

JUNE 2016

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Foreign Economic and
Security Interests

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Preface

In January 2014, the CSIS Russia and Eurasia Program launched its Eurasia Initiative. The vast Eurasian landmass, stretching from China in the east to Europe in the west and from the Arctic Ocean in the north to the Indian Ocean in the south, includes some of the world's most powerful and dynamic states, as well as some of the world's most intractable challenges. Scholars and analysts are accustomed to focusing on Eurasia's various regions—Europe, the former Soviet Union, East Asia, South Asia, and Southeast Asia—rather than on the interactions between them. The goal of this initiative is to focus on these interactions, while analyzing and understanding Eurasia in a comprehensive way.

Today, more than any time since the collapse of the Silk Road five centuries ago, understanding these individual regions is impossible without also understanding the interactions among them. Over the past two decades, Eurasia has begun to slowly reconnect, with the emergence of new trade relationships and transit infrastructures, as well as the integration of Russia, China, and India into the global economy. Even as this reconnection is under way, the center of economic dynamism in Eurasia, and in the world as a whole, continues shifting to the East. The impact of these shifts is potentially enormous, but they remain poorly understood because of intellectual and bureaucratic stovepiping in government and the broader analytic community.

The report you are holding in your hands is one of the fruits of the Eurasia Initiative. Following the production of six reports as part of our 2015 series on *Central Asia in a Reconnecting Eurasia*, the CSIS Russia and Eurasia Program is now proud to announce the release of the next installment: *The South Caucasus in a Reconnecting Eurasia*. This four-report series includes detailed analytic reports on the foreign economic and security interests of Armenia, Azerbaijan, and Georgia, as well as a summary report laying out the challenges and opportunities for U.S. policy in the region. Long an important transit corridor between the western and eastern parts of Eurasia, the South Caucasus continues to face a range of geopolitical challenges, exacerbated by tectonic shifts taking place around the region's borders: the crisis in Ukraine, growing confrontation between Russia and Turkey, turmoil in the Middle East, and reduced appetite for engagement in both the European Union and the United States.

To better understand the geopolitical and geoeconomic environment confronting the South Caucasus states, starting in 2014, members of the CSIS Russia and Eurasia Program traveled to the region and conducted interviews with a wide range of government officials, experts, private-sector actors, and representatives of international organizations to understand how elites in Armenia, Azerbaijan, and Georgia perceive the economic and security environment changing around them.

This report and the others in the series reflect what we gleaned from these interviews, along with analysis of published data and secondary literature, to provide a broad overview of how the world looks from the perspective of the South Caucasus. As in our earlier report series on Central Asia, the emphasis in these reports is the foreign economic and security policies of the three states. While we are cognizant of the complex situation surrounding domestic politics and human rights in some of these countries, the focus of this particular project is the strategic implications of a reconnecting Eurasia—in other words, how the states of the South Caucasus interact with each other and with the outside world. We address domestic issues, including human rights, corruption, and authoritarian practices, to the extent that they affect the interactions between Armenia, Azerbaijan, and Georgia, on the one hand, and the rest of the world, on the other.

The South Caucasus has throughout history been a political and civilizational fault zone between Europe, Turkey, Russia, and Persia. Since the Soviet collapse, the South Caucasus states have themselves acquired agency in international politics, even as they remain buffeted by the larger forces swirling around them. For the United States and other Western governments, effective policymaking in the South Caucasus requires a nuanced understanding of the interests, objectives, worries, and levers of influence available to the South Caucasus states. *The South Caucasus in a Reconnecting Eurasia* report series is designed to give a regional perspective to foreign officials, activists, investors, and others to help them better navigate the complex environment of the South Caucasus.

Acknowledgments

We would like to take this opportunity to express our gratitude to the many institutions and individuals who made this report and the others in the series possible. The project would not have been possible without the generous financial support of the Smith Richardson Foundation, the Ministry of Foreign Affairs of the Republic of Kazakhstan, and Carlos Bulgheroni. We are also extremely grateful for program support provided by the Carnegie Corporation of New York to the CSIS Russia and Eurasia Program. Additionally, we are grateful to the many government officials, experts, NGO staff, and private-sector actors who shared their insights with us during research trips to the region and in Washington, DC. Thanks are due as well to the embassies of Armenia, Azerbaijan, and Georgia in Washington, whose staff helped facilitate our travel to their respective countries, and in particular to Ambassadors Tigran Sargsyan (Armenia), Elin Suleymanov (Azerbaijan), and Archil Gegishidze (Georgia). The assistance of Hrachia Tashchian at the Embassy of Armenia, Mammad Talibov at the Embassy of Azerbaijan, and Tinatin Mikiashvili and Giorgi Khelashvili at the Embassy of Georgia is also worthy of special thanks.

