

A FUTURE VISION FOR THE CAUCASUS CASPIAN REGION AND ITS EUROPEAN DIMENSION

The starting point of the Caucasus-Caspian Commission is that “the current status quo in the Caucasus contributes to the further entrenchment of the region’s fault-lines into its development. Unresolved conflict casts a pervasive mood of uncertainty over the politics of the entire region, deflects resources that could be directed towards development and hampers region-wide co-operation”. While the Commission states that “military gains resulting from the previous use of force during conflict” should be renounced, it also argues that the short term the existence of unrecognized entities must be regularized.

The Caucasus-Caspian Commission *

* Chairman: Dimitrij Rupel; Deputy Chairmen: Mustafa Aydın and Artur Baghdasaryan; Commissioners: Madeline Albright, Paddy Ashdown, Marc Perrin de Blichambaut, Joschka Fischer, Erkin Gadirli, Craig Kennedy, Vytautas Landsbergis, Abbas Maleki, Mikhail Margelov, George Reid, Adam Daniel Rotfield, Oleh Rybachuk, Mario Soares, Bulat Sultanov, David Usupashvili, Karel Schwarzenberg; Spokesperson: Duncan Hamilton; Co-rapporteurs: Borut Grgic, Dennis Sammut.

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The Caucasus Caspian region, stretching from the shores of the Black Sea to the heart of Central Asia, is the home of many nations, a corridor that connects Asia with Europe, a region with huge economic potential and a meeting point between cultures and civilizations. The Caucasus-Caspian Commission has set out in this report to think ambitiously about the region's future and its European dimension. Our approach is to look at the problems facing the region, but also to look beyond current problems at the region's huge human, economic, political and strategic potential.

This report aims to inform, and contribute towards, the development of policies for the European Union and other European institutions towards the region, whilst also contributing to the debate within the states concerned. This report therefore throws challenges to the leaders of the Caucasus Caspian region and to decision makers in Europe and beyond, to learn from the lessons of history but not to be history's slaves, to grasp the vision for a future based on peace and good neighbourly relations, to build a future of good governance and economic prosperity, a future where the South Caucasus will be Europe's beacon towards the East and Asia's window towards the west.

The Caucasus Caspian space is not a precisely defined region either geographically or politically. In preparing this report the Caucasus-Caspian Commission has decided to look at three concentric circles:

The inner 'core', comprised of Armenia, Azerbaijan and Georgia, the three states stretching between the Black Sea and the Caspian, usually referred to as the South Caucasus.

The outer 'ring', comprised of the states surrounding the Black and Caspian seas, namely Russia, Turkey, Iran, Kazakhstan, Turkmenistan, Ukraine and the European Union. We have limited analysis here to ways in which these states have interacted with the inner core. Obviously this could not be a precise exercise and the Commission has allowed for flexibility in approach where appropriate.

The third circle is the wider world, including the states of the Middle East, the United States, China and India. In a globalized context all of these states are interested in the region and this interaction is likely to increase in the future.

The demise of the Soviet Union not only engendered eight newly independent or restored states in the South Caucasus and Central Asia, it also redefined the relations of neighbouring states to this region. Most obviously, for Russia this transformation entailed readjustment from the role of metropolitan center and political capital to that of the largest regional power with vested interests to protect – as well as numerous levers of influence over its former territories. The emergence of independent states in the region also presented Turkey and Iran with new opportunities and risks. For Turkey the demise of the Soviet Union signified vastly increased opportunities for interaction with the Turkic world of Central Asia and Azerbaijan. Iran has also pursued a policy of developing economic, political and social relations with the region. One of the most important implications for Iran has been the emergence of three sovereign states on the

shores of the Caspian Sea – Azerbaijan, Turkmenistan and Kazakhstan - which has necessitated a new arrangement for the delineation of the economic zones of the resource-rich Caspian Sea.

Finally other external powers in the form of the United States and the European Union have become significant players in the region, initially in the economic sphere but increasingly in political and military spheres too. They have recently been increasingly joined by external actors, including China, India and the Gulf states.

A number of central issues define the imperatives confronting the region today, and are likely to continue to do so for some time to come. These are:

Ensuring the region's security and solutions to the problems posed by unresolved conflicts in the Caucasus; Improving standards of governance, transparency and accountability, in ways that ensure governments will further improve respect for human rights and fully introduce competitive politics; Realizing the region's economic potential and securing its role as an energy provider and energy transit route; related issues include energy security and economic sustainability in the light of the finite nature of the region's natural resources; The region's relations with the world, and particularly for the countries of the South Caucasus, their relations with the European Union.

All four issues are interconnected. Trying to address one issue without dealing with the others is not an option. This report recommends a comprehensive approach with movement on all fronts simultaneously.

