

# DRIVERS AND STRATEGY IN TURKEY, RUSSIA, IRAN ECONOMIC AND ENERGY RELATIONS

*Authored by*

**Stephen J. Flanagan<sup>1</sup>**

*Henry A. Kissinger Chair in Diplomacy and National Security  
Center for Strategic and International Studies*

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This paper was prepared as part of a CSIS research project called “The Turkey, Russia, Iran Nexus: Regional Perspectives.” This project, which CSIS is pursuing in cooperation with the Economic Policy Research Institute of Turkey (TEPAV) and Institute of Oriental Studies (IVRAN) Moscow, is exploring evolving relations between these three pivotal countries and their implications for regional developments in the Caucasus, Central Asia, and the Eastern Mediterranean, and for their relations with the United States and other countries. It seeks to promote dialogue and a deeper understanding of these relations among experts and officials in all four countries. CSIS will develop a comprehensive assessment of the forces driving these relations and their long-term implications, and offer various policy recommendations. For more information on the project, please visit our website at <http://csis.org/program/turkey-russia-iran-nexus>.

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## *The Context*

Bilateral economic, energy, political, and security relations between Turkey, Russia, and Iran are shaping regional developments in Eurasia and the Middle East. The nexus of the three sets of relations are influencing each country's dealings with the other two and with a number of other countries, including the United States. These dynamics have important regional and global implications that our project seeks to assess.

Cooperation and competition in economic and energy affairs are major drivers of all three bilateral relationships. Each country appears to be pursuing a strategy of deepening economic and energy cooperation with the other two even as they are engaged in competition of varying intensities for markets and influence in the Caucasus, Central Asia, and the Middle East.

Lingering effects of the end of the Cold War, internal political developments, and growing polarization in the Muslim world are also influencing this nexus. While the vestiges of empire provide certain advantages and liabilities, Moscow lacks the resources to dominate Eurasia to the extent that imperial Russia and the Soviet Union did. Turkey and Iran have become more capable competitors, and China is an increasingly important actor in Central Asia. As political change and tensions between Sunni and Shi'a communities in the Middle East continue to unfold, the wary partnership between Turkey and Iran has been strained. A more intense struggle for regional influence is developing as the two governments pursue starkly different policies toward the Arab awakening and the popular uprising in Syria. Kremlin leaders, apprehensive about the political turmoil in the Middle East and what they perceive to be a building wave of Islamization that could ripple through Eurasia, have sought to reassert a role in the region. But in backing old allies, Moscow has been seen as aligned against political change.

There has been some trilateral cooperation in areas where the three countries share mutual interests. A prominent example of this came in June 2010 when the three held their third summit—on the margins of the Conference on Interaction and Confidence Building in Asia summit—and took a strong stance against further sanctions on Iran in connection with its nuclear program. However, important differences and lingering rivalries make it unlikely that the three will form a new Eurasian alignment. These longtime rivals appear to be using mechanisms for bilateral dialogue and cooperation to manage divergent interests and enduring mutual suspicions to avoid direct conflicts. This is becoming increasingly difficult for Turkey and Iran, as differences over Syria and other political developments in the Middle East deepen.

An overarching question for discussion was: will these three governments be able to expand trade and energy ties and will those links help manage political differences and realization of a stable regional balance of power? Or are the competitive elements of economic and energy dealings more likely to exacerbate differing regional interests?

### *Russia-Turkey: Toward a Strategic Partnership?*

The current Turkish government has made improvement of relations with Russia a priority since it took office in 2002. Trade with Russia began to grow in the last decade of the Soviet period, and Ankara has sought to use deepening economic and energy ties to pave the way for cooperation on political and security issues. Many Russian constituencies benefit from bilateral economic ties, and the Kremlin has sought to leverage those ties to encourage Ankara's recent inclination to pursue a more independent stance in international politics, periodically challenging U.S. and European policies.

Trade, investment, and tourism between the two countries have grown enormously over the past decade. Russia has been Turkey's leading trade partner (after the EU as a bloc) since 2008. Total bilateral trade

topped \$30 billion in 2011. The balance of trade is skewed in Russia's favor. Russian exports to Turkey were almost triple the value of Turkish exports to Russia. Energy comprised the bulk of Russian exports. Still Russia is Turkey's third biggest export market with sales of produce, textiles, and some consumer products being the leading sectors.

