

# ECONOMIC AND STRATEGIC STAKES IN THE CASPIAN ENERGY MARKETS

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## **Overview**

One axiom of the post-Cold War order is that the international system has moved from an uneasy stasis to chaotic fluidity. In this much altered climate, certain regions which once languished in relative obscurity behind the Iron Curtain are now garnering far greater attention. The Caspian region is a case in point. As countless articles in the Western press have suggested, the Caspian is attracting increasing attention from business leaders and strategic thinkers alike who see the region in terms of its great economic potential but who worry about the strategic challenges it poses. The confluence of opportunity and risk as well as the apparent interest of the world's most powerful countries in the region has inspired some to describe what appears to be the emerging rivalry for influence and riches as a reincarnation of the Great Game - the strategic rivalry between Victorian Britain and Czarist Russia for the riches of India and the East.<sup>1</sup>

Such comparisons, while convenient and certainly intellectually stimulating, can also be misleading. As a point of departure, it would be ill-informed to use any colonial paradigms to describe the situation in the Caspian region and, by extension, to assume that the region's governments will be passive players in the now developing "game". To the contrary, the states around the Caspian, while beset by daunting internal problems, are deeply marked by the region's past inclusion in the empires of distant states and consequently seem determined both to preserve their newly gained sovereignty and to ensure a degree of control over their economic development. The interest of some outside actors like Europe and the United States, moreover, lies not only in the development of the region's energy potential and in insuring their own access to that energy. Their policy also recognises that their economic and strategic goals are most likely to be achieved if stable, self-confident countries emerge along the Caspian littoral which are capable of advancing economic and democratic development, promoting peaceful relations with their neighbours and preventing their own subjugation at the hands of any single outside player. Thus one distinctive element of the current Great Game is that local players want to ensure that no

single outsider exercises regional hegemony, while some outsiders want to see the emergence of sufficiently resilient, stable and democratic societies capable of entering the global economy with confidence. This is not to say that a clash of interest is not in evidence. The region is beset by clashing interests, and keeping a lid on this cauldron while developing its energy potential represents its greatest challenge.

## **Strategic Issues**

Indeed, the Caspian-Caucasus is a region of almost unspoken instability and upheaval. This area has witnessed some of the worst violence to befall the successor states of the Soviet Union. The region's borders are ill-defined, and, decades ago, Soviet leaders made sure that the borders of the region's Republics did not coincide precisely with ethnic and religious divisions.<sup>2</sup> Once the Soviet Union collapsed, the consequences of this policy became evident. War and civil strife broke out throughout the region in Chechnya, Nagorno-Karabakh, Georgia, Dagestan and most tragically in Chechnya. Turmoil on this scale has helped draw great powers into the region but has also inspired a degree of circumspection on the part of foreign investors who must carefully weigh risk and opportunity. Not surprisingly, the Caspian is sometimes characterised as a buffer zone between Russia and Middle East or as an energy-rich "vacuum" that the laws of physics and international relations suggest is unsustainable; the Great Powers driven by their economic and strategic interests will, in this view, invariably be drawn in.

The states around the Caspian littoral are deeply insecure; the region itself is unstable, it has long been dominated by outside powers and there is a sense that these outside powers aspire to reassert some degree of control over it, particularly given its energy potential. While several of the region's leaders enjoy decent relations with Russia, others like Azerbaijan's President Heidar Aliyev worry that Russia's traditional hegemonic aspirations are driving Russian regional policy. President Aliyev's concerns, of course, are partly inspired by Russian support for Armenia in its struggle with Azerbaijan, and this has inspired his government as well as several others to turn to the West not only for investment, but also security.

## **Russian Interests**

Russia has many interests in the Caspian region, and these interest are obviously a critical element behind the government's decision to wage a relentless war in Chechnya. Nevertheless, Russian leverage in the region as a whole has waned to a certain degree. Iran, Turkey and China have emerged as more important trade partners with the region and the West is playing an ever more important role in the region's energy sector.<sup>3</sup>

The Russian view of the Caspian is also a fractured one. While ultranationalist groups advocate reasserting Russian hegemony in the region, more sober-minded Russian gas and oil industrialists want to play a key economic role there without necessarily reasserting sovereignty over former Soviet territory. The business elite, which supports key political groups operating in Russia, is perfectly willing to exploit the fact that the Caspian pipeline infrastructure is largely oriented toward the markets of the former Soviet Union. For Russian industrialists, this pre-existing condition has been greatly advantageous, and has granted them leverage over potential competitors. Above all, the Russian energy moguls want to ensure stable export markets for their oil and gas, which is a vital source of scarce foreign exchange earnings and tax revenues for the Russian state and windfall profits for them. Russian business thus sees the Caspian region as ripe for development for large energy concerns like *Gazprom* and *LUKOIL* but it also fears competition from region gas and oil producers.