For some time policy makers and analysts in both Europe and beyond have perceived shortfalls in the way the challenges confronting the region stretching from the Black Sea to Central Asia were being met. There is a widespread view that these shortfalls have translated into wasted potential for the development of the region. This perception is shared by many in the region, although to varying extents and with differing emphases depending on particular aspirations and visions of the future.

The urgency of meeting existing challenges whilst simultaneously addressing emergent ones is keenly felt in the region, while the region's potential is increasingly recognized by a critical mass of outside actors. There is enough interest to justify the commitment required from all parties if some of the recommendations presented in this report are to be realized. The states of the region should redefine their relationships with each other. Redefinition of their relations with Europe should also be explored. This report is a contribution to a debate on these issues that has already started.

The European dimension of the Caucasus Caspian region

Armenia, Azerbaijan and Georgia are also European countries. They define themselves and are recognized as such through their participation in European institutions, ranging from the Council of Europe to the Eurovision Song Contest and the Euro Cup football competition. Despite this the three states struggle to emerge on the map of European

policy makers. More distant than the Balkans and lacking the emotional familiarity and pull of an unequivocally 'European' identity, the countries of the South Caucasus have generally struggled to imprint themselves on the cognitive map of the European public. Europe has been engaged cautiously in the Caucasus. Yet recent years have seen an emerging realization that the South Caucasus is ignored at Europe's own peril. On the negative side the region has the potential to confront Europe with a source of major instability on its own doorstep. Furthermore, the fault-lines in the region have the capacity to generate much wider conflict involving other regional players. On the positive side the region is important both as a supplier of energy resources in its own right, and as a route for other resources further a field in Kazakhstan, Turkmenistan and beyond. The nations of the South Caucasus are rich in culture, history and traditions, many of which share much with wider European traditions. A situation has emerged in which relations between the European Union (EU) and the countries of the South Caucasus are becoming stronger, more complex and quickly evolving. This development requires from the European Union rapid and flexible mechanisms and responses and a higher level of political commitment than has been the case so far.

The relationship between the EU and the Caucasus Caspian region has changed significantly as a result of the EU's own enlargement process. With the accession of Bulgaria and Romania the EU is now a Black Sea power. The opening of accession negotiations with Turkey further increases the dynamic of interaction between Europe and the region. The EU must start looking at this region through this new prism as well.

The Commission welcomes the successes that have been achieved so far through the European Neighbourhood Policy (ENP). This important instrument of the EU continues to evolve to respond to changing challenges. The Caucasus-Caspian Commission welcomes the changes proposed to the ENP by the European Commission in December 2006. However, the Commission recommends a clear distinction in EU priorities as expressed in ENP objectives vis-à-vis the neighbouring states to the east that seek EU membership and those to the South that look for a different relationship with the EU.

The Commission similarly notes and welcomes the fact that the European Union has recently adopted policies vis-à-vis Central Asia and the Black Sea region at large. It calls for a process through which these policies, together with the ENP programs for the South Caucasus and a new more engaging strategy towards the South Caucasus and the Caspian can work in harmony with each other, in order that they may be mutually reinforcing and more effective. It calls on the European Parliament to be more engaged in overseeing this process.

The Caucasus-Caspian Commission heard concerns from the region about a lack of a clear, robust and comprehensive EU policy towards the region. The Commission believes that with increasing interest in the region amongst the member states an opportunity exists for stronger EU leverage particularly on issues of governance and the peaceful resolution of conflicts.

Peace and Security

Addressing Security in the Caucasus Caspian Space

The Caucasus Caspian space has long been perceived as an area of strategic importance and interest to both neighbouring states and global powers. It is an important overland route between Asia and Europe, complemented by the Black and Caspian Seas. Its position at the meeting point of more powerful states has meant that for much of its history the region has been at heart of global confrontations, such as the ‘Great Game’ of the nineteenth century and the Cold War of the twentieth.

The twenty-first century and the advent of globalized approaches to issues and problems offer an opportunity for the region to play a different role, more beneficial for the people who live in it and for the wider global community.

In the process of preparing this report, the Caucasus-Caspian Commission has been fully cognizant of the security concerns of the South Caucasus states and in the wider Caucasus Caspian region. These concerns have increased since the end of the Cold War, as new structures have failed to fill the vacuum created by the demise of the old. The emergent ‘security vacuum’ has resulted in a free-for-all quest for security mechanisms that are sometimes linked with foreign structures.

The Caucasus-Caspian Commission calls for a new, more holistic approach to security involving all the states of the region and other interested parties. This approach should aim to establish a new security arrangement that can help build trust between the states of the Caucasus Caspian region and their neighbours, introduce where appropriate a European perspective as an alternative, and put a halt to the slow but steady process of militarization of the region. The Commission understands that the establishment of a new security system will be long and difficult and will require commitment on the part of those states participating.

