure of historical argument as a basis for territorial pretensions is obvious from today's perspective, but it played a large role in events, given the context and nature of Azerbaijani and Armenian conflicts over the preceding century. Such ethnic conflicts had always broken out at times of social and historical upheaval, such as the dissolution of the Russian and Soviet empires, as well as after the first Russian revolution (1905-07).

The two nations have turned against each other three times in 100 years. From the Azerbaijani perspective, conflict was always initiated by the Armenians, who also always emerged as victors at every twist in this long-running rivalry. Armenians took control of Baku gubernia's oil industry at the beginning of the 20th century, intruding into the rich oil extraction business. After the Soviet takeover of the South Caucasus, they persuaded Moscow to create a separate Armenian republic out of Azerbaijani territory and make NK an autonomous *oblast* within the Azerbaijan SSR. During the dissolution of the Soviet empire, Armenians managed to ethnically cleanse Azeris from the former Armenia SSR in a short period of time and to create a second, de facto Armenian state by occupying one fifth of the Republic of Azerbaijan as a supposed 'security zone' around NK.

For these reasons, we may presume that an idea has formed in the Armenian collective unconscious that any great convulsion, including revolution, always plays into its hands, bringing territorial expansion, the attention of the international community and growing consolidation of the Armenian nation. Given the changing context, this notion disturbs Armenia's neighbours. Even Christian Georgia is more wary of its Armenian residents than its Azeri minority. This is understandable since Georgia's Djavakhetia region is de facto administered by Armenians, there are significant numbers in Georgia's other troubled regions and they are overly represented in the country's political and economic elite.

Armenia's political campaign was followed by the eviction of people from their property on the basis of ethnicity. By the end of 1988, 219,800 Azeris had been forcibly displaced from their homes in Armenia and not a single Azeri family remained.² Armenians continued to live in Azerbaijan's capital and other cities throughout 1989 – though a gradual exodus had begun – in the belief that the authorities in Moscow would intervene to end the growing conflict. But the fate of Armenians in Azerbaijan was sealed after the pogrom in Baku in January 1990, as a result of which up to 400,000 Armenians left the country.³

In early October 1991, Armenia's military forces launched operations to drive the Azeri population from the territory of Upper Karabakh, a continuation of the ethnic cleansing in Armenia proper.

According to Azerbaijani military sources, 490 Armenians were killed and 1,350 injured between 1988 and the end of 1991. Of the dead, 119 were killed in pogroms in Sumgait, Baku and Ganja. More than 930 Azerbaijanis were killed and 2,300 wounded during the same period, 216 of whom were victims of pogroms in Armenia and 240 who died when Soviet troops entered Baku on 20 January 1990. The rest died in terrorist operations and fighting in NK.

Throughout 1989, entire villages of Armenians in Azerbaijan and Azeris in Armenia demonstrated their peasant wisdom and desire for peace by exchanging homes and fields with one another. In one case, Azeris in one of the highest settlements in Armenia, Gyzyk Shafag, traded their village with Armenians from Cherkez in Shemakhin region in Azerbaijan after months of negotiation. It is interesting that this wisdom proved to be infinitely stronger than attachment to one's place of residence. Among Azeris in Cherkez, one still hears stories of an Azeri's cat that managed to brave the snow-filled mountain passes and return to its former home in Gyzyk Shafag. Unfortunately, politicians ignored such phenomena.

Armenian nationalist organisations used terrorist tactics from the first phase of the ethnic conflict. They never denied the fact and some terrorists were lionised as patriotic fighters. One only has to recall the Moscow metro bombing in 1977. In pictures broadcast by national television, the terrorist, Stepan Zatikyan, who carried out the bombing, repeated the word *vrezh*, the Armenian for 'revenge'. From the beginning of ethnic conflict to the eruption of all-out war, such organisations conducted more than 40 terrorist operations (bombing buses, trains and metro, shooting at cars and their passengers). Criminal cases were opened after every incident but not a single one was solved, partly due to the prejudice of the then Soviet prosecutor's office. Throughout an entire century of latent conflict and outright fighting, it should be noted, Azerbaijan never once expressed territorial ambitions in Armenia, nor used terrorism to gain advantage.

Parallel with these events, both sides began to create regular armies out of disorganised self-defence units, militant organisations attached to political parties, the republican national guard and the police force.

2.1 FROM CIVIC TO MILITARY CONFLICT

Outright war broke out as a cumulative effect of different terrorist acts. In 1991, the third year of the conflict, Armenians launched large-scale military operations against Azerbaijani territory, seeing this as the most effective way to continue the conflict. In September 1991, they attacked Soviet Special Forces' positions in western Geranboy region, taking control of a number of towns and villages. This attack was probably in reaction to the forced deportation by Russian forces of

Armenians from the villages above Ganja, but it was their last hostile action against Armenians.

The dissolution of the Soviet Union in December 1991 had a huge impact on later events. The declarations of Armenia and Azerbaijan's independence transformed what had hitherto been an internal ethnic crisis into an international military conflict, a fact Armenia had previously denied. Armenia scored significant success with this propaganda-charged approach.

Only three eastern-bloc countries recognised Armenia as the aggressor during the conflict. The 56 countries of the Islamic Conference later joined them, and the Socialist International came to a similar conclusion in 1994. Though separatists in NK talk openly of unification with Armenia, the leading Western nations refrained from judging it an inter-state conflict.

After an agreement between the commanders of the newly formed Russian Federation's Caucasus military unit, Armenia's 7th Guards Division enjoyed unlimited access to the arms, ammunition, flammable and explosive materials, and other military equipment in Armenian-controlled regions between January and April 1992.

The Armenian capture of Shushi, the second largest, Azeri-populated city in NK, and then of Lachin, an Azerbaijani town on the border with Armenia, triggered the most intensive phase of fighting between Armenia and Azerbaijan. At the same time, military action had led to the almost total deportation of the Azeri population of NK.

These events occurred even as Azerbaijan and Armenia were meeting in Tehran for peace negotiations brokered by Iran. Their coincidence with the peace talks tarnished Iran's role as an intermediary and further delayed prospects for further negotiations, though an international mission to settle the NK issue made its first appearance in March.

The Azerbaijani army launched a large-scale offensive in northern Karabakh after the National Front came to power in the summer of 1992. Azerbaijani forces penetrated as far as Khankendy (Stepanakert), the capital of NK, but this military success was not supported by any parallel diplomacy. In fact, military euphoria was partially to blame for this lost opportunity though, in fairness, it would have taken enormous political will to carry off a diplomatic victory in face of Russia's opposition.

Amid the difficult social and political challenges confronting Azerbaijan in early 1993, Armenian forces captured Kelbadjar region, opening another corridor between NK and Armenia. This victory could not have occurred without the explicit encouragement and support of Russia. Around the same time, the term 'security zone' began to appear in the lexicon of Russian mediators. After President Heidar Aliyev came to power in 1993 and Azerbaijan joined the CIS after losing six more regions, the Armenian 'security zone' was consolidated in autumn 1993.

By early 1994, Armenian forces controlled the NK Autonomous Region, seven additional regions and a number of border villages, equivalent to 12,500 km² or 14.5% of Azerbaijani territory. Before the conflict, this area contained more than 870 settlements, including 11 Azerbaijani cities, five other urban centres as well as numerous towns, villages and communities.⁴

Azerbaijan's attempt to launch a counter-attack in January 1994 did not produce the desired results and ended in many senseless deaths. The fighting lasted throughout the winter and both armies were exhausted when the campaign finally ended the following spring. Some 4,000 Azerbaijani soldiers were killed and 10,000 injured; the majority of fatalities froze to death in the Kelbadjar Mountains. Armenian losses were 2,000 dead and 6,000 other casualties. Anti-war attitudes began to spread in Armenia, which was formally trying to distance itself from the Karabakh problem.