We also owe a debt of gratitude to the reviewers who read and provided feedback on drafts of the reports in this series. These include Ambassador William Courtney, Rosemarie Forsythe, Richard Giragosian, Ambassador Batu Kutelia, Ambassador Richard Morningstar, Wayne Merry, and Sufian Zhemukhov. Finally, we would also like to extend our thanks to the many current and former members of the CSIS Russia and Eurasia Program who contributed to the project in various ways: Program Coordinator Sung In Marshall, as well as interns Fuad Abdul, Yulia Danilina, Jacob Gladysz, Yana Gololobova, Eric Griffith, Kendra Harkins, Vlad Kondratiuk, Peter Krivicich, Allen Maggard, Brina Malachowski, Daniel Mark, Kirill Prudnikov, Dylan Royce, Narek Sevacheryan, Jason Siler, and Nic Wondra.

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The View from Yerevan

More than two decades since it ended, the 1992–1994 Nagorno-Karabakh War and its legacy continue to define Armenia’s regional security and economic environment. The conflict left Armenia in control of the disputed territory of Nagorno-Karabakh (as well as seven surrounding Azerbaijani districts), but at the price of an enduring confrontation with not just Baku, but also Azerbaijan’s ally Turkey.¹ In response, Armenia had little choice but to deepen its own political and economic ties to Russia. Today Russia not only underwrites Armenia’s security, but occupies a dominant position in the Armenian economy. Russia has thousands of troops and other security personnel deployed to Armenia, while Russian companies have assumed a controlling stake in key infrastructure and utilities, providing the bulk of Armenia’s foreign investment and trade. Nagorno-Karabakh meanwhile is deeply integrated with the Republic of Armenia, even though Yerevan does not claim formal sovereignty over the region, nor regard it as independent.

Armenia is thus closely tied to and dependent on Russia, even though many Armenian elites worry that excessive dependence on Russia threatens Armenia’s sovereignty. Yerevan is Moscow’s closest ally in the South Caucasus, participating in Russian-led multilateral organizations such as the Collective Security Treaty Organization (CSTO) and the Eurasian Economic Union (EEU). Several of our interlocutors pointed to Yerevan’s 2013 decision to abandon efforts to sign an association agreement with the European Union and join the EEU instead as an example of the constraints Armenia faces as a result of its political and economic dependence on Moscow.

During the Nagorno-Karabakh War, Azerbaijan and Turkey sealed their respective borders with Armenia and imposed an economic blockade that has lasted to the present day.² New

1. In addition to the Soviet-era Nagorno-Karabakh Autonomous Oblast, Armenia took control of the Azerbaijani districts of Kelbajar, Lachin, Kubaltı, Jibrail, Zangelan, as well as parts of Agdam and Fusuli (see Map 2.1). The Organization for Security and Co-operation in Europe (OSCE), which seeks to mediate the conflict, regards Nagorno-Karabakh proper as disputed territory and the other regions as occupied.

2. The Turkish blockade is partial, as Armenia and Turkey conduct more than \$200 million of bilateral trade each year through Georgia and direct air links exist between Armenian and Turkish cities. The Azerbaijani blockade, in contrast, is all but total.

infrastructure projects built across the South Caucasus over the past two decades have in consequence largely bypassed Armenia, while many Soviet-era connections have fallen into disuse. Armenia has thus missed out on the benefits of connectivity that have transformed the South Caucasus into an increasingly important corridor for east-west trade and transit. Instead, Armenia has had to rely on economic and trade connections with its neighbors to the north and south, Georgia, Russia (via Georgia), and Iran.

An effort by Armenian and Turkish leaders to normalize relations in 2009–2010 foundered on Baku's demands that any normalization be linked to a resolution of the Karabakh conflict. That failure has made it virtually impossible to delink the Azerbaijani-Turkish blockades on the one hand and the future of the contested territories on the other. Many Armenians perceive the hostility of Azerbaijan and, more important, Turkey as an existential threat, requiring close political, military, and economic cooperation with Russia.