The Commission considers this to be a long term challenge. It calls for in-depth international debate that could lead to an inclusive Conference on Security and Co-operation in Europe (CSCE) type process that will consider the region’s security challenges.

The Caucasus-Caspian Commission attaches great importance to respect for the principles of independence and territorial integrity of states and the right of self determination as incorporated in the Helsinki Final Act and other international instruments. Smaller states in the region continue to have serious concerns regarding the attitudes towards them of some of their neighbours. The Commission calls on all states in the region to avoid acts which could be construed as unfriendly and threatening to their neighbours.

The Caucasus-Caspian Commission has acquainted itself with the arguments relating to the legal regime in the Caspian Sea. It considers it important for enduring peace in the

region, for the realization of the region's potential, and for the smooth and uninterrupted flow of energy supplies, that a comprehensive agreement is reached between the parties concerned on this issue, based on international law. It welcomes the fact that the countries bordering the Caspian Sea are conducting discussions at the highest level on this important issue. Whilst these discussions are ongoing, the Caspian Sea states must find ways to ensure that their economic development continues and regional economic co-operation is expanded.

Russia's relations with the states and cultures of the South Caucasus go back centuries. These relations are far from unequivocal, being charged with both positive and negative memories and emotions on both sides. A shared history of common sacrifices and successes, the human relationship resulting from the large communities in each other's countries, and linguistic and cultural connections create a deep bond between Russia and the South Caucasus. Russia's relations with the re-established sovereign states of the South Caucasus can only succeed if they are based on mutual respect and common interests. As long as the conflicts in the South Caucasus remain unresolved Russia's position will remain complicated.

Security concerns related to the South Caucasus have been raised by Russia. These concerns need to be taken into account by the states of the South Caucasus. On the other hand Russia has take into account security concerns of South Caucasus countries. A new multilateral security framework as mentioned earlier may be a mechanism where all these concerns can be discussed and addressed.

The Commission believes that the opening of the negotiations for Turkey's accession as a full member of the EU is a step that impacts positively on Turkey's neighbours in the Caucasus Caspian region.

The Caucasus-Caspian Commission believes that Iran has long-standing historical and economic interests in the Caucasus region and as a Caspian Sea state. In this regard the Commission supports the current EU policy of engagement with Iran.

New Approaches to the Conflicts in the South Caucasus

There is no doubt that the conflicts emergent at the end of the Soviet era in Nagorno Karabakh, Abkhazia and South Ossetia have played an immensely destructive role in the development of the region over the last 15 years, hindered the progress of individual states, made regional co-operation difficult, in some cases non-existent, and continue to create serious problems for peace and security in the region. The conflicts have been clumsily, if on the whole effectively, managed by a mixture of international institutions, with the governments of the states involved, the self-proclaimed authorities of the states unrecognized by the international community and interested outside parties. This has been a mixed blessing: on the one hand this has prevented the resumption of full-blown hostilities, on the other hand it has maintained the status quo to the satisfaction only of those who have a vested interest in the non-resolution of the conflicts. As more urgent issues elsewhere distract the attention of the international community, the suffering of

those displaced by conflict or living under blockades remains unaddressed. The Commission cannot but regret the failure on the part of the parties to the conflicts to demonstrate the courage and vision to seize periodic opportunities to resolve conflict through peaceful means. There is urgent need for the governments and authorities involved to abandon time-worn rhetorical arsenals in favor of forward-looking visions of a region without conflict.

The Commission hopes for a more intensive engagement by the international community to the resolution of the conflicts in the Caucasus Caspian region. The 'no war, no peace' situation is a source of instability. The Commission therefore calls for a stronger commitment on the part of the states and organizations involved in the conflicts and their resolution. The Commission welcomes the continued effort of the Minsk process on the Nagorno Karabakh conflict, working under the aegis of the Organization for Security and Co-operation in Europe (OSCE). It feels that this process needs to be revitalized and upgraded in its capacity to implement measures contributing to change on the ground and paving the way towards a negotiated solution. At the same time the Commission welcomes the efforts being expended towards the resolution of the conflicts in Abkhazia and South Ossetia, but regrets the lack of progress on both fronts.

The Commission feels that crucial for a resolution of the conflicts is the renunciation of force strengthened by corresponding action taken to renounce military gains resulting from the previous use of force during conflict. This process can be implemented under international supervision and territories released should remain demilitarized.

Three unrecognized entities emerged in the South Caucasus after the collapse of the Soviet Union, namely in Abkhazia, South Ossetia and Nagorno Karabakh (a fourth emerged in the Transnistria region in Moldova). Despite their unrecognized status, these entities have survived for more than a decade outside the international legal system. The Commission believes that this situation not only creates great hardships to the people living in, or displaced from, these lands that are part of the wider Europe, but that this situation can also create other kinds of problems related to organized crime. As efforts continue to find solutions to the problems of these territories in the long term, their existence in the short term must be regularized. In order to avoid human rights violations in possibly lawless areas, their systems of governance need to be brought in from the cold and into frameworks or structures subject to full international scrutiny of human rights standards.