A Russian-sponsored ceasefire signed on 9 May 1994 in Bishkek, Kyrgyzstan, produced a fragile peace based on questionable political documents. The ceasefire was supposed to lead to a final agreement on NK and modalities for the withdrawal of military forces from the occupied territories. The ceasefire envisaged the deployment of two Russian peacekeeping battalions (Russia made much the same proposal during fighting in the Kelbadjar Mountains), but the OSCE's Minsk Group contested the idea. In the end, a joint peacekeeping contingent composed of four countries – Russia, Austria, Turkey and Hungary – was mobilised. As Azerbaijan prepared to sign contracts with international oil companies, however, Russia determined to slow the peace process down. The ceasefire provided time for all sides to re-evaluate the situation, but Armenia's de facto incorporation of NK and its Armenian population was a diplomatic coup and Azerbaijan has suffered the consequences ever since. The status of NK's displaced Azeri population was quietly dropped from the agenda, a situation that continues to the present.

After signing the Bishkek Protocol, President Aliyev began to address his own political survival, a policy followed to this day. OSCE contributions were activated post factum. Russian forces have not remained the exclusive peacekeepers in the region, but the status quo established by the Bishkek agreement was fully agreeable to a Russia now preoccupied by its own internal problems.

Geopolitical influences in the conflict were initially defined by the presence of Russian military forces in the region, but the number of stakeholders has increased over time.

The political challenges linked to the NK conflict have also changed. In 1988, Mikhail Gorbachev had attempted to use the conflict to apply pressure on clan-based political groups in Armenia and Azerbaijan, but his overriding task was keeping the USSR together. After the formation of the CIS, Russia exploited the conflict to retain a military presence in the region, but it tried to remain even-handed until 1992. After Russia's 363rd Motorised Infantry Division

participated in shooting Azerbaijanis in Khodzaly and Russian troops were withdrawn from Azerbaijan at the latter's insistence, Moscow had no further need to disguise its military and political preferences in the conflict. Russia currently retains two military bases in Armenia and two in Georgia. From time to time, Georgia demands the bases' closure and the repatriation of Russian troops, but Moscow is convinced they should remain for at least a decade.

Russia's humbling experience in Chechnya forced Moscow to rethink its position on NK. Clearly, the absence of a lasting peace in the South Caucasus and a possible escalation in the conflicts there did nothing to encourage the search for a suitable solution to the Chechen war. Though this conflict convinced Russia to behave more cautiously in the region, the reality was more complex than it seemed. The concentration of Russian military power in Chechnya could be used as leverage to ensure that the South Caucasus remained obedient.

The US has steadily outmanoeuvred Russia in the region, however. This process began with the admission of South Caucasian republics into NATO's Partnership for Peace programme in the 1990s, but it gained strength with the signature of pipeline contracts and Washington's toughening stance towards Iran. Nonetheless, the US continues to take Russian – and, to a lesser degree, European – priorities into consideration.

Turkish influence in Georgia and Azerbaijan has also been growing. The EU has shown an increased interest in the context of an expanding, united Europe that can compete with the US. The region has also attracted interest from Asian powers, notably Japan and China. In economic terms, the Islamic Bank for Reconstruction, the Economic Cooperation Organisation and Arab financial foundations have become active. Though they all proclaim the principle of territorial integrity, the former are largely indifferent to the conflict, while the latter tend to view Armenia as the aggressor.

2.2 THE COST OF THE CONFLICT

Official records of the numbers who died in the war date back only to the end of 1993 and contain contradictions, though the minimum estimates are huge. On a visit to the US in 1993, Armenian Prime Minister Grant Bagratian said that 15,000 lives had been lost on both sides in six years of conflict. But the Armenian peace advocate and parliamentarian Ashot Bleyan asserts that up to 1,000 Armenians died in January 1993 alone, and that as many as 15,000 Armenians may have lost their lives in total.

According to a statement by President Aliyev at the end of 1993, Azerbaijan lost 11,000 dead and 25,000 wounded in the war. The casualty lists cited by both sides have varied greatly over time, partly because of inaccurate statistics but also due to propaganda needs. The military historian Arif Yunusov estimates that around 11,000 Azerbaijanis and 6,000 Armenians were killed, and 30,000 Azerbaijanis and over 20,000 Armenians were injured from February 1988 to

April 1994. A large proportion of Azerbaijan's losses were non-military: 1,400 Azerbaijani civilians lost their lives in 1992 alone.

Despite the pathos of the peacemaking process, none of the intermediaries or international organisations involved has been able to negotiate an exchange of prisoners or other hostages. In 1994, 4,034 Azerbaijanis, including women and children, were still being held prisoner by the Armenians. An agreement clearing the way for a full exchange of prisoners seems impossible because there are so few Armenian prisoners in Azerbaijan. The exchange or liberation of prisoners is a vital, first step to rebuilding trust between the two nations.

The number of Armenian refugees from Azerbaijan now in Armenia or Russia is estimated at around 350,000. The number of Azeris deported from Armenia in 1988–90 is 219,800. In 1989, up to 40,000 Meskhetian Turks also fled to Azerbaijan from Uzbekistan. According to Azerbaijan's State Statistical Committee, 477,000 people lived in areas of Azerbaijan now occupied by Armenia on 1 January 1993. Including those evicted from the former NK Autonomous Region and a number of border areas, some 520,000 Azerbaijanis were IDP from 1991–93. By this calculation, a total of 755,000 ethnic Azeris became refugees, IDPs or were deported from Armenia, Armenian-occupied Azerbaijan and Uzbekistan from 1988–94. Official statements, citing a total of one million Azeri refugees, reflect the fact that the residents of many frontline areas have also been evacuated.

The conflict notably retarded the region's economic development. Both governments widely employed 'social mobilisation' in the war, subordinating social life, institutions and individuals to the need to confront a wide array of real or imagined emergencies, military and quasi-military: the struggle for stability, for national order, for a record harvest, for the fulfilment of economic plans and other slogans inherited from the Soviet era. The NK issue became an instrument for manipulating society, and it held back the introduction of a free-market economy.

The freezing of the military conflict also had an impact on investment, maintaining high investor risk levels and weakening the position of national governments in concluding economic agreements. The absence in the 'contract of the century' oil agreement of a chapter favouring local industry – of immense importance for Azerbaijan – was a classic example of the conflict's negative impact on the investment climate. Similarly, the recent transfer of a number of strategic structures in the Armenian economy to Russian management would never have happened, but for the extreme conditions produced by the conflict.

Economic crisis and continuing instability have led to the emigration of significant parts of the populations of Armenia and Azerbaijan, though the process is more advanced in the former due to the strength of the Armenian Diaspora and its ability to support newcomers in countries around the world. Shortages of labour and qualified personnel are no longer hypothetical in both countries.

At the micro-level, the conflict has caused widespread psychological stress, particularly among those in mixed marriages. Only a few hundred such couples still live in Armenia, according to some statistics, though the last census claimed that there were up to 8,000 Azerbaijani residents. There are some 2,000 mixed marriages involving Armenian women in Azerbaijan, according to Ministry of the Interior and registry statistics for 1999. Some researchers estimate the real number might be close to 3-5,000; others that it is as high as 10,000. This uncertainty is understandable since many Armenians married to Azerbaijanis have adopted Azerbaijani names.