Both the Primakov and Putin government have seen the Commonwealth of Independent States (CIS) as a potential source of stability in the Caspian, although that moribund body has hardly fostered strategic coherence. Moscow is also strongly opposed to the extension of NATO or American security guarantees to Caspian regional actors and has reacted with anger to Georgian and Azeri aspirations to engage NATO help in defending local energy infrastructure.<sup>4</sup> Pipeline politics in Russia are thus complex, and companies such as *Gazprom* play an active (and sometimes contentious) role in Russian politics.<sup>5</sup> These firms do not intend to lose vast potential markets in Turkey and Europe to Caspian producers. *Gazprom's* European income, for instance, compensates for the losses in the domestic market where barter is the predominant form of payment. In the words of one analyst, "*Gazprom* and the whole of the energy sector subsidizes the rest of the Russian economy."<sup>6</sup> Moscow's economic interest in the region is thus unlikely to wane as long as such a substantial component of its income is generated by the oil and gas sectors.

For its part, the Russian military in recent years has not been particularly focused on energy issues at all, but rather has expressed anxieties that instability on Russia's southern borders would spill into Russian territory where overlapping ethnic and religious divisions have the potential to explode into more serious strife.<sup>7</sup> This, of course has already happened in Chechnya and Dagestan, and the grave difficulty the Russian state's has confronted in reasserting its authority in those cases underscores the complex challenge it faces in preserving a strategic foothold in the region and the potential dangers that could pose to other states in the region. It is worth mentioning that Russian troops are currently based both in Armenia and Georgia and have actively supported ethnic Armenians in the war over the enclave of Nagorno-Karabakh.<sup>8</sup> In short the existence of important gas and oil reserves, the fact that there are Russian minorities living in the region, and an historical legacy of a strong Russian presence there ensures

that Russia will continue to discern important national interests in the Caspian and Transcaucasus.<sup>9</sup>

Russian tactics in the region compound its difficulties. The war in Chechnya is unlikely to produce any long-term solutions and Russia has been accused of fomenting ethnic disputes in countries, like Azerbaijan, which have refused to co-operate with Russia on an array of economic and strategic issues.<sup>10</sup> But if this is the case, they are playing a risky game as ethnic battles are hard to control, risk drawing in other powers, and can raise international stakes in local conflicts. The oil and gas factor obviously compounds this already dangerous problem. At the same time, if the “Islamic Revival” in the Middle East has abated somewhat, it is just beginning to gather strength in Central Asia. Russia is not well positioned to contain these forces and seems to offer the region very little to fill the vacuum left by the Soviet collapse.

## **American Interests**

The United States could never benefit directly from Caspian gas, and even oil from the region is more likely to be shipped to Europe and Asia than to the United States. But oil, of course, is a fungible commodity, and new discoveries in one part of the world will drive down global prices. Thus, as a net energy importer, the United States sees economic benefits from the development of the region’s energy potential. That American multinationals, like *Amoco Corp.*, which have invested heavily in Azerbaijan’s oil development, are seeking to play a key role in this development is also a critical component of the US government’s perspective on the region. US industry has already invested more than \$2 billion in the three largest oil producers in the region, and will certainly invest much more if exploration yields results.<sup>11</sup> The United States has also been a guarantor of international access to fossil fuel, and as such, naturally perceives an important set of issues at stake in the Caspian region.

The American strategic vision is partly shaped by an optimistic view that some modicum of stability can be achieved for the Caspian partly through a much enlarged Euro-Atlantic Community. This community would extend into distant Central Asia, and overlaying institutions like NATO’s Euro-Atlantic Partnership Council (EAPC), the Organisation for Security and Co-operation in Europe (OSCE) and the EU would all contribute to regional integration. Indeed those institutions are all playing a role in the region. It should be noted that NATO relations with the Caspian began with the signing of the Conventional Forces in Europe (CFE) treaty in 1990. Following the Soviet Union’s collapse, NATO established deeper security contacts through the Partnership for Peace (PfP) and the EAPC, and the region’s forces have subsequently participated in joint exercises.

It is also true, however, that the United States wants to ensure that Russia is not in a position to dominate the region militarily and economically. American officials have expressed deep concern about Russian conduct of the war in Chechnya, and US policy is clearly aimed at creating alternatives to Russian hegemony for regional actors.