The Caucasus-Caspian Commission considers that considerable international engagement will need to be exercised to push the conflict resolution processes forward. In particular, there is urgent need to consider possibilities for transitional arrangements between the current status quo and a final settlement. Partners in the region and beyond could start discussing possible future international engagement of a different nature.

The Commission remains convinced that a much more visible engagement on the part of the international community in the management of the interim period arrangements will be necessary. The Commission is further convinced that no solution to the conflicts,

whether it is that proposed here or an alternative framework, will be successful without conviction and vision from the parties to the conflict to allow for compromise and for the benefits of resolution to become evident. These elements form the ingredients that have been missing so far in the quest for a solution.

The work done by the Presidents and the Foreign Ministers of Armenia and Azerbaijan on the Nagorno Karabakh conflict is commended. They must now have the courage to bring the years of hard work that lie behind this process to a successful conclusion. The international community needs to be ready to edge them forward in this direction and to stand by them in this process.

The Commission notes the work of some think-tanks and non-governmental organizations (NGOs) that have produced credible proposals for conflict transformation and resolution. The Commission has not sought to replicate this process, and strongly recommends to all conflicting parties and international structures engaged with the resolution of the conflicts to benefit from these proposals.

Many of the conflict zones in the South Caucasus remain heavily mined. The Commission welcomes the work that has been done by several humanitarian organizations to start the process of de-mining. This process must be intensified and must continue at a steady pace independently of progress in the conflict resolution process. The Commission urges the Council of Europe to take on the responsibility for monitoring and promoting this process and to issue corresponding quarterly reports naming and shaming governments or self-proclaimed authorities failing to meet standards agreed for the fulfillment of de-mining. The Commission further encourages the countries of the South Caucasus to demonstrate their commitment to addressing the problem of land mines by establishing national capacities to deal with the task of de-mining, and to provide these national capacities with proper resources.

Promoting regional dialogue and co-operation

The Commission strongly believes that the future of the Caucasus Caspian region will depend on the ability of the countries concerned to forge effective, functional regional arrangements that would address their security concerns, heal the wounds of the past and pave the way for economic prosperity.

The Caucasus-Caspian Commission supports the idea of a stratified, multi-polar regional interaction system, through which countries can cooperate with neighbours in a variety of forums and frameworks in line with their political aspirations, economic trends and cultural heritage. However, the Commission sees great advantage in regional institutions being as inclusive as possible and this should be obvious to all the parties concerned.

Whatever other forms of regional cooperation they seek, there will always remain a need for the states of the South Caucasus to interact with each other trilaterally. Although historical legacies suggest that this relationship will be far from easy, demography, geography, economics and indeed political realities connect the three states in a complex

but undeniable manner. The existence of deep-rooted problems, such as the poisoning effect of the Nagorno Karabakh conflict on Armenian-Azerbaijani relations, makes the need for dialogue and cooperation greater, not lesser. Even without such imperatives, regional cooperation offers interesting and exciting opportunities that are at the moment lost. Similarly, a second tier of regional cooperation, involving the countries of the Caspian, as well as Turkey, offers a chance for all those participating to gain substantially from such a relationship. The Economic Cooperation Organization has given a start to some such processes. The EU is now a Black Sea power in its own right, and could further contribute to building regional cooperation.

The Commission believes that efforts must be made to improve Armenian-Turkish relations. It welcomes all initiatives with the aim to contribute to a dialogue between the two countries. The Commission believes that the opening of the border between Armenia and Turkey for humanitarian traffic and for the movement of people from the border regions could facilitate the process of reconciliation and full normalization of mutual ties.

The Commission believes that the Caucasus Caspian region faces a number of challenges in the field of environment, challenges that can only be properly addressed in a regional context. The Commission supports the idea of a South Caucasus Environment Convention to be adopted by the three South Caucasus states and welcomes proposals for a broader set of agreements involving other neighbouring countries that can enhance cooperation in dealing with these challenges.

Economic development, natural resources and sustainable development

Economics as the backbone for future regional development

The Caucasus-Caspian Commission accepts that the backbone of regional progress and integration must be economics. Economic growth is not only essential to regional development but also a precondition for this region's ability to cope with the dynamics of globalization. Progress is intrinsically tied to harnessing and increasing the economic potential of the region.

The Caucasus Caspian region has yet to recover economically from the collapse of the Soviet command (or planned) economy. The command economy has left a significant imprint on the production, supply and distribution patterns extant in the region. The signs of this legacy were evident in the economies that emerged in the region. These are economies which predominantly produce and export raw materials, in the form of basic commodities such as coal, cotton, crude oil and natural gas, rather than refined products or derivatives such as electricity, gasoline and bio-diesel.