A number of international fora were established after the Bishkek Protocol to consolidate the truce and launch serious peacemaking efforts. The Budapest Summit in 1994 raised the issue of introducing international peacekeepers to the region, a move that was blocked by Russia. Meanwhile, the Lisbon Summit in 1996 reaffirmed the sanctity of Azerbaijan's territorial unity.

The conflicting sides have twice appeared close to reaching a settlement. The first such breakthrough occurred when President Levon Ter-Petrosian of Armenia urged his people in 1997 not to be misled by military victory and to think about the future. 'We have only won a battle,' he said, 'not the fight.' Ter-Petrosian's support for a gradual resolution of the conflict ultimately cost him the presidency. The second sign of a rapprochement occurred on the eve of the OSCE summit in Istanbul in 1999, but the opportunity was lost after the murder of two of the greatest figures in Armenia's political establishment, Prime Minister Vazgen Sarkisyan and Karen Demirchyan, the parliamentary speaker. There does not appear to have been a Russian link to the murders. More than likely, their murders were motivated by Armenian nationalist attitudes, and Russia's ability to exploit such sentiments was purely incidental.

The Minsk 'troika', composed of Russia, the US and France, accelerated its activities after 1996. Attempts to find an agreement through personal negotiations between the presidents of Azerbaijan and Armenia (there have been about 20 such meetings) have not produced results, partly due to Armenian politicians decrying the absence of a representative from the 'third' conflicting party, the NK Armenians. The Minsk Group's authority fell into decline when three potential settlements under discussion were leaked to the press; the Minsk Group is constantly attacked for its incompetence, particularly in Azerbaijan.

There have been two further high-profile attempts to find a compromise, one in Key West, Florida, in 2000, with the participation of senior US officials, and the other in Paris in 2003 with the participation of President Jacques Chirac. Both proved unsuccessful – though the term 'Paris Agreement' was subsequently added to the conflict's expanding lexicon. According to Armenian sources, the still unpublished principles of the Paris Agreement focus on territorial exchange and the opening of lines of communication. Further negotiations in Geneva – from which much was anticipated – never held. Though President Heidar Aliyev

and President Robert Kocharian were reportedly prepared to sign a peace agreement, it appears their peoples were still not ready for one.

Attempts to reach a peace will undoubtedly continue and, judging from the frequency of previous peacemaking missions, with something approaching the same degree of intensity. Immediately after winning the presidential elections in Azerbaijan, President Ilham Aliyev held his first meeting with President Kocharian in Geneva. Reports of an eventual, step-by-step settlement, including the exchange of occupied territory and the restoration of communication and transport links, appeared in the press. For now the Armenians deny this, but there is no doubt that a new push in the negotiating process will soon be underway.

2.3 NEW REALITIES

A number of geopolitical changes in the last few years may have an additional bearing on the prospects for settling the conflict, including:

- Both countries have become members of the Council of Europe;
- The growing presence and influence of the US in the region;
- A number of small disagreements between the US and Europe;
- US-Iranian relations have deteriorated;
- The cancellation of Chapter 907 of the US Freedom Support Act that disallowed assistance to the Armenian or Azerbaijani governments;
- The global, anti-terrorism campaign has changed geopolitical calculations everywhere.

New peacemaking formulae were introduced under the 1995 Dayton Accords, namely 'peace enforcement'. Azerbaijan's economic situation has improved in the last 10 years and its armed forces have been strengthened since the ceasefire was signed. The balance of power would have shifted more in Azerbaijan's favour were it not for excessive corruption, growing monopolist tendencies and a decrease in economic freedoms. But Azerbaijan is still in a strong position were it to come to a 'war of resources' with Armenia. By contrast, Armenia has been excluded from the region's great economic projects and has major problems in transport and communications.

If Kazakhstan and Turkmenistan join the nearly finished BTC pipeline project, the resulting energy corridor will further reduce Russian influence in the South Caucasus. An important obstacle to this plan, however, is Russia's close ally, Armenia. If the West tries to break Yerevan's dependence on Moscow, it will only play into Armenia's hands. Armenian diplomats understand this situation only too well and will try to gain as much as possible from it. According to many analysts, there is no single scenario in which either Armenia or Azerbaijan could emerge as victor.

Since the attacks of 11 September 2001, US military campaigns in Afghanistan and Iraq, and the global campaign against terrorism, have significantly altered perceptions of the NK conflict. Shifts in the Cyprus stand-off also have a secondary effect on the dynamic of conflict transformation in the region. Against this backdrop of geopolitical change, many regional conflicts have lost their urgency, creating stronger incentives to resolve them as soon as possible.

Though there are occasional reports of possible ‘peace enforcement’ in the region, it is increasingly clear that the participants are banking on a ‘staged settlement’ to the conflict based on regional economic integration. But the lack of trust between two very excitable publics in Armenia and Azerbaijan is still too great. In Azerbaijan, calls for greater economic integration are viewed as yet another concession to Armenia while large parts of the country remain under occupation. Fear of Turkey has also revived in Armenian society and there is an outcry over the possible (but so far hypothetical) opening of a railway route between Gyumri and Kars, with an extension to Georgia and Azerbaijan.

In any case, the search for mutually agreeable solutions and attempts to reduce the level of mutual fear between the conflicting sides will continue.

3. THE RESEARCH RESULTS

3.1 GOALS AND METHODOLOGY

The phenomenon of outdoor markets in the South Caucasus, where members of conflicting sides trade with one other despite difficult political conditions between their states of origin, deserves serious and unbiased examination. The focus of our research is the market in Sadakhly where we conducted field research in 2003. We sought to answer the following questions:

- What factors provide for the stable operation of the market in Sadakhly?
- How is Sadakhly market perceived in the ‘mother’ countries of Azerbaijan and Armenia?
- What influence does the market have on the currents of the NK conflict and relations between Armenia and Azerbaijan?

We thoroughly studied one example of an unofficial market (in effect, a case study). This involved concrete sociological research with the aim of exposing the main rules and conditions under which it functions. Our goal was to reveal those characteristics of Sadakhly market that could make it a model for further cooperation between groups whose ‘mother’ countries are in conflict. On one hand, we viewed the market as a model for satisfying the material needs of the

Armenian, Azeri and Georgian populations that live on the periphery of Georgia and Armenia, whose economies are unable to fulfil their expectations. On the other, we tested such universal clichés as ‘ancient hatreds’ and ‘insurmountable contradictions’ – often taken as characteristic of relations between Armenians and Azeris – on the basis of existing relations between members of these ethnic groups who make a living in Sadakhly market. Such clichés limit the choice of options to military victory by one side or the other or, at best, a cold-war situation. This, in turn, leads to isolation, unrelenting tension and inflammatory military hysteria. Sadakhly demonstrates that relations between the two nations can be different under different conditions and within certain social, political and economic frameworks. However, Sadakhly market’s role in settling the conflict should not be overstated.

Field research methods included interviews with participants in the market, as well as observations made there. All interviews were confidential.

3.2 HISTORY OF SADAKHLY MARKET

The market is named after Sadakhlo, a village in Georgia near Sadakhly Bridge over the River Debet, which separates Armenia and Georgia. The village is spelled differently in all three countries. The official Georgian name is Sadakhlo; Azerbaijanis call it Sadakhly; and the Armenians, Sadakhli. In the present study we have used Azerbaijani spelling.