The Americans have also long sought to isolate Iran, but Europe is not likely to be a willing partner in such a policy, particularly if the government in Tehran continues to move in a moderate direction. Indeed, the US view of Iran differs from that of Europe, which has already begun to restore diplomatic relations with Tehran to encourage the Khatami government, which is proving more reasonable than its revolutionary predecessors. Khatami's lifting of the Fatwah against the British writer Salman Rushdie and moderate victories in recent local elections could mark a turning point in the European-Iranian relationship. In March, Iran signed a \$1 billion deal with *Elf Aquitaine* and *ENI* to refurbish the Doroud offshore field in the Gulf which suggests that American efforts to restrict large foreign investment in Iran have partly broken down.<sup>12</sup> The US approach to Iran is far more cautious, and the Iranian leadership equally worries that any lessening of traditional anti-American rhetoric would invite the wrath of Iran's conservative clerics who still exercise great power in Iranian society. Finally, the US policy in the region is also informed by other national interests and aims particularly at halting the growing transshipment of arms and drugs.

## European Interests

European interests in the region are largely, though not exclusively, economic. Its energy companies are investing in countries which they anticipate will become major exporters of energy to Europe. European leaders would not claim at this juncture to have fundamental geo-political interests in the region. The European Union is seen as a generally positive presence in the region, and has worked to foster a greater degree of regional co-operation. But until Europe has the machinery for developing and carrying out common foreign and security policies, its activism will be somewhat limited and its most high-profile players will come from the business community. Europe, however, welcomes the opportunity to develop new sources of energy in order to reduce its reliance on Middle Eastern and Russian energy and European governments provide diplomatic support for their energy companies operating in the region. Like the United States, the European Union hopes to help foster regional stability and promote the development of democratic institutions in these new states.

Europe has a long history of exchange with the region, and the European Union's Transport Corridor Europe-Caucasus-Asia (TRACECA) initiative to upgrade regional transport infrastructure suggests that many European leaders expect to use these traditional commercial ties as a foundation for a common policy toward the region.<sup>13</sup> Most EU governments would not object strenuously

to the construction of a pipeline through Iran even though the United States is strongly opposed to doing so. This is obviously an important source of division between Europe and the United States, and the Europeans have complained bitterly about the threat of US imposed sanctions on companies doing business with Iran.

## **Turkish Interests**

Turkey's interest in the region is far greater than any other European or North American state. It shares a common cultural and linguistic heritage with the dominant ethnic groups of several Caspian states, and these ethnic ties underpin Turkey's economic, strategic and environmental interests. Turkey undoubtedly sees the Caspian, Southern Caucasus and Central Asia as regions where it can and should be a player. Some argue that Turkey's sometimes uneasy relationship with Europe gives it few options but to increase its activism in the region. But the EU-Turkish relationship is rapidly improving so this contention may no longer be relevant. Last summer the Turks called for a NATO-led peace force in the Caucasus region, something which the Russians strenuously opposed.<sup>14</sup>

Turkish relations with the states of the region are generally quite good, and Turkish entrepreneurs are operating with some success in the Caspian. Indeed, Turkey has emerged as a leading investor in the region. Turkish firms are working on both energy production and transportation projects that could bring profits to investors, while helping Turkey meet its ever-mounting energy demand. Turkey currently enjoys a trade surplus with the Caspian states. The government clearly hopes to develop new sources of energy supply to meet rapidly expanding domestic demand and to emerge as a key energy transshipment hub for both economic and strategic reasons.

The Turks are also strongly opposed to increasing oil transshipment through the already crowded Turkish Straits, fearing that an accident would pose a serious hazard to millions of Turks living along the shores as well as to the priceless historical, cultural, and environmental patrimony of that coastline.<sup>15</sup> The Turkish Straits simply cannot absorb any more tanker traffic. Partly, for these reasons as well as broader strategic interests, the government favours transshipment through the Mediterranean, and have endorsed the US-backed projects like the Baku-Ceyhan pipeline. The Turkish, Azeri and Georgian authorities have recently signed four agreements to undertake this project and on 18 November 1999, the Presidents of Azerbaijan, Georgia and Turkey and Kazakhstan signed the Istanbul Declaration to complete this project by 2004. US President Clinton signed these agreements as a witness but there is now a dispute with Georgia regarding future transshipment fees. At the same time, Turkey has made arrangements with *Gazprom* to initiate the "Blue Stream" project which would supply Turkey via a pipeline through the Black Sea. *Gazprom* is

competing with Central Asian countries for the access to, and possible control of, the Turkish gas market.