Another fundamental problem for the region is that it lacks a diversified market strategy. By default or by strategic choice some countries have been more successful than others in attracting an international FDI structure, though the regional picture remains bleak. The region is still primarily dependent on Russia for exports, and in large part is composed of what still remain single-sector economies. The non-energy sectors are in particularly bad

condition. Income differentials are both significant and growing, and poverty levels are still high, especially outside the capitals. There is a pressing need to modernize economies by increasing market access, promoting regional integration, and improving local production cycles so as to increase the region's ability to export finished products rather than rely exclusively on raw materials.

Economic underdevelopment is pervasive in the Caucasus Caspian region. Low economic yield in the region is causing significant imbalances in the trade balance sheets, making most of these economies import dependent. The various economic shortfalls are also likely to have a negative impact on population trends and immigration, with brain-drains likely to continue having a severe impact on the region's medium term economic potential. Economic development and social cohesion of countries is also closely linked to high education and to health standards. To this effect these must improve throughout the region. Clearly differences exist on a country-by-country level and some are doing better than others in attaining stable economic growth.

Internal market diversity and interoperability

The Caucasus Caspian region, due in large part to outdated and underdeveloped infrastructure, lacks sufficient intra-region transport links and connections allowing for greater regional economic development and cooperation. The potential represented by the region's location, offering a hub between Europe, Russia, the Middle East, China and India, is currently not being exploited. Within the region the absence of transparency and other obstacles to an open business environment, coupled with ongoing and future potential sources of political instability, seriously curtail opportunities for the emergence of a liberal market economy in the region. In such a climate considerations such as to how to integrate environmentally sustainable policies into an overall economic development plan unfortunately remain secondary.

The Commission therefore considers the following measures relevant to the achievement of a positive and sustainable rate of economic development in the Caucasus Caspian region. First, export-import market diversity must be achieved in order to provide for stable economic growth. The current lack of market diversity exposes the region to a number of political and economic risks associated with over-reliance on a single market. Diversified exports and imports not only help reduce strategic market risk, but also help attract foreign investors.

The Commission is convinced that regional efforts at diversifying trade and economic dynamics should not come at the expense of the region's currently vibrant trade with Russia, but in addition to it. The objective, rather, is to increase real trade volumes by increasing the economic potential of the Caucasus Caspian region, as well as increase the real potential of these economies. The better economic performance of this region should in turn help to strengthen and increase the trade volumes between Russia and the region.

The Commission believes that infrastructure upgrades are necessary across the Caucasus Caspian region in order to improve the region's access to external markets and increase

the region's interconnectivity. There is a need to better integrate the Caucasus Caspian region through improved regional road, rail, air and sea links, especially energy infrastructure which would further connect the region with Europe is needed.

The region must also work to enhance its link to the market of the European Union (EU), which can help improve the region's trade balance and income flows and increase the region's strategic market security. It is predicted that the general price for the region's commodity exports will increase if part of the commodities produced in the region can be sold directly to the EU consumers. This makes projects like Nabucco and TRACECA of strategic significance for both the regional economic development and Europe's access to the broader Caucasus Caspian region. These projects will be even more relevant if a modern trans-Caspian network can be constructed and made operational. The option of linking the trans-Caspian line with Nabucco will help increase the operational utility of the east-west corridor.

The next relevant factor to be addressed at the regional level is economic diversity. In fact, over-reliance on the production, extraction and export of commodities creates an unstable dependency on external market trends. This makes it difficult to plan budgets and set medium term market development priorities. Revenue streams are always subject to external conditions and in the case of energy, to asymmetric factors like the environment and international, regional and intrastate conflicts. To stabilize the budget streams and thus increase both predictability and sustainability in market trends across the region, it is necessary to diversify the national income streams by increasing the variety of domestic economic activity.

Furthermore, a vibrant small- and medium-size enterprise sector is necessary to both increase the general wellbeing of households in the Caucasus Caspian region and narrow income differentials. Small and medium-size enterprises (SMEs) are also the backbone of a modern economy ensuring both stable revenue for the government and an increase in the purchasing power of the average consumer. A vibrant domestic SME sector is also a safety mechanism against external market shocks. In order to stimulate SME development, it is necessary to decrease bureaucratic obstacles to business registration, increase transparency of public institutions, improve education and health standards, and provide stimuli – in terms of low-interest or interest-rate free loans – for entrepreneurial vision and ambitions.

Finally, the process of economic overhaul in the Caspian region will depend on a modernized and globally integrated banking sector able to service both structural investors as well as ordinary consumers competitively. This above all means introducing low interest rate loan schemes aimed at supporting business and entrepreneurship innovation. It also means increasing regional capacity for preparing projects, tender procedures and regulations providing the necessary standards to attract a diversified FDI inflow. Europe has a significant role to play in this context. The EU can help local government develop the facilities that in turn will prepare competitive projects.