The Krasny Most border crossing on the Georgian-Azerbaijani border is 50km from Sadakhly village. The Armenian village of Bagratashen, connected by train to Sadakhly on the Tbilisi–Yerevan line that runs through Alaverdi, is 10km distant. Tbilisi is 90 minutes away from Sadakhly by train, the same time it takes to travel to Tbilisi or Krasny Most by car.

The ‘international’ market has existed since the early 1990s and is located not far from Sadakhly, near the Armenian border, and also close to a village in Armenia called Lambali where Azeris lived before the war. We were told that Sadakhly market provides an income for up to 500,000 people in Azerbaijan, Georgia and Armenia in one way or another. This number may not be so exaggerated if one considers that almost all Azeris in Georgia are drawn to trade at the market in one way or another.

The market was established in the fields of a collective farm that fell into disuse at the beginning of the 1990s. Trees were uprooted and a few entrepreneurs from Sadakhly decided to begin trading on the site. All went well and for a long while the Georgian authorities paid little attention, or pretended not to notice, preferring to use the market as a corridor for illegally exported goods. Initially, the market director was Azeri, but he later acquired a Georgian deputy director and, in the past few years, the director has been Georgian. The change in directors is indicative of how profitable the market has become, but it is also practical in that it is far easier for a

Georgian director to reach agreement with Georgian customs officials.

The existence of a *khafta bazaar* (weekly market) servicing the surrounding villages is not new to the region. A similar market has operated near Sadakhly since 1935 and, initially, there was competition between the villages of Gachagan, Shulaver and Sadakhly as to which would host it. The village elders determined it was best to locate it in Sadakhly and, to ensure the market's dominant position, they promised high prices and called on farmers to bring their produce. Prices later fell, but the market gained a reputation for being very profitable. The 'international' market formed under very different circumstances from the old bazaar. While the previous market mostly served the local population, the new market became a trading zone for the entire South Caucasus.

In 1990-91, all countries in the South Caucasus underwent difficult transitions to independence, accompanied by inter-ethnic conflicts in which Moscow played a leading role. Their declining economies left the population increasingly poorer. Memories of bread queues and the rationing of basic necessities in 1992-94 are still fresh.

In some ways, the development of Sadakhly market went against the rules of logic. A prosperous market should be well-connected to transport, but the roads to Sadakhly from Krasny Most and Tbilisi were mostly in ruins with just a few stretches of unbroken asphalt, largely due to the transit of heavy trucks smuggling petroleum during the war between Armenia and Azerbaijan. The illegal trade in oil products continues today and critical articles on the topic appear in the Azerbaijani press from time to time. Large deals are usually protected by powerful figures in the two countries' governments, though Georgian middlemen tend to implement them. This trade has little to do with entrepreneurs at Sadakhly. Only when prices are raised in Armenia do petroleum and oil from Krasny Most appear on the market in bottles or small canisters.

Of course, when a sizeable village is located near a large market, it begins to play a direct role in it. Sadakhly and Bagratashen, across the border in Armenia, enjoy the greatest advantage from the market, but other actors benefit further down the supply chain. For this reason, it is necessary to describe the layout of Sadakhly village in more detail: Sadakhly is the largest village in Azerbaijani-speaking Georgia with some 12,000 inhabitants, two secondary schools and a regional polyclinic. It is located on the railway connecting Tbilisi, Yerevan and Gyumri, from which there are rail and road connections to the Turkish town of Kars.

Sadakhly's biggest problem is its uneven energy supply. Lights work for only a few hours each day, and then not every day. There have been a number of celebrated cases in which villagers collected money and purchased electricity from Azerbaijan, thanks to the power lines built in the Soviet era.

Another practice has been to purchase one generator for every 30 or 40 families, which has helped to reduce shortages. The inhabitants of Sadakhly mostly live on subsistence farming. Wage labour scarcely exists and is unlikely to develop in the foreseeable future. For this reason, the local peasantry lobbied hard to be allowed to work on the BTC pipeline that passes through the region.

The village formerly had a hospital with 35 places, but it was closed and only the maternity ward functions effectively. There is virtually no bribe-giving for health care since there are 22 doctors in the village and everyone is related to one another in some form – leaving no one to take bribes from.

Sadakhly is one of the few villages in Georgia from which there has not been a steady stream of emigrants, either to Russia or Azerbaijan. This is largely due to the existence of Sadakhly market.

3.3 HOW THE MARKET FUNCTIONS

The volume of trade at Sadakhly peaked in 1991 and 1992 when it was the only place where trading was possible. The market is divided into two parts, an Armenian section and an Azeri section, separated by an iron gate which is locked at night. Like any border market, there are customs officials and border guards, both Georgian and Armenian. Georgian Azeris sometimes trade in Armenia, but Armenians freely cross over to Azeri-inhabited Georgia. Though an understanding was clearly reached long ago with customs officials, the gate is still ritually locked each night. This is one of the main differences between the Georgian-Armenian border and the Azerbaijani-Armenian border at Krasny Most. The market is further divided into a ‘wholesale’ section, where food products are sold, and a ‘retail’ section selling clothes. The main trading days are Tuesday and Wednesday, though the market is open all week long. These two days are busiest partly because most goods sold at the market are brought from other wholesale markets, and transporting them to Sadakhly can take up to a week. Sellers of foodstuffs have adjusted to this rhythm, though they work more or less throughout the week. On Tuesday, no less than 5,000 people are working at the market.

The authors conducted their field research in summer and were left with the impression that no one cleans up or takes care of the market’s grounds. The hygiene situation is even worse in winter when the ground turns to mud and traders light fires in iron stoves so they can stand at their stalls all day without freezing.

Goods are brought to the market from across the region. Some were originally purchased at Lilo market near Tbilisi, others at the airport market in Baku and still others were imported from Turkey. To a lesser degree, goods are shipped in from Jalilabad on the Azerbaijani-Iranian border. Prices are not very different from Baku, but the market lives off tight margins on products

purchased at cheaper, more remote markets. The Krasny Most market is scarcely involved in the trade in Sadakhly for an interesting reason. It is well known that border markets attract the interest of groups from neighbouring countries who seek to bring the flow of goods under their control. The market at Krasny Most was once very active; Georgians used to trade there in the early 1990s when life was very harsh. Now the market mostly facilitates trade between Azeris in Georgia and Azeris in Azerbaijan. As the market developed, so did the appetite of nearby customs officials with the result that the delivery of goods from Krasny Most to Sadakhly is no longer profitable. Conditions for the movement of goods across the Georgian border have also become stricter, with customs duties as high as 30% of the value of the cargo. Of course, it cannot be excluded that groups in government are ‘regulating’ the flow of selected goods for their own purposes.

Sadakhly market is dependent on these cross-border flows. Flour, bran and salt are sold into Armenia, while Armenian smoked and fresh river fish are sold to Azerbaijan. The market is full of agricultural produce, each country presenting what it has in abundance and can grow cheaply. Georgians bring fruit – apples, tangerines and oranges – Turkish sweets and clothing, illegally produced spirits and non-alcoholic drinks, game-birds, lamb, beef and pork. Armenians sell cigarettes, drinks, shoes and, lately, jewellery; they sometimes sell fruit, but rarely. Azeris sell herbs and green vegetables (considered a strictly ‘Azeri’ trade in Georgia and Armenia), industrial products such as car tyres, cheap clothing and processed goods, including butter, tea and sweets. The sale of fruit is subject to seasonal fluctuations. Many fruits ripen later in Armenia and, therefore, are purchased at Sadakhly market before the domestic season begins. Other fruits, such as persimmon, tangerines and oranges, do not grow in Armenia at all. Sturgeon and combustible fuels from Azerbaijan, and electronics from Armenia also regularly cross the borders, but trade in these products is not evident in the market since the relevant trades are made directly between offices in Azerbaijan and Armenia. Cattle and other livestock are sold without attracting customs duties since it is common knowledge that farmers can easily find a ford far from the customs post and simply run the animals across the river to their Azerbaijani buyers. Accounts are then settled at the market.

