

The Economic Importance of the Caucasus Region

Mikail Darbinyan
Master in International Politics
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In the 15 years that lapsed between 1996 and 2011, income from road infrastructures alone in Georgia increased from 9% to 14% of the country's gross domestic product (GDP), from \$285 million to \$2.1 billion¹. Georgia has proved itself as a key player in Europe's energy security game, thanks to which it receives ample amounts of foreign capital and makes use of transit tariffs from oil and gas exporters who use its territory. For the economy of Kazakhstan, transit through the Caucasus makes up for 75% of its exports², approximately 51% destined for markets in the European Union³. This allows Astana to compete with Russian and Azeri exports, all three of whom rely on revenue from hydrocarbon exports for more than half of their state budgets. The local economies are not the only ones who benefit from energy resources, as many Western-based companies have invested heavily in the region. Since the 1990's the Caucasus provides enormous economic benefits and revenues to governments, multinational oil companies and other actors which we will discuss in due course. Currently, the importance of this region for its energy resources gives it a geostrategic value as important as its other two characteristics mentioned before, its importance as a transit space and its impact on national security of powers.

Throughout history, great powers' interest in the Caucasus has not been linked with the regions natural resources. What really motivated interests in the region were strategic trade routes (transit spaces) and challenges to the national security of the three surrounding powers.

Historically, tensions between the local peoples existed, as many were obliged to share a small territory highly diverse in agricultural products, fruits, vegetables, animals and even plants used for medicinal purposes⁴. Natural resources, however, only played an important role for local communities and never galvanised the interests of the imperial powers. Division of production based on ethnic lines existed between local communities, as each community specialised in a certain sector (fishing, agriculture, horticulture, hunting, and husbandry among others) dependent on the climate and topographic profile its settled lands. The environmental diversity allowed locals to live off the land in relatively autarchic economies, but always at the verge of conflict

¹Asian Development Bank: *Georgia Transport Sector Assessment, Strategy and Road Map*, Asian Development Bank., Manila, 2014, p. 3.

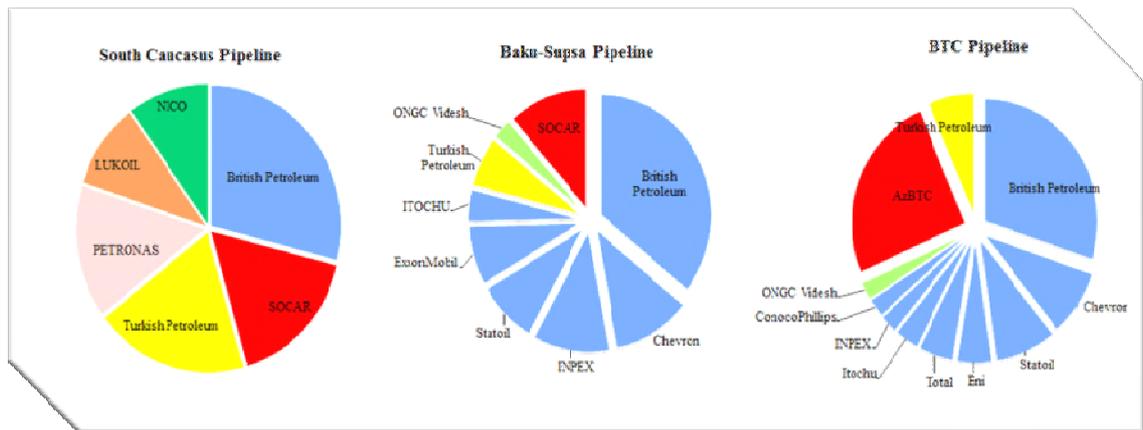
²U.S. Energy Information Administration: "Kazakhstan: International energy data and analysis", 14 January 2015, p. 5.

³European Commission. Directorate General for Trade: "European Union, Trade in goods with Kazakhstan", 14 April 2016, units A4/G2.

⁴ The fertile lands of Karabakh and the cities of Gandzak and Yevlakh offered abundant goods such as wood, wildlife, grains, vegetables, cotton and silk. The Persian's often resorted to the Caucasus' for its endless supply of wood, as its own territory lacked dense forests. Nonetheless, the remoteness of the Caucasus from the Persian Gulf hindered the transport of large quantities of wood, a factor which contributed to the fact that the Persians were never able to construct a big maritime military force.

conflict with one another. With the gradual development of the Western economies during the Industrial revolutions in Europe, which later slowly inched its way to the Russian Empire, a new natural resource gained importance among many others: crude oil. The Caspian basin's petroleum deposits were discovered around 1870, and only since then has an economic interest based on the region's *natural resources* arisen.