The Commission strongly recommends that regional sovereign funds invest a portion of

their assets in regional projects – particularly infrastructure projects – thus promoting regional economic integration. Europe’s role in helping the Caucasus Caspian countries build facilities to identify and outline projects is paramount to their ability to diversify investment intakes. There is otherwise a danger is that money from the private sector and Western investment funds will skirt the region.

Commercial banking sector reform and banking sector liberalization are also relevant to progressive and sustained economic growth particularly within the SME sectors. Available private capital is necessary to stimulate and drive entrepreneurship activities. It is not sufficient to have government-run banks controlling the bulk of financial transactions. Loan rates must reflect both domestic market trends – in particular market and household liquidity – as well as external market interest for this region, which makes it paramount to have a liberalized banking sector. The Commission attaches particular priority to this objective, as banking is an irrefutable cornerstone of any modern economy.

The Caucasus Caspian region has an abundance of energy resources. Beyond gas and oil, there are also major coal and high-level water deposits, which create opportunities for power production and export. As such, this region is a focal center of international energy companies, often dubbed the market of key strategic significance. Many international energy companies are already active in the region while the region is surrounded by at least four massive energy importers – China, India, the EU and Turkey – and at least two major energy exporters, Russia and Iran.

Access to strategic external markets

In the case of oil and gas exports there is a need to ensure stable and secure access to international and neighbouring markets. This makes pipeline projects an urgent priority and necessity, of which the Baku-Tbilisi-Ceyhan pipeline is an example. The region needs to construct a modern and diversified pipeline system better connecting the region internally and directly connecting it with external strategic markets, particularly the EU. The region is already well connected to Russia. Because of the high importance of the energy exports for the region’s economic vitality, the Commission recommends the installation of region-wide pipeline security infrastructure, which will help minimize risks to supply deliveries.

It is important that the states of the South Caucasus do not become simply transit zones. They have the potential to become an economic hub for some of the most interesting economic developments in the current globalization process. Different countries may opt for different ways in which they can add value – from the establishment of refineries to the creation of centers for training and education of a skilled workforce. Initiatives involving two or more countries of the region will have added benefit.

Perhaps the greatest single challenge in the region for energy producing states is the management of energy incomes. As the price of oil and gas increases on the global market the national incomes of countries like Azerbaijan and Kazakhstan but also

Turkmenistan and will increase exponentially. Azerbaijan's economic growth in 2007 is likely again to reach 36 percent. Transit states are also set to benefit as transit tariffs go up.

Such high dollar-based income inflow can be hazardous for economic growth and sustainable development if not properly managed. The danger of 'Dutch disease' – where income injections are eaten away by high inflation – is all too real. Thus, the Commission urges against over-spending. Governments should resist popular calls to use the oil and gas money to artificially lift base salaries. Rather, salary levels should remain fixed to market performance. Adjusting salary levels without first increasing the economic performance will only push up the price of goods. Hyperinflation could set in, which will eat away the national incomes without producing any sustainable change in economic performance.

The question of transparency in the distribution of oil and gas income flows is also vital. The Caucasus Caspian region does not have the luxury of having developed mature democratic institutions prior to the exploitation of oil and gas resources. Vibrant debates over how the distribution of these income flows can be subjected to effective review and accountability mechanisms have already been ongoing for several years. The Commission attaches great importance to such mechanisms in order to forestall the potential for political instability deriving from unrealized expectations of 'trickle-down' and generalized improvements in standards of living.

The Commission supports the use of government funds which should spend oil and gas revenues in ways that promote the region's diverse economic development. For example, part of the energy income could be used to support the transformation of the region's agriculture by integrating technology and modern farming know-how. Part of this income is already being used to increase educational and health standards (in the case of Azerbaijan and Kazakhstan), which the Commission commends. Furthermore oil and gas revenues can be used to boost services and high-end economic activities in the region, such as power generation that could be then exported to China, Turkey, Iran and India.

The Commission also considers it relevant for the energy suppliers from the Caucasus Caspian region to invest portions of their oil and gas income into stable external markets – most notably into high-performance government bonds and treasury bills, and low-risk private equity. For this purpose, the Commission encourages the establishment of sovereign investment funds specializing in investment in external equity markets.

The Caucasus-Caspian Commission welcomes the participation of Azerbaijan and Kazakhstan in the Extractive Industries Transparency Initiative. It calls on other governments in the region to join this process where appropriate.

Sustainable development

The Caucasus Caspian region must shift towards sustainable economic development, which in addition to promoting a diverse economic base also takes into account

environmental protection and the emergence of a broad middle class through the promotion of SME activities. Health standards and education are part of this socio-economic development as well. A broad middle class is the backbone of a modern economy, which can, under suitable circumstances, provide conditions for social and political stability. The Commission considers an environmentally friendly economic growth plan as an important component of economic development in the Caucasus Caspian region.