Goods that change hands at Sadakhly can later be found in the capitals of the conflicting states. Stores selling tea and coffee in Yerevan carry significant stocks of tea from Azerbaijan imported via Sadakhly. Yerevan’s best restaurants serve sturgeon that can only be caught in the Caspian. Similarly, Armenian products are for sale in Azerbaijan (with effort and money, one can even find Armenian cognac in Baku). Some traders confided ‘secretly’ that potatoes and other vegetables from Armenia are imported to Azerbaijan through Georgia. In Sadakhly, we were told that some of the smoked fish sold near Baku’s Sabunchi railway station comes from Armenia.

Georgian citizens, and especially Georgian Azeris, dominate the market. This makes sense because it is easier for them to transport goods to and from Sadakhly.

In 2002, a joint raid on a number of commercial outlets in central Baku by Azerbaijan's Ministry of Taxes and State Customs Committee discovered 'Cigaronne' cigarettes of Armenian origin. The further one travels from Baku, the more frequent such discoveries are. In Ganja, 72 240g and four 1,300g cans of herring fish were found with mainly Russian labels but a trademark, 'Ararat', that is one of Armenia's national symbols. Herring were also found in Akstafa and Tovuz regions. Though the owners claimed to have bought them at Sadarak market in Baku, they probably originated from Sadakhly.

Sadakhly also does a sizeable trade in CDs of Azerbaijani singers, who are popular in Armenia. Though many songs can be downloaded from the Internet, Sadakhly is considered the main source for pirated audiocassettes of Azerbaijani theatrical and wedding songs. Of course, singing wedding songs from an enemy country is not considered acceptable, but the texts are translated into Armenian and sung as 'Armenian songs'. This musical exchange launched an information war against songs based on the Azerbaijani classical, improvisational style, known as *mugam*. Conversely, Azerbaijani singers in Baku earn a lot of money from covering Armenian songs from the 1960s and 1980s. The exchange is not entirely equal, however, because Armenians have always loved Azerbaijani music.

Another unique and bizarre service is also available at Sadakhly market. For a price one can arrange through an intermediary to have former Azeri villages in Armenia recorded on videotape. Clients are usually deported Azeris with a sense of nostalgia for the place where their ancestors are buried. We were not interested in the service and could not determine its cost, but it was reportedly inexpensive. One might consider it sacrilegious that private feelings could be the target of such marketing, or assume that former Armenian neighbours would film everything for free, but it is hard for Azeris to get in touch with their old neighbours. And, after all, the purpose of a market like Sadakhly is to sell whatever a customer wants, from a T-shirt showing an exploding World Trade Centre to a jar of 'mountain air'.

3.4 MARKET INFRASTRUCTURE

In the larger scheme of things, a market's size can be measured not only in the intensity of trade, but also the scale of the infrastructure needed to support it. Sadakhly's infrastructure is almost as large as the market itself, reaching far beyond its periphery. Measuring the market's broader economic effects is easiest when the support infrastructure is located nearby.

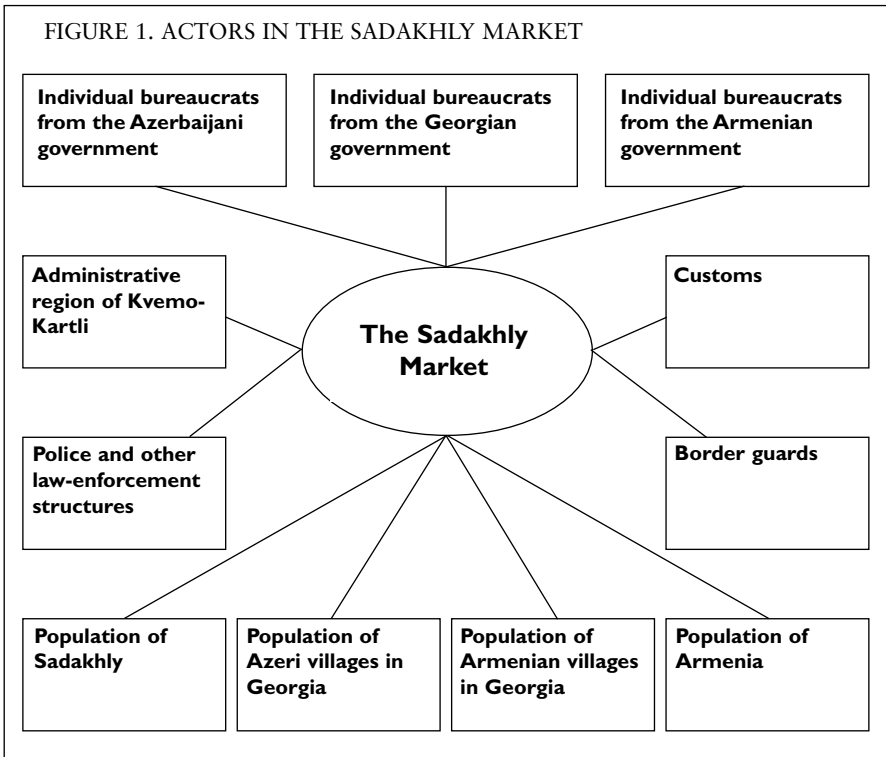
There are over 40 different cafes and restaurants in the market. The people working in them mainly come from Sadakhly or are Armenians from nearby areas, particularly in the coffee shops.

In Sadakhly village, local residents have purchased 22 Hungarian-made Ikarus buses dating from the Soviet era, renovated and smartened them up, and they now

deliver a large proportion of the goods that reach the market. This enterprise was a further survival strategy and evidence that they had realised that if they did not supply the transport themselves, strangers would move in and take their place.

Other villagers work in the market as controllers, filling out registration slips and collecting fees from the vehicles that arrive. Each trading place costs one lari (\$0.50) a day. On a busy Tuesday, when thousands come to trade, this can amount to a tidy sum for the market's directors, but the controllers keep 3-5% of what they bring in. The market's organisers have begun to charge special rates for select aisles and better placement. Money is also made from renting containers for secure storage.

Another part of Sadakhly's population works in the transport of passengers from Krasny Most and Tbilisi. Because of the bad roads, it is rare to find a car or bus that has not been involved in an accident.



3.5 IMPORTANCE OF THE MARKET

Sadakhly market is of utmost importance to Azeris and Armenians. Without Sadakhly, the largely agrarian Azeri population in Georgia would not know where to sell its excess production. It should be stressed that the exchange in agricultural produce has a seasonal character. Peaches are first sold by Azeris to Armenians and are then sold back when the later Armenian harvest comes in. The same is true for potatoes.

Most local employment is generated by the exchange of goods or the control of the market and its trading slots. The market supports a stable, but not luxurious, level of existence, although everyone recalls how the first 10-15 individuals to realise Sadakhly's potential are now very wealthy indeed. Some have more than one car and apartments in Baku. Among the original founders is a former maths teacher, who expanded his business by hiring a truck to transport produce from Jalilabad market on the Azerbaijani border with Iran. Georgian customs officials probably earned as much as the Sadakhly elite. At the top of the wealth pyramid, however, are the wholesalers in all three countries, although Sadakhly is just one source of their income.