The two governments have set in train a number of initiatives designed to more than triple trade to over \$100 billion a year by 2015. Among these are an agreement to boost cooperation between small and medium-sized enterprises in each country and efforts to promote joint projects that would pair dynamic Turkish SMEs with Russia's substantial industrial investment potential. A number of economists we have consulted thus far find it hard to see how trade volume could grow to these levels. The workshop examined the most promising sectors for expansion of two-way trade and investment.

Turkish businesses have invested more than \$7 billion in Russia and Turkish contractors have completed projects in the country worth \$33.8 billion. Shuttle (suitcase) trade and tourism between the two countries have expanded over the last two decades, and have grown further with the initiation of visa-free travel after April 2011.

Bilateral energy relations reflect substantial mutual interests, but have competitive elements. Turkey's energy strategy seeks to balance its needs for robust supplies from Russia with its ambition to become a critical "energy bridge" to Europe and the West. Turkey is seeking to reduce its heavy dependency on Russian natural gas (55 percent of total in 2011) and oil (12 percent in 2011 but higher in previous years) imports through diversification. Russian efforts to control the flow of energy from the Black Sea and Caspian Basin regions threaten Turkey's ambition to play a key role in expanding the East-West energy transit corridor—even as it further develops the North-South energy axis with Russia.

The situation with respect to East-West energy flows from the Black and Caspian Sea regions remains very uncertain. The Turkish government supports development of the Southern Gas Corridor (Nabucco, TAP, ITGI, and TANAP) to bring Azeri and perhaps eventually Turkmen and, more controversially, Iranian gas to Europe via Turkey. Moscow has pushed development of the rival South Stream pipeline, a subsea route running from its Black Sea coast to Bulgaria. Turkey procrastinated for several years before reaching agreement with Russia in late 2011 on the route South Stream could take through its maritime exclusive economic zone in the Black Sea in an effort to gain concessions on the price of imported gas. While President Putin directed Gazprom to begin work in December 2012 with completion by 2015, South Stream still faces significant financial and technical hurdles—including construction of complex underwater and 2,000 kilometers of onshore pipeline. Turkey continues to work on expanding gas transit from Azerbaijan. The Nabucco project has little chance of succeeding without additional monetary support and upstream gas supplies. The Southeastern European Pipeline (SEEP), which would use existing Turkish and Azeri infrastructure to transport gas to the Turkish border with Bulgaria where the new SEEP infrastructure would send the gas onward to Austria, has the benefit of support from BP as the operating partner at Shah Deniz. However, the volume involved in SEEP would likely be significantly lower than some of the other Southern Corridor proposals and appears no more attractive to the Russians than other routes. Russia's strategy on Caspian demarcation and development runs contrary to Turkey's interest in development of the Trans-Caspian Natural Gas Project to route Turkmen and Kazhak gas to Europe.

Plans to build the Samsun-Ceyhan oil pipeline project, designed to connect Kazakhstan—via Russia, the Black Sea, and overland in Turkey—to the Mediterranean have also stalled in the face of negotiations between Turkey and Russia. Turkey favors the Samsun-Ceyhan pipeline to reduce tanker traffic through the Bosphorus and enhance Ceyhan's role as an energy hub. However the economic viability of the project has been in question from the outset, and some industry analysts have suspected that Transneft

participation in this and other Turkish Straits bypass projects has been driven more to draw Caspian oil to the BPS2 and ESPO pipelines, thereby extracting economic rent from Kazakh crude production.

In May 2010, the Turkish and Russian governments signed an agreement to cooperate on the construction and operation of four 1,200 megawatt Russian-design VVER power reactors at Akkuyu in southwestern Turkey. The Russian state-controlled AtomStroyExport will construct the plants, paying all the \$20 billion construction costs. Despite safety concerns due to potential seismic activity in the area, the Turkish parliament approved the deal and construction is scheduled to begin in 2013 with a projected operational date somewhere between 2016 and 2019. The terms of the Akkuyu agreement, including Russian training of Turkish personnel in plant operations, open the door to further cooperation in development of Turkey's nuclear power sector.