The Caspian Sea is currently under particular environmental strain. This can worsen as new energy projects commence operations and new trans-Caspian pipelines are built, but this need not be the case if modern technology using international best practice is used. The freight volumes crossing the Caspian are likely to increase as the links between Europe and China across the Caspian improve. In order to respond to the environmental challenges adequately, the Commission suggests the establishment of a Caspian environment oversight committee, which will help manage the impact of increased industrialization in the Caspian region on the environment.

The Commission also recommends a review of the region's power generation facilities and the introduction of the process of making existing facilities more environmentally friendly by introducing modern know-how, and by switching from coal and oil-intensive power generation to hydropower facilities, particularly mini-hydropower avoiding the need to construct large dams.

A progressive dialogue between Europe and the Caucasus Caspian region on how to achieve sustainable environmental development and a competitive and durable economic outlook is strongly recommended. Europe is a leading voice on sustainable development and environment protection, and as such it can be a value added partner in helping the Caucasus Caspian region achieve a better environmental standing.

Specific recommendations

The Caucasus Caspian Commission has positively evaluated a number of other proposals, which if implemented should help improve regional economic integration and dynamics, increase the region's economic yield, better integrate the region into the global economy by increasing the links with strategic markets, and finally increase the security of individual economic markets by increasing the level of SME activities in each of them.¹

The fight against corruption

The problem of corruption in the Caucasus Caspian region remains serious. The Commission welcomes the efforts that have been undertaken in recent years by some of the region's governments to fight corruption, and to eradicate its root causes. However, the Commission believes that the strongest tool in the fight against corruption is transparency and the rule of law and in this regard the Commission's recommendations in

¹ Some suggestions to jumpstart the process of economic reform and development can be found in the full report available at www.caucascom.org.

the area of governance are equally valid when it comes to building economic prosperity.

Governance and political development

The future economic prosperity of the Caucasus Caspian region, its relationship with the EU, the peaceful resolution of conflicts and other objectives already outlined in this report are very much dependant on an improvement in standards of governance in the region.

Processes of reform in the post-Soviet states of the South Caucasus and Central Asia have overall been slow. The wider region exhibits examples of quite contrasting trends. While Georgia has actively sought rapid integration with Euro-Atlantic structures, several Central Asian states have promoted models of political authority rooted in the permanence of individual leaders in power. Despite this breadth of experience, the absence of tangible progress in most states of the region justifies a broad disappointment. Across the region, the absence of independent judiciaries, accountable law enforcement agencies and parliamentary oversight of the executive all remain sources of concern.

The Commission believes that the process of democratic state building can only be further supported through increases in levels of transparency and accountability in government. This is a pre-requisite to countering the cultures of impunity that currently pervade the Caucasus and the wider region. Two further vital pillars of democratic state building are an independent judiciary upholding the rule of law and scrutiny of official practice by a free media.

Most states in the region already possess a constitutional and legal architecture ostensibly protecting the rule of law. These structures should be exploited more.

The Commission has identified three forms of ‘legitimacy deficit’ in the South Caucasus undermining the entrenchment of the rule of law throughout the region.

The first form of legitimacy deficit concerns the disparity between metropolitan states and self-proclaimed authorities. While those of the metropolitan states in the region have been designed and reformed with international recognition, and at times assistance, those in the unrecognized entities, where self-proclaimed authorities are not recognized by the international community, have not been subject to the same scrutiny. The region is therefore divided into one set of constitutional frameworks subject to an international regulatory environment and one which is not.

Second, all constitutional frameworks in the region are incomplete. For all states and authorities the incompleteness of current arrangements has resulted in preferences for unitary models of statehood, which are fundamentally at odds with the demands of minority groups seeking self-government or autonomy.

A third form of legitimacy deficit is constituted by the weakness of democratic mandates throughout the region. This is underlined by the fact that throughout the region there has

not been a constitutional transfer of power through free and fair elections. Governments have either remained in power or have been pushed out. The model of liberal democracy as known in the West has not been fully adopted or developed.

The Commission feels that the depth of the problem and the lack of any serious progress in this field, as well as the complexities arising out of the conflict situations, justify a major commitment on the part of the international community to assist the governments and other actors within the countries of the region. The Commission proposes the establishment of an *ad hoc* task force within the Council of Europe that will engage with the countries of the South Caucasus, including the unrecognized entities, to promote and monitor the judicial process, make recommendations, and provide technical assistance where possible.

However, it is also possible and desirable to encourage the countries themselves to sign up to a series of voluntary benchmarks, similar to the commitments that countries make as part of their participation in the Extractive Industries Transparency Initiative that some South Caucasian and Central Asian states are already signatories of. They can at a later stage also be embedded into a human dimension of a broader security arrangement. These benchmarks should start with the accessibility to information on a wide range of topics.