The market is likely to remain the place where Azeri farmers in Georgia make the money needed to sustain their modest living standards. Of the 72 Azeri villages in Georgia, all are, to one degree or another, dependent on trade at Sadakhly. It is possible that the situation will change. The Georgian economy may pick up and the embargo between Azerbaijan and Armenia may be lifted. In either scenario, the position of people working at the market will need to be taken into consideration, for there are few employment alternatives in the region apart from Sadakhly market. In Soviet times, there was a leather tannery, a wool factory and a plant processing marble, but they have since closed. We visited the marble plant and it obviously needs millions of dollars of investment to restart production; the cable connections along the railway have been destroyed, and the bearings and lines sold as scrap. However, a new tannery is under construction and an asphalt factory will soon begin production since a need for both of these materials has emerged.

A similar situation prevails on the other side of the border. There are few opportunities for work apart from café jobs for Armenian girls. The uncle of one of our interlocutors, an Azeri, has found work as a lumberjack in Armenia because he possessed a Georgian passport and worked hard. But the Armenians regard their forests just as a means of extorting money from Azeri loggers.

Local residents' relations with the market director, a man called Tamaz, bear witness to their dependence on Sadakhly market. One often hears comments like: 'We have to support Tamaz in the elections or he will close the market and we will lose our means of surviving'. This is completely understandable because Tamaz, angered by the local population, once shut the market on the pretext of carrying out renovations. These were the darkest of days for the people of Sadakhly.

3.6 RELATIONS IN THE MARKET

Armenians work in Sadakhly throughout the year as artisans and hired help. They cut firewood, build houses, dig holes for latrines – in short, they will do anything. But there is no hatred towards Armenians here. Unlike the border areas of Azerbaijan, local residents cross national and ethnic borders to attend weddings or funerals. However, one must be careful not to oversimplify ethnic relations at the market. Some traders can speak all three languages of the region, like Sayat Nova, a 19th century Armenian poet from Tbilisi. A ‘proletarian internationalism’ is an occupational necessity and all the traders are ‘proletarian traders’. As one journalist noted: ‘No Karabakhs, no Abkhazias and no Ossetias here, just smiles, handshakes and a slap on the back – with a quiet cursing between the teeth later in one’s own close circle.’ The majority of Armenians who work at the market are haulers and porters. This earns the Azeris’ respect: money for hard labour. There are hundreds of metal carts at Sadakhly and they work all day long. The carts are well made, or they would fall apart after a few hours’ work on the market’s bumpy surface.

Monetary exchange has been decided at Sadakhly for a long time and the market is the site of a curious – if unofficial – economic experiment. US dollars, Russian roubles, Azerbaijani manats, Armenian drams and Georgian lari are freely accepted and can be exchanged at special Sadakhly rates. The difference in an agreed price can be paid in any currency, obviating the need for moneychangers.

However, most traders set their prices in Armenian drams because drams are fixed at a lower rate to the dollar than lari, the second most commonly used currency. At 560 drams to the dollar, traders can account for every cent and still end up with a round number. This stresses the fact that the market is primarily for the poor. For example, a 50kg sack of sugar can be bought wholesale at Sadakhly for \$18.80 and then sell in retail shops around the market for \$19 – a profit of just \$0.20 per sack.

Armenians come to the market mainly as consumers, and Georgian Azeris and Georgians as sellers. Well-to-do Armenian ladies are among the main buyers of clothing. Recently a ‘problem of assortment’ arose, as one Armenian buyer explained. One of the ministers controlling a certain import trade in Armenia banned the import of similar products from Sadakhly in case they lowered the profitability of ‘his’ goods. This, of course, is not good for ordinary Armenians.

From time to time, there are hopes that the government will improve the roads. Contributions from local communities have financed the paving of the road from Krasny Most to Shulaver. The Georgian government has built a road from Shulaver to Marneuli and now plans to build another section from Marneuli to the Armenian border. On the face of it, this should improve the situation at Sadakhly because more goods will appear and it will be easier to transport them to market. But traders also reason along contrary lines: it may also become easier to deliver products directly to Armenia, in which case the market’s Azeri and Armenian middlemen will lose business.

The market tries to deal with counterfeit products as carefully as possible since it would take just one such case for trading to cease. For the most part, people at the market trust each other although, as at any large market, there are occasional scandals and frauds. Traders complain that losses from providing goods on credit have become more common. This works according to a simple mechanism. An Armenian takes delivery of a small amount of goods on credit (without any legal guarantees) and pays on time over the course of years until a significant level of trust has built up between the two parties. Then one day the Armenian takes a large delivery of goods on credit and is never seen again. A number of Sadakhly traders have been 'burned' in this way and have had to start again from scratch. The senior doctor in the village hospital claimed that a number of his patients suffer from psychopathic and other nervous conditions as a result of bankruptcy or fraud. Such deceptions do not, of course, happen every day or every month, but they do occur periodically. Some traders even suggest that Armenian Special Forces may have been behind such scams since the perpetrators often have invented names and are impossible to trace, even through Armenian acquaintances.

Attempts are underway to expand the scale of contacts between Armenians and Azerbaijanis, though they are already well developed at the market. The international NGO, MSF, wanted people from Sadakhly in need of quality medical care to visit their clinic at Lambali, across the Armenian border. Local Azeri doctors said that this would be impossible given the animosity between the two nations. MSF's representative replied in astonishment that this animosity did not seem to affect the market, so why should it affect health care? The argument seemed convincing at first glance, but it has one major weakness: it is one thing to have commercial relations at the border but quite another to enter deeply into 'enemy territory'. Despite the trading, a deep lack of trust remains.

Everyone at the market tries to avoid politics. They know they have no alternative but to live side by side and so prefer not to raise contentious issues, particularly the NK problem. Sadakhly's residents are quite candid about this. There are occasional rows in which one trader or another will call for renewed military action to 'restore justice', but they are dismissed as having the least significance. The consensus is that such rhetoric is best left to politicians seeking to profit from escalating an already tense situation, while the market's purpose is to sell and to survive. Residents say that the Armenian 'guest workers' are politically well educated, but if a political conversation arises, it is usually principled and reasoned.

It is also significant that relatively few Azerbaijanis regard the Azeris trading with Armenians in Sadakhly as 'traitors'. There is a healthy line of reasoning that it was a good thing that fighting did not break out between the Armenians and Azeris in Georgia because the consequences would have been even more catastrophic for the South Caucasus. Even in the most violent periods of NK conflict, no clashes ever took place between Georgia's Armenian and Azeri minorities. The Azeris in Georgia

treat the Armenians with a certain amount of distrust, but with no malicious intent. My driver in Sadakhly pointed to a burning field not far from the road and explained it was the fault of the Armenian border guards. According to him, they wait until the wind is blowing in the right direction and then set fire to tyres and throw them on to a field ready for harvesting. This seemed like pure barbarity, but the driver told his story with a certain aloofness as if there were ‘these Armenians’ and ‘those Armenians’. In any case, the Sadakhly experiment has demonstrated that no matter how tense relations are, trade can bring warring nations closer together and enrich both sides.

3.7 THE MARKET’S FUTURE DEVELOPMENT

The political context that makes Sadakhly market possible cannot last forever. The countries of the South Caucasus are not only developing economically, they are re-establishing – no matter how slowly – the rule of law.