Despite its dependence on Russia, Yerevan maintains ties with external powers, including the European Union and the United States, that it would like to further deepen. Even with the collapse of negotiations on an EU association agreement and Armenia's decision to join the EEU, Yerevan continued pushing for a preferential trade arrangement that would also help liberalize its economy and attract foreign investment from a wider range of sources, leading to the opening of talks on a bilateral framework agreement with Brussels in late 2015. Yerevan would also like to deepen security ties with the North Atlantic Treaty Organization (NATO), since it already contributes peacekeepers to the NATO-led International Security Assistance Force in Afghanistan and the Kosovo Force (and previously had peacekeepers in Iraq as well), and with the United States, as a means of creating additional stakeholders in Armenia's continued sovereignty and independence, and as even a minor counterweight to Russia's influence.

In the meantime, the situation in and around Nagorno-Karabakh itself is becoming increasingly fraught. The Minsk Group of the Organization for Security and Co-operation in Europe (OSCE), cochaired by France, Russia, and the United States, continues to seek a resolution, though critics charge that it has increasingly taken on the role of managing rather than resolving the conflict.

Incidents along the Line of Contact have increased in both frequency and severity in recent years, while Armenia has also faced cross-border attacks beyond the frontiers of Nagorno-Karabakh. Concerns about a resumption of full-scale conflict are growing, especially following an outburst of major fighting in early April 2016 that saw Azerbaijani forces seize some strategic heights across the Line of Contact. The balance of power on the ground appears to be shifting in favor of Azerbaijan, whose energy riches have allowed it to dramatically boost military spending. Yet Armenia retains considerable advantages, including the mountainous terrain of Nagorno-Karabakh that favors defensive operations; a Karabakhi population highly motivated to remain under Armenian suzerainty; and a well-trained, professional military establishment. Renewed conflict is likely to result in a bloody catastrophe for both sides, even without direct intervention by Russian or Turkish forces.

Armenia's elite is clear eyed about the nature of the challenge the country faces. Surrounded on its east and west by hostile neighbors, Armenia has had little choice but to move further and further into the Russian embrace. Many Armenians resent the extent of their country's dependence on Moscow but recognize they have few alternatives. Under the circumstances, Yerevan is opportunistic about deepening ties with external powers, but is unwilling to risk jeopardizing its fundamental security, and hence, its relationship with Moscow.

Armenia's Foreign and Security Policy

Armenia's foreign relations are based on the concept of complementarity, defined as mutually beneficial political and economic cooperation with partner states, possible partners, and states interested in South Caucasus and Armenia, "aimed at maintaining an overall balance in the region."¹ According to the official National Security Strategy adopted in 2007, Armenia's national interest is composed of five pillars: independence, protection of the state and its population, peace and international cooperation, preservation of national identity, and prosperity.²

Armenia's strategic choices, however, are limited due to the ongoing Nagorno-Karabakh conflict, the closure of its borders with Azerbaijan and Turkey, as well as its economic (especially energy) and security dependence on Russia. Yerevan perceives Baku's military rhetoric, growing military spending, and increased cross-border attacks as a threat not only to its hold on Nagorno-Karabakh and the surrounding territories, but to Armenia's national security writ large. Meanwhile, Azerbaijan and Turkey's economic blockades isolate Armenia from east-west connectivity and limit the scope of Yerevan's international economic policies. Under the circumstances, Yerevan's strategic choices largely reflect the imperatives of ensuring security in a hostile neighborhood. The combination of the economic blockade and perceptions of threat from Azerbaijan and Turkey have led Armenia to pursue a very close relationship with Moscow, which in turn constrains its ability to engage with outside powers, including the European Union and NATO. Lacking a common frontier with Russia and facing closed borders with Turkey and Azerbaijan, Armenia's direct outlets to the rest of the world go through neighboring Georgia and Iran, which are both important strategic as well as economic partners.

1. Office of the President of the Republic of Armenia, "Republic of Armenia National Security Strategy," January 26, 2007, http://www.mfa.am/u_files/file/doctrine/Doctrineeng.pdf.

2. Ibid.

AZERBAIJAN AND NAGORNO-KARABAKH

Yerevan firmly believes that the peace and stability of the South Caucasus demand closer economic and political relations with neighbors, some of which, however, have intentionally sought to keep Armenia isolated since the Nagorno-Karabakh war of the early 1990s. Armenia sees a hostile Azerbaijan as the main obstacle to achieving both its national security objectives as well as regional integration.