## **Iranian Interests**

Iran too perceives vital strategic and economic interests in the Caspian, and its leaders are certainly disposed to use religious ties to further their ends. In fact, their rivalry with Azerbaijan's secular government does have religious overtones, and the Iranians have willingly exploited the fact that most Azeris are Shiite Muslims. The Iranians would like to play a role in moving Caspian energy to market. They oppose American-supported projects which would make Baku the focal point of Caspian energy exports. Iranian ambition will thus continue to meet American resistance. Iran is also conducting important trading relations with several of the region's states. For example, it is undertaking oil swaps with Kazakhstan, whereby Kazakhstan supplies crude oil to northern Iranian refineries in exchange for Iranian oil deliveries in the Persian Gulf, which can then be exported on world markets. Since Kazakhstan is not investing directly in Iran and because the trade is in hydrocarbon swaps, it has so far skirted the American sanctions regime. Turkmenistan has built a natural gas pipeline to Iran which links its western fields to industrialised northern Iran.<sup>16</sup>

## **Chinese Interests**

Surprisingly, China has also become an important player in the region. It hopes to develop new sources of energy to meet rising domestic and Asian demand and to reduce its dependence on ocean-bound energy imports. China has been building up its naval forces partly to guarantee continued access to imported energy; yet it is looking for other energy options as well to ensure, for example, that a naval blockade could never paralyse the national economy. It is precisely this logic that allows the Chinese to justify such massive projects as the *Three Gorges Dam* which is costing billions of dollars but which, on paper, should give China new energy options. This same rationale partly accounts for Chinese policy in the Caspian. It has been the largest investor in Caspian energy projects and is now developing plans for an extremely long pipeline to help meet burgeoning national gas demand. But like Russia, Chinese regional policy must also contend with the emergence of Turkic speaking states that could galvanise its own discontented and culturally oppressed Turkic minorities living along the Tajikistan, Afghanistan and Kyrgyz Republic's borderlands. So far, however, Turkic states have sought to ease tensions with China. In the Fifth Turkic Summit in Astana, Kazakhstan, Uzbek President Karimov cautioned that Turkic unity had limits, noting that supporting the Uighur minority would endanger relations with the "Great China".<sup>17</sup> China, like Russia, does not welcome greater NATO engagement in the region.

## **Energy Markets and Oil and Gas Reserves**

World oil prices will remain a critical variable in Caspian economic development. From January to December 1998, global crude prices fell to around \$11 a barrel.<sup>18</sup> This price collapse precipitated industry-wide restructuring which dramatically stretched out exploration and development schedules in the Caspian.<sup>19</sup> Production elsewhere in the world was on the rise and, because oil is a fungible commodity, increased production contributed to falling prices globally. So too did declining demand, which reflected not only more efficient consumption patterns, but in recent months, the downturn in Asian economic growth. Low prices combined with the very high cost of building certain proposed pipelines seemed to render the possibility of rapid energy development highly problematic. Large oil companies were well aware of the risks, both economic and political, and tend to make investment decisions with great caution.

Several recent unsuccessful exploration drills have reinforced investor caution. Although Azerbaijan has been producing oil for over 100 years, its recoverable reserves in fields now under production is only 2.6 billion barrels. Recent exploration has turned up more gas than oil. This is not good news for Western drilling consortia as there is no large domestic market for gas and no pipeline in place to export it to markets of dynamic demand.<sup>20</sup> Exploration in Azerbaijan is currently concentrated on the very deep Shah Deniz reservoir near Baku.

On the other hand, the rise of the price of oil to \$22 a barrel once again has forced investors to reassess prospects for the region. The promise of a sufficient return on investment as well as government encouragement explains why the Baku-Ceyhan pipeline agreement was recently signed.

Yet while prices may be high today, potential investors are unlikely to forget the recent free-fall of oil prices and are now disposed to proceed with greater caution in the Caspian. Given today's price uncertainty, it often makes more sense to continue investments in geographically favoured states with proven oil reserves, such as Saudi Arabia, than risk developing production and distribution facilities in a region fraught with supply and political uncertainties., Saudi Arabia in particular is pursuing a policy to discourage investment in the Caspian, so that it may retain its jealously guarded place as the world's first supplier of petroleum. Caspian oil politics are hence tied not only to a regional "Great Game", but also to global oil politics.