Turkish leaders have been able to work effectively with Russia to promote economic cooperation and security in the Black Sea region and have resisted expanded NATO operations there. Ankara's strategy is that deepening economic, energy, and security cooperation with Russia give it leverage in advancing Turkish interests in that region. However, the Black Sea cooperation does not seem to have produced much concrete benefit economically to littoral states. Moreover, it did not serve as an effective mechanism for regional crisis management during the Russia-Georgia War in 2008.

Turkey-Russia relations remain sound and robust but may be heading into a difficult period. Turkish leaders appear optimistic that deepening economic and energy ties, high-level political coordination, and growing civil society contacts can be institutionalized into a true strategic partnership. There is a growing pro-Russia lobby in Turkey supported by those who have benefited from bilateral economic ties. Despite these factors and close personal ties between Prime Ministers Erdoğan and Vladimir Putin, some Turkish officials and analysts appear concerned that Putin's return to the presidency will result in more assertive Russian policies in the Caucasus and Central Asia to the detriment of Turkish interests and Muslim communities in the region.

Official Russian assessments of relations with Turkey seem mixed. Bilateral economic and energy ties have paid clear financial dividends and have incentivized more independent Turkish policies. Over the past year, Moscow has no doubt been disappointed that Ankara has been closely aligned with U.S. and Western stances in the Middle East and North Africa. Differences over Syria and Russia's efforts to reengage in the Eastern Mediterranean are also likely to remain sources of friction in bilateral relations. Some Russian analysts see the potential for more intense competition for influence in the Caucasus. While Turkish activism in the region is presently limited to cultural, religious, and educational activities with Circassian and other Muslim communities, there are fears that it could, over time, foster radical Islamist movements in border states and in the North Caucasus and Crimea.

### ***Turkey-Iran: A Wary Partnership Under Strain***

Turkey's relations with Iran have had their ups and downs. Both governments have given a high priority to regional cooperation and pursued mutually-beneficial economic and energy ties as a way to avoid confrontations. Enduring rivalry and suspicion, as well as sectarian and cultural differences, seem likely to limit the scope of this partnership. Turkey's "zero problems" policy holds no illusions about the nature of the Iranian state. Rather, it is a strategy to keep competition with Iran peaceful, while sustaining its economic growth and role as an energy hub. The Iranian government has sought to leverage Turkey's need for energy and expanded markets to prevent further political isolation and unfavorable military developments in Turkey.

Turkey has been repeatedly disappointed in a number of trade and investment deals with Iran over the past decade. Tehran has failed to fulfill deals with Turkey on supply and exploitation of gas and oil resources and canceled major contracts with Turkish firms for high profile projects such as modernization of the Tehran airport and development of the Iranian mobile telephone network. Still, Iran has become Turkey's fifth largest trading partner. Total bilateral trade volume rose five fold from 2000-09, and eclipsed \$16 billion in 2011. Iranian exports to Turkey, particularly energy, account for over \$12 billion of that total. In 2010 the two governments pledged to reach a further expansion of trade to \$30B, including through the opening of more border crossings. However, analysts and business executives we have consulted feel this goal is unrealistic. Turkish executives continue to express frustration in navigating the complex, opaque, and corrupt business environment in Iran. Commerce with Turkey accounts for less than eight percent of Iran's total trade volume, and there are voices in Iran who argue their big emerging markets for goods and energy are to their East and North.

Two significant growth areas in economic relations have been Iranian investment in and travel to Turkey. Iranian firms are increasingly operating in Turkey as a way to access international markets in the face of a more restrictive business climate in Dubai and other Gulf states due to sanctions. More than 1,470 Iranian firms were operating in Turkey at the end of 2010, up from only 319 firms in 2002. Turkish banks have also positioned themselves as an acceptable international intermediary for financial transactions between the Islamic Republic of Iran and states such as India that do not want to infringe on U.S. sanctions/incur U.S. condemnation for such conduct. The U.S. government has been concerned about Iran using these commercial links to evade sanctions. Iranians now constitute the 4<sup>th</sup> largest group of foreign tourists in Turkey thanks to visa free travel with nearly 2 million visitors in 2011 adding to the growth in Turkey's robust tourism sector.