The Commission believes that the process of governance in the Caucasus Caspian region will benefit greatly from better interaction between government and citizens. It therefore recommends that special programs should be developed that would assist this process. These programs should be able to empower civil society and media to access information and to play an increased oversight role.

Towards broad-based governance: strengthening the process of competitive politics

Despite the various forms of legitimacy deficit described above, the Commission believes that Armenia, Azerbaijan and Georgia are ready for a qualitative leap forward in the way they conduct competitive politics. The Commission has come to this conclusion not on the basis of the records of these states in conducting elections, the organization and performance of their political parties or the ability of their politicians to compete on a roughly equal basis in the democratic process. The record of the region in this regard remains patchy. However, the three states have political elites with sufficient links to their grassroots support to make competitive politics a real possibility in the short term. This situation has to be nurtured and developed.

The Commission believes that more effort has to be made to develop in the South Caucasus political parties with elected leaderships that are accountable to their membership base. Political parties are the cornerstone of the European political system and if the states of the South Caucasus want to embrace European political culture they should also develop similar structures.

The Commission supports the development of multiple networks for politicians and political activists in the South Caucasus to interact with each other and with their

European counterparts and calls for a much more systematic engagement by EU political parties with counterparts in the South Caucasus. The Commission looks forward to more active participation of politicians from the South Caucasus in events organized by European political parties, by the political groups within the European Parliament and by the youth and women's sections of these entities. The Commission hopes that this networking can take place around issues rather than ideological platforms that are not relevant to the South Caucasus context.

With reference to elections and election monitoring, the Commission is aware that the electoral process in the South Caucasus remains problematic. This should be seen as the symptom of a wider democratic malaise and will never be cured until the root causes of the problem are dealt with. In 2008 all three South Caucasus countries face important presidential and parliamentary elections. The monitoring of these elections by the international community should be based on clear benchmarks accompanied by clear response if the benchmarks are not met.

The Caucasus-Caspian Commission recognizes that the admission of Armenia, Azerbaijan and Georgia as full members of the Council of Europe nearly a decade ago has been an important stimulant for political reform. It welcomes the role that the Council of Europe structures, particularly the Parliamentary Assembly, the Commissioner on Human Rights and the European Court of Human Rights have played in promoting principles of good governance and the rule of law. The Commission, however, remains concerned by the patchy record of human rights protection throughout the region. Rights to the freedoms of assembly, conscience and expression have been regularly violated over the course of the post-Soviet period. Some obligations undertaken upon accession to the Council of Europe have not been fulfilled, such as the failure in some cases to create an effective alternative civilian services allowing for fulfillment of the right to conscientious objection. The safety of journalists, particularly those reporting on official malpractice and corruption remains a source of concern, as does the use of libel and insult laws to insulate officials from due scrutiny. Torture, ill-treatment and prison conditions are also a source of concern to domestic and international human rights organizations. The Commission calls upon intergovernmental organizations with the relevant remits to expend greater efforts to ensure that obligations undertaken by states in the region are fulfilled.

The Commission is also concerned by shortfalls in government policies to fulfill the economic, social and cultural rights of marginalized communities, including internally displaced populations. The Commission is concerned that increasing revenues deriving from the extraction and transit of Caspian oil and gas supplies may not translate into the improved fulfillment of economic, social and cultural rights of these populations. The Commission urges governments throughout the region to ensure transparency and accountability in the distribution of funds deriving from resource extraction.

Conclusion

The Commission is in no doubt that this is a defining moment for the Caucasus Caspian region. What happens now will impact the region for the next two decades and beyond. This is why the Commission believes that there is a need for all interested parties to rise to the occasion, in order to both accept the challenges and seize the opportunities available.

At the level of regional security, a more holistic approach than has been seen so far is necessary. This approach needs to bring to the table the states of the South Caucasus and the Caspian, as well as other regional and global powers, to address core issues of security and lay the foundation for long term regional stability. The region is ready for regional cooperation which should be multi-layered and inclusive.

Russia, Turkey and Iran have historically been important stakeholders in the region. Despite the fact that they bring with them historical baggage, they also have an interest in the region's future and its prosperity.

Debates over the internal political development of the South Caucasus remain open. The citizens of Armenia, Azerbaijan and Georgia have expectations from their political elites that need to be satisfied. This is best done through systems of governance that provide for checks and balances and through transparent government. The region is ready for the next qualitative step forward, regardless of setbacks and disappointments.

Armenia, Azerbaijan and Georgia are also European countries. There is an opportunity for Europe to transfer its experience and achievements in conflict transformation, economic prosperity, democracy and institution building to the countries of the region and through them showcase its own success to Asia and the Middle East.

The Caucasus-Caspian Commission believes that the time to move on all these issues is now.