Political factors in Georgia have little influence over the market. Government in Georgia is more decentralised than in Azerbaijan and every regional head is, to a certain degree, his own tsar and lord. The director of Sadakhly market mentioned above is considered a personal ally of the head of Kvemo-Kartli region. Many Azeris live in the region and official relations with them are sufficiently good to allow the market to operate to the benefit of all.

However, politics impacts upon the market in another way in that the traders follow with great anxiety the negotiations between Turkey and Armenia on opening their common border. Turkey is under international pressure to open its border with Armenia, but refuses to do so because of Armenia’s continued insistence on recognition of the 1915 events as genocide. People monitor negotiations as if they were taking place at Sadakhly itself, because everyone is convinced that opening the border will spell the death of ‘their’ market which, it is generally accepted, could not survive competition from a new border market on the Turkish-Armenian border.

The countries of the South Caucasus hold differing views on Sadakhly market. Some believe it is operated exclusively by state-organised mafias in Georgia, and that Azerbaijan and Armenia lose out in terms of unpaid taxes and customs revenue. The Armenian Ministry of Finance, for example, concludes that \$300-400 million worth of untaxed goods enters the country from Sadakhly every year, a fantastically inflated figure when compared to \$991 million in official customs duties collected by the government. Nonetheless, Armenia is setting more difficult and expensive conditions for the import of products from Sadakhly. Customs forms are processed in a building on the River Debet. When duty reaches up to 37-40% of a product’s value, it is clear the product will not enter Armenia legally. As noted above, such high rates are often explained as the result of the protectionist tendencies of high-ranking Armenian officials seeking to control specific goods. Traders related how many products that used to be sold at Sadakhly are no longer available for this reason, including coffee, wine and mineral water.

More attention is paid to the development of infrastructure and customs regimes at the market than to any other external factor. The Georgian government has passed numerous orders for the creation of customs, border guard and traffic police posts at the frontier, but it has not been able to eliminate corruption. There are about 10 police checkpoints on the road between Tbilisi and Sadakhly (there were 29 a year earlier), each taking 2-10 lari (\$1-5) from every vehicle they stop. The Azerbaijani government remained silent on this topic, preferring to consider it Georgia's internal problem. But the Armenian government has threatened to transport cargo through Iran in order to keep their truckers' and traders' wallets out of the reach of Georgian traffic police.

There is a certain distrust in the market even of beneficial developments, such as the construction of the Tbilisi-Sadakhly highway, which is widely considered an initiative of the Armenian government. A driver with whom we spoke claimed that it was being built with international credit and that Georgia did not want the road. The biggest fear, of course, is that as soon as the highway opens, goods (at least from other Georgian wholesale markets) will bypass Sadakhly and head directly to Armenia.

New developments may also determine the market's fate. Representatives of the Georgian and Armenian foreign ministries were due to meet in Yerevan in mid-September 2004 for negotiations on delimiting and demarcating their shared border. There are few disputed sections, but there are a number of incidental questions, notably border trade issues and simplification of the visa regime so as to allow citizens from third countries to obtain Georgian visas at the Georgian-Armenian border. Georgia has an unequivocal position on the border trade: there should not be any.

The traders' worries are understandable. Azeris living in Georgia have aligned their futures with the Georgian state, realising that their community would not be allowed to resettle in Azerbaijan even if things go well there (there are 350-500,000 Azeris in Georgia according to official and unofficial sources). But there is an equally widespread understanding that this part of Georgia is the land of their fathers and ancestors.

4. CONCLUSION

Experience of numerous conflicts demonstrates that conflicting parties need to go through a number of stages before reaching a final solution to inter-ethnic problems. The most important stages are:

- Ceasefire and temporary peace;
- A reduction of propaganda campaigns, and accusations in the press;
- A return to the status quo;

- The beginning of commercial relations between conflicting parties;
- A halt to internal propaganda (the publishing of textbooks that stir inter-ethnic hatred, 'brain washing' and other forms of indoctrination in film, theatre and entertainment);
- A final political solution of the conflict if, of course, it is possible to avoid military conflict.

Viewed from this perspective, the situation in the South Caucasus is not as simple as it is sometimes portrayed in the West. If the above conditions for peace are analysed and their nuances taken into account, it must be frankly stated that a 'normal' evolution of events agreeable to both sides is not in sight and, moreover, that the good neighbourly relations so much discussed by Western intermediaries are lost in the mists of an unknown future.

There are a number of reasons for this pessimism. More than 15 years have elapsed since the beginning of the last Armenia-Azerbaijan conflict (up to September 2003). In that time, both sides not only went to war, they lived through the de-humanising horrors of ethnic cleansing. Though more than nine years have passed since the ceasefire agreement in the NK conflict, this is too short a period for the human psyche to forget the horror of war. Despite the ceasefire, exchanges of fire continue at the frontlines and the number of victims continues to mount. More than 500 Azerbaijani soldiers have died during the ceasefire. According a BBC Yerevan correspondent, the Armenian army has lost 50 servicemen at the front and fatalities on both sides have averaged around 50 a year since 1993. But the real losses could be significantly higher since it is only recently that civil society has begun to monitor losses independently.

It must also be admitted that the location of the conflict (at the crossroads of Europe and Asia, east and west, and north and south) automatically increases the number of geopolitical actors involved in the search for a resolution. The great powers and the region's larger neighbours have their own national and political interests that often conflict with one other. It can be said without exaggeration that a political solution to the NK conflict will not be attained in the near future.

New problems continually arise. Of course, it is tempting to report that there is a movement of the two peoples towards one another and that trade between them humanises the conflict, but it is difficult to estimate the value of such localised human contacts. Real commercial relations, whether through necessity or desire, only hinder the exacerbation of the conflict in a virtual sense.

The Armenia-Azerbaijan conflict is a 'popular' topic on websites, a fact not readily noted in Sadakhly due to its limited access to the Internet. This continuation of the conflict in cyberspace includes participants from all over the world. For example, when the Armenian lobby wanted the US Senate to table a special resolution in April 2003 on the 'genocide' of Armenians in the Ottoman

empire, congressmen received more than 1,000 letters from Azerbaijanis asking Congress to include an amendment mentioning the massacre of Azeris in Khodzhalı, NK. The most popular forum on the website of the Russian newspaper *Nezavisimaya Gazeta* in May was dedicated to the Armenia-Azerbaijan conflict. It attracted 11,000 visitors, while the most acute problems of modern Russia rarely attract more than 750. The participants in such forums are mostly young people. Though *Nezavisimaya Gazeta* warns visitors not to offend others with their contributions, opposing groups attack one other with such vehemence, they might have just returned from the battlefield. This information war by proxy – with all guns blazing – is rearing a new generation, irrespective of place of residence, on the principle of a supposed national duty to triumph over the enemy. Victory remains virtual, but the hatred generated is real.

These proxy battles on the Internet should be the focus of serious research since they may threaten the formation of economic and cultural relations between the conflicting parties, even as they germinate.

The West places great emphasis on economic integration and active trade between Armenia and Azerbaijan as one of the chief instruments of fostering peace. These suggestions include opening a Baku-Nakhichevan-Yerevan-Gyumri-Kars railway link, though the Armenian government is lukewarm about the project. The deputy director of Armenian railways recently said at a conference in Baku that if a rail link were needed with Nakhichevan, it could be serviced by the Baku-Idjevan-Yerevan-Nakhichevan line – in other words, avoiding the Azerbaijani territory occupied by Armenia which remains the main focus of negotiations and would need demilitarisation for the new link to be realised. The overtones were obvious. Meanwhile, Georgia actively lobbies for the construction of a Tbilisi-Kars railway line on the understanding that rail connections between Azerbaijan and Turkey should run through Georgia.