## **Pipeline Politics**

Oil is virtually worthless without a means to move it to blue water, and gas is a valueless commodity without a pipeline grid to deliver it to consumers. Currently Caspian oil is pumped through two small pipelines that end in the Russian Black Sea port of Novorossiysk and the Georgian Black sea port of Supsa. Neither of these pipelines has sufficient capacity to accommodate a

dramatically increased flow of oil, and there is still the problem of getting this oil to blue water. Turkey strongly opposes increased tanker traffic through the crowded Turkish Straits for safety and environmental reasons, and has announced that the number of tanker crossings in 1999 will be cut - a move which put some pressure on oil companies to move more rapidly to a financing arrangement on the Baku-Ceyhan pipeline.<sup>21</sup> The AIOC, a *BP-Amoco*-led consortium had wanted to increase the volume of oil pumped through the recently upgraded Baku-Supsa line, while the Azeris want a guarantee of that company's support for the eventual construction of the line to Ceyhan which will be needed if a significant quantity of oil is pumped.<sup>22</sup> The AIOC initially saw this option as far too risky given the level of proven reserves in the Caspian, but the oil price hike has helped change its posture. The US Ambassador initially insisted that Turkey would have to compensate companies for cost overruns on the estimated \$2.4 billion project.<sup>23</sup> The United States was worried that further delay on the Baku-Ceyhan pipeline would lead to the construction of other pipelines which would invariably render it less justifiable in cost terms. The American government sees this proposed pipeline as a prized strategic asset, and this is precisely why the administration pushed so hard for its construction.

Naturally economic factors are critical to shaping decisions about new pipeline construction. Firms financing those pipelines need to assess both the potential volume of oil or gas that might be pumped through the system and the price that energy will command on the market. Getting exports to the international market from the eastern Caspian would cost up to \$7 a gallon, and Turkmenistan and Kazakhstan need oil prices at \$15 a barrel to make their oil economically viable.<sup>24</sup> Some optimistic proponents of various projects use numbers which intimate that a particular pipeline would command a high percentage of all the oil or gas produced in the region. But if several pipelines are built, those optimistic figures would change dramatically, and the potential volume for any one pipeline would consequently fall. There is also the fact that Caspian proved oil reserves are still relatively low and may not justify the huge outlays needed to build a complex pipeline infrastructure. If world demand is slack and if oil production remains relatively cheaper for the foreseeable future in regions like the Middle East and the North Sea, then investing in expensive pipelines in the Caspian region may not seem particularly attractive over the short to medium term. Furthermore, any eventual lifting of sanctions on Iran and Iraq would further depress world oil prices, and could therefore further delay much needed investment in the Caspian.

One must also consider the inherent risk of laying pipelines across politically unstable regions where warring factions might possess the means and motives to attack pipelines. The recent turmoil in Dagestan and Chechnya raises new concerns about a Baku-Novorossiysk pipeline, traversing the troubled northern Caucasus.<sup>25</sup> Throughout last year, there were repeated interruptions of oil flow in Chechnya, a development which in April prevented Azerbaijan's *SOCAR*

from selling any oil. It then renegotiated prices with Russian pipeline operator *Transneft* in May. Unfortunately Russian policy in the Caucasus has failed to resolve the litany of problems besetting the region, including the rise of fundamentalist, Islamic movements, crime and attacks on the pipelines. The use of Islam as an ideological weapon by both insurgents and the Russian government is likely to perpetuate the Caucasus crisis.<sup>26</sup> Georgia is quite wary of Russian intentions in the region, particularly in light of Russian support for Abkhazi separatists. Accordingly the government of Eduard Shevardnadze supports the development of new pipelines to reduce its reliance on Russian infrastructure. Shevardnadze told journalists in Tbilisi on 22 February that a “special unit” had been created to guard the Baku-Ceyhan pipeline.

To understand the political-geographical-economic dimensions of the pipeline problem, it is first necessary to recognise the fundamental technical difference between oil and gas pipelines. Oil pipelines can deliver crude oil directly to refineries or to transhipment points where it is loaded on ocean faring ships for distant delivery. Gas pipelines, however, must deliver energy directly to market. There is therefore no global market for gas; only regional markets exist. Perhaps the most dynamic potential market for Caspian gas is Turkey, and Turkish energy needs are expected to grow significantly over the coming twenty years. Turkish consumers already suffering from energy shortages, and electrical brownouts are relatively common. The dilemma, of course, is that a large gas producer, like Turkmenistan is remote, and pipelines will be expensive to build. The signing of the Turkmenistan-Turkey-Europe Gas Pipeline agreement in October 1998 is a step both toward helping Turkey meet its energy needs and linking Turkmenistan to dynamic gas markets. In November 1999 a “Declaration of Principals on Intergovernmental Agreement for Implementation of the Trans-Caspian Natural Gas Pipeline Project” was signed by the Presidents of Turkmenistan, Azerbaijan, Georgia and Turkey. The emergence of Azerbaijan as a producer of gas may eventually pose a challenge to countries like Turkmenistan, which rely on Azerbaijan for transit facilities.