Distribution of shares in the three major hydrocarbon transport projects of the Caucasus



Description: the importance that the Caucasus presents for its hydrocarbons is reflected in the high number of transnational oil companies involved in the three existing projects. Combined Western companies (France, United States, United Kingdom, Japan, Italy and Norway) are marked in blue and account for the majority of investments in these three projects.

Source: British Petroleum: BP in Georgia, [2016].⁵

The economic benefits for external actors can be classed in three main categories, hydrocarbons (petroleum, natural gas and their derived products), minerals (gold, copper, zinc, bauxite, magnesium, molybdenum and coal)⁶ and particular markets (armament and hydrocarbon extraction technology). Hydrocarbons by far are the most distinguished of the three and remain the principal motive for scores of governments linking their national interests with the region. The Caspian basin contains less than 5% of the world's reserves of oil and gas, occupying a fairly insignificant position in the ranking of the world's producing countries. But the importance here is the *marginal* reserve the Caspian contains, which is quite relevant in terms of the influence it has on overall oil and gas prices in the world's markets. The diversification of energy sources so sought after not only by the world's developed economies, but also the emerging ones brings them all to this region of the world, where the sector is still in development with vast reserves waiting to be exploited.

⁵British Petroleum: BP in Georgia, [2016]. Available at: http://www.bp.com/en_ge/bp-georgia/about-bp/bp-in-georgia/western-route-export-pipeline--wrep-.html

⁶Central Intelligence Agency: [Data collected from sections *Armenia, Georgia* and *Azerbaijan* of *The World Factbook*].

Recent discoveries of natural gas and oil deposits at the end of the 1990s, more specifically the Shah Deniz field in Azerbaijan and the Kashagan in Kazakhstan make the hydrocarbon factor an essential one for attractiveness of the region. The urge to find new energy sources for their economies has generated the particular interest of the European Union⁷, Israel, China, Turkey, India and Japan.

In view of the regions non-hydrocarbon mineral reserves, they do not generate the interest hydrocarbons generate, as compared with other mineral producing countries the Caucasian republics do not constitute a considerable advantage. Not playing an important international role, mineral reserves in Armenia and Georgia, who lack hydrocarbon reserves, nonetheless, form a significant part of their exports. For Armenia minerals make up 37% of all exports, while for Georgia the figure is 63%; For Azeri exports on the other hand, minerals barely come to 1,5% of total exports⁸. Just as with minerals, agriculture has only a local impact. Arable land makes up 48% of the Caucasian territory, while forests cover another 22%⁹.

The economic impact of the two can only be measured locally, as internationally they are insignificant.

In Georgia, foreign direct investments (FDI) in capital in the mining sector between 2007-2015 have hovered around 3,2% of total FDI, while the infrastructure and energy sector received around average 35% of the same¹⁰. In Armenia, the mining sector is the biggest recipient of FDI, receiving in 2015 around \$135 million¹¹. It is important to stress that between 1995-2015, FDI directed to the energy sector in Georgia and Azerbaijan alone surpassed \$58 billion in investments¹². One can conclude that the energy sector is of far greater importance to outside investors than mining and agriculture.

⁷Particularly Italy, France, Germany, Netherlands and the UK, who are also the main sources of investment in the energy sectors of Georgia, Azerbaijan, Kazakhstan and Turkmenistan.

⁸Massachusetts Institute of Technology: The Observatory of Economic Complexity, [Data collected from the country sections dedicated to Armenia, Azerbaijan and Georgia respectively].

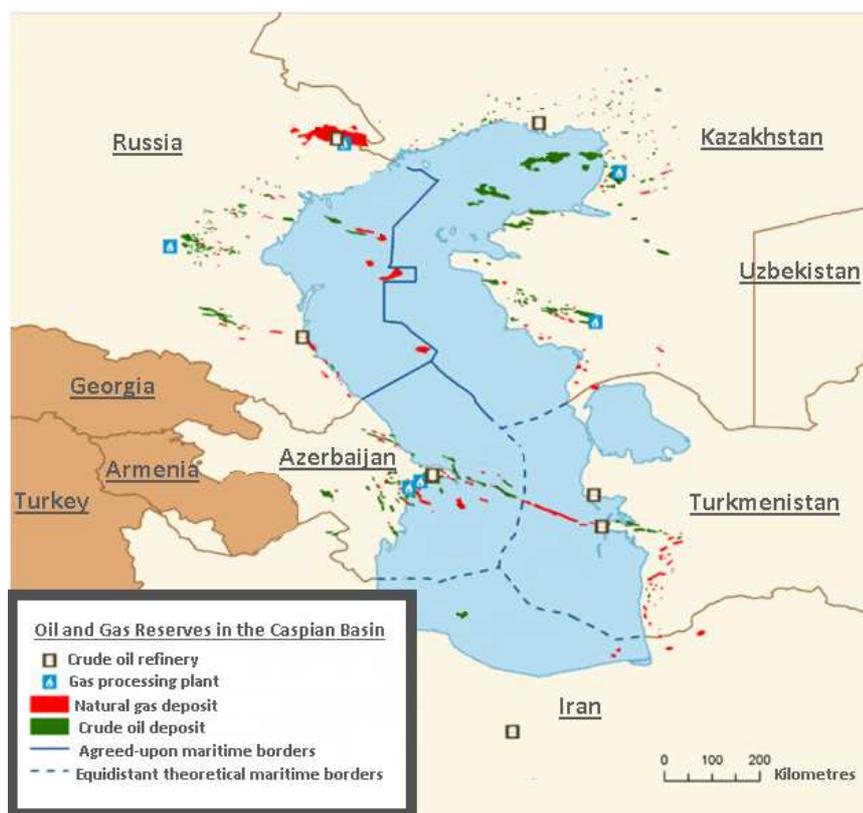
⁹Central Intelligence Agency: *op. cit.*