Disregarding all the rhetoric about the peaceloving or aggressive nature of this nation or that, it must be noted that Armenia is currently very interested in economic cooperation. No one argues today that economics will not eventually overcome conflict in the long-term, but is it really true? Firstly, society still remembers the conflict and politics serves as a constant reminder in those places where it might have been forgotten. Secondly, for economics to resolve conflicts would require a large amount of foreign investment, which is not yet forthcoming.

As noted at the outset, the Armenian news agency ArcNews estimates that unofficial trade between Azerbaijan and Armenia had reached an annual turnover of \$40 million by the middle of 2002. Armenia imports petroleum and cotton fibre from Azerbaijan and exports electronics, light industry and processed food products. Most of these exchanges are realised through Georgia and Iran. Trade between Armenia and Turkey, which also do not have diplomatic relations, has reached \$60-80 million per year according to some sources (a

figure as high as \$450 million has also been suggested). These numbers can hardly be taken at face value and do not withstand close analysis. Azerbaijan has barely \$60-70 million in trade with Ukraine and China, and trade with Poland does not exceed \$10 million.

Even if it is allowed that these numbers are based on realistic accounting, the effect of such information is purely propagandist. The economic situation in Armenia is clearly abnormal, and the country has only two real trading partners, Russia and Iran.

Armenian society does not view the opening of the Armenian-Turkish border as a positive development, because the domestic market would be flooded with inexpensive products and its territory overrun with Turkish trucks. Turkish capital would buy up enterprises, resulting in an influx of Turkish citizens who, in turn, could act in the interests of Turkish intelligence. Moreover, Turkey cannot easily ignore the interests of its close strategic ally, Azerbaijan, which closely monitors Turkish-Armenian relations. Azerbaijan would certainly not be indifferent to a unilateral opening of the border by Turkey, which could lose its main trading partner and power base in the Caucasus, and even access to the markets of Central Asia. It is possible that the Armenian-Turkish border will be opened under pressure from the West, but this would create a rift between Azerbaijan and Turkey if the NK issue were to remain unresolved. It is hard to imagine how – and at whose cost – this deadlock could be broken.

Azerbaijani economists consider Armenia's desire to build commercial and economic relations with Azerbaijan and Turkey understandable. Armenia is rapidly losing control of its own economy, ceding controlling shares in many of its largest enterprises to Russian companies on debt-swap deals agreed between the two governments. The country is 90% dependent on Russian and foreign energy supplies, and Armenia has been excluded from the Caucasus' largest economic projects.

Considering that Armenia produces next to nothing, and that its wages level and social services are extremely low, its consumer market needs cheap products from Turkey and Azerbaijan. For this reason, Armenia is trying to find a way of cooperating economically with Azerbaijan and Turkey. A certain amount of hope has been placed on Azerbaijan and Armenia's entry into the WTO, which would seem to imply the resumption of commercial relations as member countries. But Azerbaijan has not joined the WTO yet and has insisted at every level of negotiation that it will not establish commercial relations with Armenia before a solution to the NK conflict is found.

Having thus assessed the prospects for cooperation between Armenia and Azerbaijan, and conflict transformation in NK, we now summarise the results of the Sadakhly market study.

Firstly, the scale of the market's activities demonstrates that the potential impact of 'small' economic projects on finding a solution to the conflict is not as

significant as expected. The operation of the market is not a restraining factor on the conflicting parties. This is evident from the fact that the market's most active time was during the worst, most violent, period of the military conflict. Trade at Sadakhly market was then very profitable indeed.

Secondly, the market exists in a third country, a de facto neutral zone. In this sense, the same 'normal' relations can be observed as at any Russian market where Armenians and Azerbaijanis work side by side. Inter-ethnic relations at Russian markets are perhaps warmer because traders are more removed from the conflict zones. Geographic proximity to Sadakhly market is not as important as it might otherwise be, because residents of Azerbaijani regions bordering Georgia do not work there.

Thirdly, the market is primarily for the peasantry who have no influence on political processes. Administrative and commercial elites from all three countries play an integral role, but for the people near the market Sadakhly remains primarily a survival strategy.

Fourthly, new political and economic conditions are in the process of forming that may lead to the disappearance of Sadakhly market altogether. This model of economic interaction may prove to be too vulnerable in the contemporary economic, legal and political environment of the South Caucasus.

Fifthly, direct trade between Azerbaijan and Armenia does not exist apart from illegal trade through middlemen and intermediaries. Most commercial operations between the two countries are realised through Georgia, and are accounted for under statistics on Azerbaijani-Georgian or Armenian-Georgian trade. As a result, Sadakhly market cannot be said to ensure the institutionalisation of economic cooperation between Armenia and Azerbaijan.

The future status of Sadakhly market is viewed in the following manner. When the countries of the South Caucasus dig themselves out of their current economic crises, industry will pick up, new employment opportunities will be created and the need for the market will disappear. At present, the market is vitally important for Azeris and Armenians living in areas around the market, but all of the situations detailed above – monopolisation of the trade, the development of border trade between Turkey and Armenia, the opening of the new highway, the outlawing of border trade – threaten to lessen its future importance. However, there is a possibility the market could adapt to these changed conditions, for example, by becoming more 'civilised'. The one infallible plus that Sadakhly market exhibits – the morale factor – dictates the need for this. This atmosphere of permanent communication could be of great importance in future, but only if the market changes from a place where the poor earn their crust in sweat (and dirt) to a scene of dignified, enjoyable and profitable trade – if the conflict is brought to an end. Inequalities in prices and the varied availability of goods in the

countries of the South Caucasus will remain for some time to come and, in this sense, the border trade may also remain a profitable enterprise.

In the newly forming conditions, a more civilised market will eventually take shape. This will require asphaltting the territory of the market, setting up modern glass booths and the complete separation of the wholesale and retail sectors. Conditions must be created where people openly offer each other what they do well, and their neighbour does poorly. This is where investment is needed if the world really wants a peaceful South Caucasus.

Endnotes

¹ *Zerkalo*, 20 August 2002.

² *Statistical Yearbook of Azerbaijan*, 2000.

³ As documented by Vladimir Kazimirov, Special Representative of the Russian President at the end of 1992; Turan news agency, 21 December 1992.

⁴ *Statistical Yearbook of Azerbaijan*, 2000.

‘The economic dimensions of armed conflict are often overlooked, but they should never be underestimated. The role of business, in particular, can be crucial, for good and for ill.’

UN SECRETARY GENERAL KOFI ANNAN, SPEECH TO THE SECURITY COUNCIL, 15 APRIL 2004.

This volume of papers is the result of an 18-month research project exploring the links between economy and conflict in the South Caucasus. Brought together by the conflict transformation NGO International Alert, the authors are all from the South Caucasus region, covering Armenia, Azerbaijan, Georgia, Turkey and including Abkhazia, Nagorno-Karabakh and South Ossetia. Together they make up the Economy and Conflict Research Group of the South Caucasus (ECRG).

Each chapter has its own individual perspective on the dynamics between economy and conflict. Collectively they offer economic-oriented insights into the challenges facing those living and working in this conflict-affected region. These insights are offered as a contribution to those working to help find ways of resolving conflict, including governments, the international community, business and civil society groups.

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