It is tempting to understand the laying of pipelines for the delivery of Caspian gas and oil as simply posing a strictly economic and technical set of challenges. But to do so is fundamentally misleading. Politics and strategic calculations are playing a fundamental role in this arena as well. Indeed, international pipeline construction tends to be driven as much by strategic and political considerations as economic ones. The Chinese, for example, have signed a memorandum of understanding to build a 3,000 kilometre multibillion dollar gas pipeline from Kazakhstan to the Chinese province of Xinjiang.<sup>27</sup> This represents an extraordinarily expensive infra-structural investment that may never pay economically. But as suggested above, the Chinese feel a strategic imperative to diversify their energy sources and open new alternatives to reduce their current need to import energy through the South China Sea. It should be noted that the Chinese do not sharply

differentiate economic and strategic objectives. Many analysts have argued that strategic interests are a critical impetus to building the Baku-Ceyhan pipeline.

## **Russian Influence and Pipeline Projects**

Clearly many Caspian states want pipeline grids that will give them options other than exporting through the Russian system. Relying on the Russian pipeline system has not been a happy experience. There is evidence that some Russian officials use Caspian reliance on this pipeline system to dictate commercial terms to them. For example, Russia granted Turkmenistan access to its pipelines provided Turkmeni officials agreed only to sell in bankrupt CIS states, while *Gazprom* kept for itself clients in Western Europe capable of paying hard currency for their energy bills.<sup>28</sup> Russian officials thus see Caspian states as potential competitors to its leading energy firms, like *Gazprom*, which, it cannot be forgotten, are critical to state financing.

The problem for the Russians is that such blunt use of its infrastructural leverage is actually encouraging the construction of alternative pipelines that will reduce this leverage over the long term. If Russia wants to remain a player, it will have to extend relatively equal treatment to Caspian producers while beginning to tackle the many organisational and regulatory deficiencies which make its system so unattractive to foreign oil and gas producers.

## **The Baku-Ceyhan Pipeline**

Turkey wants pipelines to help it meet national energy needs, bolster its own regional strategic leverage, diversify its supply base and lower the risk of environmental and traffic-related catastrophe in the Turkish Straits associated with the potential for more oil tanker traffic through those extraordinarily crowded and narrow waterways. Like the Americans, the Turks are also strongly advancing the case for a Baku-Ceyhan pipeline, arguing that this would provide a safe economical and environmental means of bringing oil to the Mediterranean. The proposed Baku-Ceyhan line would provide an alternative to transporting oil across Iran or through the Russian pipeline system.<sup>30</sup>

Azerbaijan, Georgia, Kazakhstan and Uzbekistan have all announced their support for the development of the Baku-Ceyhan line which ideally would move 50 million metric tons of oil per year to the Mediterranean,<sup>31</sup> and the United States has offered Turkey \$833,000 to support the planning process.<sup>32</sup>

## **The Local Economies**

Post-Soviet Caspian economic development is so far a story of misplaced expectations. The legacy of Soviet rule continues to burden the region's

economies. Decades of misallocated capital, irrational pricing, centralised control and highly inefficient energy drilling techniques have left their mark. Exploration contracts signed by the Soviet Union with international businesses were terribly disadvantageous to the region, and only recently have governments begun to demand contract re-negotiations.

While the signing of oil and gas contracts has created a new class of extremely wealthy power brokers throughout the region, most inhabitants live in poverty. Unemployment and decay are apparent everywhere, and if anything, the region has suffered from de-industrialisation over the last decade. War too has left its mark, not only in terms of added budgetary pressures, but in uprooting entire regions and creating serious refugee problems. Baku, for example, has seen an enormous influx of refugees from the war with Armenia, and their presence has placed an enormous burden on that city's creaking social services and housing infrastructure. The effects of the war in Chechnya will be felt throughout the region for years to come.

The legacy of Soviet economic rule is not a happy one. Decades of capital misallocation and price distortion have left an almost indelible mark on the region's infrastructure which is uniquely ill-suited for the rigours of global competition. There is, for example a marked shortage of drilling platforms and equipment in the region, and there are few prospects that this situation will change quickly. The high costs of bringing in the right equipment constitutes a genuine bottleneck to energy exploration, and this is why it is taking so long to follow up on signed contracts.<sup>33</sup> Moreover, the old industrial base of the region was oriented for trade with the Soviet empire, and that empire no longer exists. The collapse of traditional markets has been devastating, and the obliteration of the social welfare, public health, and educational systems that the Soviet Union offered has led to a crisis of expectations that tempts broad social unrest. School-leaving age has declined drastically throughout the region, and thus the human capital so important to long-term economic development is not being sustained. That the region's educational systems are producing unskilled labour with no job prospects obviously has long-term implications for political stability.