¹⁰National Statistics Office of the Republic of Georgia: Foreign Direct Investments [2016].

¹¹Ministry of Economy of the Republic of Armenia: "Volume of net flows of foreign investments into the real sector of RA economy by types of activity [2015].

¹²British Petroleum: BP in Azerbaijan [2016]. at: http://www.bp.com/en_az/caspian/aboutus/atag_lance.html

Distribution of energy resources in the Caspian basin



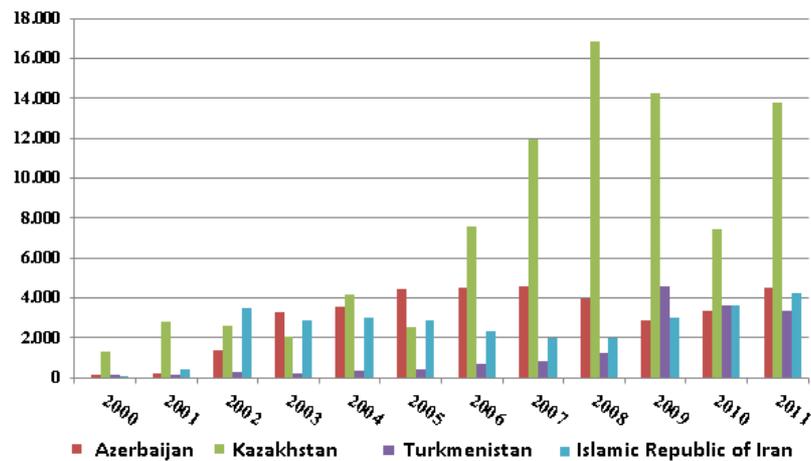
Source: U.S. Energy Information Administration:
 “Overview of oil and natural gas in the Caspian Sea region”, 26 August, 2013.

Specific markets are another point of interest in the region for foreign powers, because they yield great economic benefits. These markets include the armament market and to a lesser degree products of high-technology related to the oil and gas extraction sector. Even more so than Armenia, Azerbaijan and Georgia stand out for being the main receptors for both these foreign industries. Since its economic *boom* inaugurated by the Baku-Supsa Pipeline and concluded by the BTC and South Stream projects, between 2006-2015, Baku has come to spend more than \$24 billion in armament and defence technology¹³. Israeli, Russian and Turkish firms have found markets in Azerbaijan for products of their high technology defence industry which include guided missiles, helicopter gunships, air defence systems and unmanned aerial vehicles (UAV) just to name a few. The factor of oil plays an essential role here, as the huge importance it yields allows for arms transfers in exchange for preferential agreements, serving as a golden example is the case of Israeli-Azeri relations¹⁴.

¹³Stockholm International Peace Research Institute (SIPRI): Military Expenditure Database. Available at: <https://www.sipri.org/databases/milex>.

¹⁴Murison, Alexander: “The ties between Israel and Azerbaijan”, *Mideast Security and Policy Studies*, [Online], n°.110, October 2014

Foreign Direct Investment (in billions of US Dollars)



Source: Data collected from World Bank Database .

The regions developing energy sector has created another important market, which included high technology products along with maintenance needs and services. In recent years figures for this market have been significant. Foreign direct investments in Azerbaijan grew 68% between 2013-2014, from \$2,6 to \$4,4 billion, 80% of these investments were directed to the energy sector¹⁵. Without its energy resources the Caucasus would not have the relevance it has for the developed *Western* economies, and the geopolitical situation would surely be a different picture today. Few countries would be prepared to carry out such ambitious political and economic projects in a region so prone to armed conflict as the EU and Washington are currently doing, if it were not for the enormous benefits, fruit of Caspian hydrocarbons and its derivatives in influence and control over new geographic spaces.

¹⁵Economic and Social Commission for Asia and the Pacific of the United Nations: *Asia-Pacific Trade Briefs: Azerbaijan*, 2015.