Armenian-Azerbaijani relations are defined almost entirely by the Nagorno-Karabakh conflict. During the Soviet era, the ethnic Armenian population of Nagorno-Karabakh (94.4 percent in 1921; 77 percent in 1989, according to Soviet census figures) appealed several times to Moscow to incorporate the region into the Armenian Soviet Socialist Republic (SSR).³ During the late 1980s, these demands sparked mass demonstrations and interethnic violence in both Armenia and Azerbaijan that eventually spiraled into a full-scale conflict in 1988.⁴ A cease-fire brokered through the OSCE's Minsk Group in 1994 left the bulk of the Soviet-era Nagorno-Karabakh Autonomous Oblast, as well as seven neighboring districts of Azerbaijan, under de facto Armenian control.⁵ While the conflict has remained largely frozen since, cross-border violence remains a regular occurrence. Since 2014 or so, violence along the Line of Contact in Nagorno-Karabakh as well as along the undisputed Armenian-Azerbaijani frontier has become both more frequent and more severe, with forces on both sides resorting to heavier weaponry and inflicting higher casualties.⁶ Fighting across the Line of Contact in April 2016 left dozens dead on both sides.⁷ Armenia blames the Azerbaijani side for the escalation, while military planning in both countries assumes that a resumption of fighting over Nagorno-Karabakh will not be limited to the Line of Contact but will become a more generalized conflict, one that could potentially draw in other regional powers.

Today, Nagorno-Karabakh is tightly integrated with the Republic of Armenia, many of whose leading politicians (including current president Serzh Sargsyan and his predecessor Robert

3. Caroline Cox and John Eibner, *Ethnic Cleansing in Progress: War in Nagorno Karabakh* (Washington, DC: Institute for Religious Minorities in the Islamic World, 1993), 32. Census figures available at <http://www.ethno-kavkaz.narod.ru/rnkarabax.html>; Levon Chorbajian, Patrick Donabedian, and Claude Mutafian, *The Caucasian Knot: The History and Geopolitics of Nagorno-Karabagh* (London: Zed Books, 1994), 142.

4. Richard Giragosian, "Commentary: The Putin Paradigm—What Next for Nagorno-Karabakh?," Radio Free Europe/Radio Liberty, March 19, 2014, <http://www.rferl.org/content/russia-armenia-azerbaijan-nagorno-karabakh-crimea/25302429.html>.

5. At the time of the cease-fire, Azerbaijani forces had taken control of the Shahumyan district and part of the Martakert district of the Soviet-era Autonomous Oblast.

6. Associated Press, "Azerbaijan and Armenia Trade Attacks," *New York Times*, August 4, 2014, <http://www.nytimes.com/2014/08/05/world/europe/azerbaijan-and-armenia-trade-attacks.html>; Irina Hovhannisyan, "Armenian Border Villages 'Under Azeri Fire,'" Azatutyun.am, February 13, 2013, <http://www.azatutyun.am/content/article/24901090.html>; Sisak Gabrielian, "Armenian-Azerbaijani Fighting Claims More Lives," Azatutyun.am, February 6, 2015, <http://www.azatutyun.am/content/article/26833748.html>; Margarita Antidze, "Fatal Clashes between Azerbaijan and Armenia-backed Karabakh Stir Tension," Reuters, September 28, 2015, <http://www.reuters.com/article/us-armenia-azerbaijan-idUSKCN0RS1LO20150928>.

7. "Nagorno-Karabakh Violence: Worst Clashes in Decades Kill Dozens," BBC, April 22, 2016, <http://www.bbc.com/news/world-europe-35949991>.

Kocharyan) are of Karabakhi origin. Yerevan acts as the guarantor of Nagorno-Karabakh's security and insists that any final peace deal with Azerbaijan must be accepted by the Karabakhis as well.⁸ In practice, according to a foreign diplomat we interviewed, Yerevan would like to see the Nagorno-Karabakh conflict resolved along the lines of the conflict over Kosovo: with a referendum that ratifies Nagorno-Karabakh's independence, which may or may not be followed by the territory's formal incorporation into Armenia. During the April 2016 fighting, which saw Armenian forces driven back from some areas along the Line of Contact, Yerevan openly raised the possibility of proclaiming Nagorno-Karabakh independent, and a bill to that effect was submitted to the Armenian parliament and approved in May 2016.⁹