It is far from certain that even if the region becomes an important exporter of energy, this will have a necessarily munificent effect on the society as a whole. Some have characterised the extractive energy business as conforming to a classic enclave-style pattern of development in which "backward linkages" to the rest of the economy can be quite limited. Moreover, there is also a risk of eventually catching "Dutch disease", an economic malady in which the value of the local currency rises as a result of large oil or gas exports. But this appreciation renders locally produced manufactures and agricultural goods less competitive on international markets, a process which can hasten de-industrialisation and put farmers out of work. Indeed, rapid currency appreciation often makes imported food cheaper than domestic food. The sudden loss of

farmer income, in turn, can create tremendous social and economic polarisation, mass internal migration to cities and, ultimately, political instability. It should be noted, in addition, that agriculture in the Caspian region has already suffered enormously since the collapse of the Soviet Union. This has placed even greater burdens on the leaders of countries which are proving unable to feed themselves and lack the foreign exchange to buy sufficient quantities of food on international markets. Food expenditure has accordingly risen to 70% of household income, and malnutrition is on the rise.<sup>34</sup>

Insofar as national economies come to rely on the export of a single commodity, externally induced commodity price shocks can have disastrous implications on rigid economies which have few means to “hedge their bets” against such developments. This is particularly true for those countries which are not able to save a high percentage of commodities-generated revenue and which face political pressures to spend those earnings as quickly as they enter the national coffers. The World Bank and IMF are working with Azeri officials to develop the necessary infrastructure to handle an influx of petrol dollars. The Caspian region is also notoriously inefficient in energy use. It requires roughly 1.2 tons of oil to produce \$1,000 of GDP, compared to an efficient country like Norway where the ratio is 0.2 tons of oil to \$1,000 of GDP.<sup>35</sup> This suggests that without important structural change and micro-economic adjustment, the countries of the region may be compelled to consume an unduly high percentage of their primary foreign exchange earning commodity.

The low level of regional economic activity has driven many to turn to the black market and criminal activities. Heroin smuggling has become a big industry in the region. Afghan opium is moving through Tajikistan and Turkmenistan, while poppy production is rising in Kazakhstan and the Kyrgyz Republic. Undoubtedly the lack of economic opportunity is contributing to the corruption and criminalisation of local economies, a development which is rendering the prospects for putting local economies on a solid footing all the more remote.

Aid and capital inflows to the region have been paltry. The IMF has provided some assistance, as has the World Bank’s recovery programme. Strict IMF conditionality has put several governments in the tough position of either cutting away the tattered vestiges of public welfare or facing loan termination. Uzbekistan, for example, lost access to IMF credits when its budget deficits soared.<sup>36</sup> Last summer the IMF warned Azerbaijan that restructuring agriculture, creating stronger financial institutions, regulations, and budget cuts are essential to macro-economic stability, particularly given the country’s dependency on uncertain oil prices.<sup>37</sup>

The Caspian region is rife with political problems. The collapse of the Soviet Union did not herald the coming of democratic order, and many of today’s elites were yesterday’s apparatchiks. The groups that gained power have tended to cling to it, and the absence of party alternation in government and the varying degrees of repression in countries like Kazakhstan, Azerbaijan, and Turkmenistan

have only spawned endemic corruption and alienation. While Western governments grumble about this, little public complaint is heard from Western oil companies that have forged close relations with the region's governments.<sup>38</sup> The problem is that today's repression can and will most likely yield to tomorrow's instability.

Despite these very serious problems, there have been some positive signs over the past two years. The GDP of most Caspian countries have begun to grow, although this hardly compensates for the precipitous decline earlier in the decade. Indeed, in 1997 the GNPs of Azerbaijan, Georgia and Tajikistan were one third of the level in 1989.<sup>39</sup>