Iran and Turkey have sought to expand natural gas trade since 1996, when they concluded a 25-year agreement whereby Iran pledged to supply Turkey 10 billion cubic meters (bcm) of gas annually. Iran, citing domestic requirements, has not met this commitment. In 2002, the two countries completed a pipeline connecting the gas fields of Tabriz to Ankara, which provides the current supply. In recent years, Iran has been Turkey's second largest supplier (16-18 percent) of natural gas after Russia and a major supplier of oil (30-32 percent of imports in recent years—although it spiked to 51 percent in 2011). Iran has also offered Turkey price concessions on oil imports. Iran increased its gas exports to Turkey by 50 percent in 2010 to 8.25 bcm and reportedly reached the 10 bcm commitment level in 2011. The Turks have sought to increase this supply further (to 16 bcm annually), however, our research and interviews suggest that Turkish energy executives are dubious about securing more Iranian gas due to its high price, uncertain supplies, and the frustrations of doing business in Iran. In addition, Turkey has taken Iran to arbitration over gas prices. Turkish energy planners seem to have decided to focus their efforts on attaining more Azeri gas in the near-term and Iraqi and Turkmen gas over the longer-term.

On the issue of gas transit and Caspian Basin development, Turkish and Iranian interests appear to diverge. Turkish planners hoped to serve as a transit corridor for expanded Iranian gas supplies that might one day head to Europe. Iran appears to favor other routes through Middle East countries to reach European markets. Despite differences with Russia on Caspian demarcation, Tehran shares Moscow's opposition to the Trans-Caspian pipeline to transfer Central Asian gas Europe. Pressure on Turkey to comply with international sanctions on Iran, as well as enduring tensions over Syria and other regional issues seem likely to slow the development of Turkish-Iranian energy relations. It remains unclear whether Iran is serious about Turkish participation in upstream gas development and both countries seem likely to remain competitors with Russia in the development of Central Asian energy resources.

All elements of bilateral relations are now clouded by differences over Syria and political change in the Middle East, as well as the internal power struggle in Tehran between the Supreme Leader, the President, and the Iranian Revolutionary Guard Corps (IRGC). Turkey-Iran relations have entered a volatile phase,

despite the efforts of both governments to suggest that all is well. Still, the Turkish government does not want a confrontational relationship with Iran and still holds hope of encouraging Iran to take a more pragmatic and less ideological stance that would avoid eruption of what both sides have called a new Sunni/Shi'a "Cold War" in the Middle East. Turkey will continue to oppose efforts to impose further sanctions on Iran and seek to broker a settlement with Iran on its nuclear program. Turkey will likely remain a major buyer of Iranian crude oil, assuming it is able to secure a waiver from U.S. financial sanctions concerning dealings with Iran, but Washington will likely press Ankara to commit to reducing imports as a condition. Turkey's effort to balance security concerns and cooperation with Iran is reflected in decisions on missile defense. While it endorsed development of NATO's missile defenses at the 2010 Lisbon Summit and a year later agreed to deployment of U.S. missile defense radars on Turkish territory, it insisted that no country be cited as the threat rationale for either action.

### ***Russia-Iran Relations: Limited Cooperation***

Russia-Iran relations are the least developed side of this triangle. During the last decade, the Kremlin viewed Iran as a growing market, including for conventional arms, and a potential partner in balancing U.S. and Turkish influence in Central Asia and the Caucasus. The Kremlin has never shared the West's view of Iran as an urgent or even looming security threat. Russian leaders find Tehran's anti-Americanism useful as a way to balance U.S. political influence and have used their policies on Iran's nuclear program as a bargaining chip with Washington to gain other concessions. Iran has developed its cooperation with Russia despite abiding historical suspicions about Moscow's intentions and its policies toward Muslim communities, in support of its larger strategic goal of counterbalancing U.S. dominance and promoting a multipolar world.

Bilateral relations had soured after 2010 due to Russia's support of further UN sanctions on Iran, "technical" delays in finishing construction of the Bushehr nuclear plant, and cancellation of the sale of the S-300 air defense missile system. It appears that President Putin does not get on well with President Ahmadinejad, and is said to feel rebuffed several years ago in advancing fairly constructive proposals over disposition of spent nuclear fuel. The downturn in relations with Iran also angered an influential, pro-Iranian lobby in Moscow including defense industries that lost sizable arms sales. As differences with Washington on arms control, missile defense, Syria, and other developments in the Middle East have grown over the past year, Moscow has found new scope for cooperation with Tehran.

Total annual bilateral trade between Iran and Russia is estimated to have tripled over the past decade, but volume remains quite small—about \$4.2 billion in 2010. Russia accounts for about 2.5 percent of Iranian foreign trade volume, and Iran represents only to 0.6 percent of Russia's. The two governments have expressed a desire to expand volume to \$10 billion annually, but this does not seem like a priority for either side and there seems to be little potential for dramatic growth as the economies are not complementary.

We can find no evidence of quantifiable energy trade between Russia and Iran. Russia and Iran have worked together in exploiting gas reserves in the Caspian and signed a treaty in 2008 agreeing to cooperate on development of Iran's gas and oil reserves. We understand there are some Gazprom executives in Iran, working on Gazprom projects, but there is no sign of any commercial production. Russian enterprises may be able to provide extraction or other energy technologies that the Iranian's lack and want, but we question how open Iran really is to foreign participation in development of its energy sector. Despite delays in the completion of the Bushehr 1 plant, Iran has approached state-controlled Rosatom about construction of additional nuclear reactors at Bushehr. A 1992 Russian-Iranian intergovernmental agreement envisaged the construction of four nuclear reactors in Iran.

The two governments hold divergent positions on demarcation of the Caspian Sea. The Russian support for a median-line solution would severely limit Iran's share of Caspian energy resources. Despite that difference, the two governments both oppose development of the trans-Caspian pipeline. While united in opposing these alternative routes for Caspian energy, the two countries appear to see themselves as long-term competitors in the European market. Iran and Russia are founding members and promoters of the Gas Exporting Countries Forum and together hold about 40 percent of global natural gas reserves, but the extent of policy coordination seems quite limited.

While both Russia and Iran have an interest in challenging Western dominance, many political issues divide the two. The first is Moscow's treatment of Muslim populations in Russia. A second is what seems to be a general Russian unease—despite their cooperation—with the Iranian nuclear power program. Russia also has a more complicated set of political relationships to manage, while Iran's generalized hostility to a wide range of countries creates a different attitude toward diplomacy. Russian authorities have found Iranian counternarcotics operations in Central Asia quite effective in disrupting the drug trade from that region, which is a serious threat to law and order and public health in both countries.

In the aftermath of the Georgia War, Iran did become more active diplomatically in the Caucasus to offset Russian influence and protect its own interests in developing economic ties and energy routes. Tehran has announced a number of investments in bilateral economic projects in the region, taken steps to facilitate travel to Iran, and offered to mediate between Armenia and Azerbaijan over the Nagorno-Karabakh dispute. However, experts at a recent CSIS conference and Russian analysts interviewed in Moscow believe that Tehran has made a conscious decision to avoid causing problems for Moscow in the Caucasus. In part, this restraint seeks to induce Moscow to oppose further sanctions on Iran. The insurgents and foreign fighters operating in the North Caucasus are Sunni Salafists not aligned with or supported by Iran. There is also evidence that key elements of the regime in Tehran view the Caucasus as a side show and want to focus on the unfolding struggle for influence in the Middle East and North Africa where they see much higher stakes.

### ***Trilateral Potential***

The possibility of growing trilateral cooperation gained attention on June 8, 2010, when leaders of the three countries met in Istanbul the day before a UN Security Council vote on U.S. and EU-backed sanctions on Iran relating to its nuclear program. This display of solidarity, the third such summit to discuss regional cooperation and security issues, was calculated to counterbalance efforts by the United States and Europe in their efforts to isolate Iran.

Significant obstacles to closer trilateral cooperation remain. Both Russia and Turkey have had difficulties in dealing with Iran. Europe remains by far the most important trading partner for both Russia and Turkey, and both are heavily invested in enhancing relations with the European Union and the United States. Turkey's close ties to the United States, bid for membership in the European Union, and integration into Western institutions such as NATO and the OECD, are also impediments to closer relations with Russia and Iran. The support Moscow and Tehran have shown for the Assad regime in Syria has alarmed Turkish leaders and has the potential to cause serious fissures in relations. All three countries are competing for influence in the Caucasus, Central Asia, and the Middle East and have very different stances toward political change in those regions.