## **Recommendations**

It would be mistaken to view the Caspian region as a new Persian Gulf and accordingly to over-emphasise its strategic value to the industrialised world. To begin with, its reserves remain unknown, and even if they should turn out to be substantial, they are more likely to resemble those of the North Sea than those of Saudi Arabia. Attaching too much strategic import to the region could overextend both American and European commitments to a highly unstable region in a game that will also involve to varying degrees Russia and China. This could create situations in which, once their strategic stakes have been declared, outside powers could lose their flexibility to adjust to changed circumstances. Flexibility would be further sacrificed if outside powers begin to tie themselves inextricably to particular political groups or factions. Indeed, the political situation is likely to remain unstable, particularly given the high preponderance of autocratic regimes employing time-tested Soviet methods to cling to power. Over-enthusiastic efforts to prop up this or that regime could hypothetically lead to a quagmire where outsiders find themselves ever more enmeshed in local turf battles. Their involvement would tend to raise the stakes of local power struggles and potentially make it more difficult to develop exit strategies. It is for this reason that Zbigniew Brzezinski has labelled the region the "Eurasian Balkans".<sup>40</sup> This is one reason why the West is deeply worried by Russian actions in Chechnya.

Western governments should be cognisant that an important threat to stability in the Caspian region is not the hegemonic aspirations of any single power, but rather the perception that other powers will be tempted to make a play for hegemony, a possibility that, in turn, will inspire pre-emptive or defensive counter-initiatives by other states. This could lead to a regional escalation of tensions that, on the face of it, are unwarranted. Dialogue and confidence-building among regional and extra-regional actors are essential as this region grows more important economically.

That said, Western support for new pipeline options seems perfectly justifiable, at least from a strategic perspective. Multiple pipelines would grant new

openings for regional players and could foster improved regional inter-dependence. This too is even more self-evident given events in Chechnya.

Caspian states should not bet all their financial and political capital on a heretofore elusive oil and gas boom. That boom might not materialise for some time, and perhaps never will. In the meantime, further industrial and agricultural reforms are essential to alleviating regional poverty. Indeed, economic diversification is a central component of building a stable and sustainable economic foundation. To bet on oil as an *industrie industrialisante*, to use a phrase once favoured by the Algerian government, is only likely to increase dependency on oil prices and pipeline politics. Central Asian countries could learn much from the problems of other oil-driven states, in the Middle East or Africa, in coping with the economic problems common to such countries.

The *Silk Road* project is a promising and prescient initiative. Given the lack of linkages among Caspian states, the creation of a sub-regional group similar in structure and purpose to Black Sea Economic Co-operation would be most helpful. The *Silk Road* secretariat in Baku might be a good first start. It will provide a new means for the region to co-operate in forging relations with outside powers and setting up some machinery for economic co-operation and dispute resolution among themselves. Other regional institutions are expanding: last April, during the festivities for NATO's 50<sup>th</sup> Anniversary, the leaders of Georgia, Ukraine, Azerbaijan and Moldova met with Uzbek President Islam Karimov at the Uzbek Embassy in Washington, and announced that Uzbekistan was to become the fifth member of GUAM, forcing the alliance of former Soviet republics to change its acronym from GUAM to GUUAM. GUUAM member countries seek to expand their co-operation as part of the TRACECA project, the Euro-Atlantic Partnership Council and NATO's Partnership for Peace programme. They also seek to pool their efforts against local threats such as terrorism, secessionism and religious extremism.<sup>41</sup>

Greater flexibility in Western policy toward Iran is needed. While recognising that the Iranian state has not abided by rules of international conduct through its past support for terrorism and in its violation of human rights at home, today Iran could well be in the midst of an important transition. A struggle appears to be underway between moderates and more extremist groups. This is not to say that the West should rush to sign contracts with Iran. Iran must be convinced that its reintegration into the international community hinges on definitively ending those practices which led to its exclusion in the first place. But the time for dialogue is fast approaching. The West should be prepared to support positive domestic changes in Iran by showing a willingness to re-establish economic ties. If events move in this direction, lower cost options for moving Caspian oil and gas could materialise.

The Russians for reasons of geography will continue to perceive certain vital strategic interests in the region and will feel these more profoundly than the Americans. Indeed, the Russians do have legitimate concerns that regional

instability could create problems within their own territory; but of course, any Russian temptation to destabilise the region for short-term economic gain should be discouraged. Indeed, such behaviour on the part of Russia has only lowered its leverage there and will certainly discourage the region's states from forging healthy economic ties with it. The Russians must find ways to make its pipeline system available without using it to club its competitors. Russia must recognise that if it wants to remain a player in the Caspian market, it must be able to provide services to the region that do not tie the hands of the Caspian states and local and foreign businesses. At the same time, a proliferation of redundant pipelines would undermine the economics of their infrastructure.

Deepening Western dialogue with other political forces in the Caspian region through EAPC and the NATO Parliamentary Assembly would be welcomed. Along these lines, it might be very fruitful to organise NATO PA Rose-Roth Seminars in the region.

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