During the 1992–1994 Nagorno-Karabakh conflict, Armenian forces also overran seven districts of Azerbaijan beyond the frontiers of Soviet-era Nagorno-Karabakh. International mediators treat these seven districts as occupied territory (unlike Nagorno-Karabakh proper, which the United States and others regard as disputed), and efforts to promote a rapprochement between Baku and Yerevan mostly emphasize the need to return these districts to Azerbaijani control. While official Yerevan clearly delineates the seven districts from Nagorno-Karabakh proper, our interlocutors suggested that in both Nagorno-Karabakh and in Armenia, the public is less and less inclined to distinguish between Nagorno-Karabakh and the surrounding districts, making withdrawal even from these other regions politically problematic. According to a senior foreign diplomat, these concerns are especially pronounced with regard to the strategically important Lachin and Kelbajar districts.

The OSCE's Minsk Group continues its efforts to resolve the conflict, but our interlocutors from the Armenian government and foreign diplomats were skeptical about the prospects. They worry too much time has passed without concrete results, and by now the Minsk Group has become more about managing the conflict than ending it. Many diplomats nevertheless believe that the Minsk Group retains a vital role in arresting the slide toward a resumption of the conflict. Other analysts suggest the need for the United States and its allies to bypass the Minsk Group and act as honest brokers between Baku and Yerevan.¹⁰ Yerevan firmly opposes any efforts at bypassing the Minsk Group, which it fears would precipitate a renewal of hostilities.

Nagorno-Karabakh's disputed status is also a source of friction in the context of Armenia's decision to join the Eurasian Economic Union. As none of the EEU members recognize Nagorno-Karabakh as part of Armenia, it remains excluded from the EEU's customs zone. Some Armenian officials and analysts worried ahead of Yerevan's EEU accession that Armenia would be forced to establish customs posts along the frontier between the occupied regions and Armenia proper. The EEU has

8. Ministry of Foreign Affairs of the Republic of Armenia, "Minister of Foreign Affairs of Armenia visited Stepanakert," press release, July 19, 2013, http://www.mfa.am/en/press-releases/item/2013/07/19/vis_step/.

9. "Armenia Submits Bill Recognizing Independent Nagorno-Karabakh," *Moscow Times*, May 5, 2016, <http://www.themoscowtimes.com/news/article/armenia-submits-bill-recognizing-independent-nagorno-karabakh/568076.html>.

10. Svante E. Cornell, S. Frederick Starr, and Mamuka Tseretali, *A Western Strategy for the South Caucasus* (Washington, DC: Central Asia–Caucasus Institute a Silk Road Studies Program, February 2015), <http://www.silkroadstudies.org/publications/silkroad-papers-and-monographs/item/13075-a-western-strategy-for-the-south-caucasus.html>.

thus far finessed this issue by leaving Nagorno-Karabakh formally outside the union, but not requiring Armenia to establish customs checkpoints.¹¹

The enduring nature of the Nagorno-Karabakh conflict has entrenched mistrust between the governments as well as the populations of both Armenia and Azerbaijan, complicating efforts to seek reconciliation in the longer term. The conflict is the main obstacle to Armenia's regional integration and economic development. It is also the source of Armenia's principal security concerns because of the resulting hostility from Azerbaijan and its regional patron Turkey. With the eruption of the conflict, all bilateral and multilateral relations between the newly independent states of Armenia and Azerbaijan were abruptly cut and the border sealed. Despite the 1994 cease-fire, the border remains tightly closed, with practically no cross-border movement or trade (see Map 2.1).

Armenia's Military Doctrine lists "the Republic of Azerbaijan's aspirations to gain military superiority . . . and to resolve the Karabakh conflict through military means" among the principal threats facing the country.¹² Contributing to this perception is Azerbaijan's rapidly growing military budget and military capabilities and the increasingly harsh rhetoric coming from official Baku.¹³ Azerbaijan's military spending was around \$4.8 billion in 2015, whereas Armenia's *total* state budget is \$3.2 billion.¹⁴

Armenia's view of its security environment is also shaped by its long history of conflict and ethnic cleansing, one that dates back to the Ottoman era. Several of our interlocutors pointed to the 1915 genocide, in addition to the more recent Nagorno-Karabakh War and ethnic violence against Armenians in Azerbaijan, as contributing to Yerevan's threat perception and sense of insecurity. Turkey's continued denial that the events of 1915 constituted genocide, a position Azerbaijan also embraces, does little to allay these fears.

GEORGIA

Despite extensive security and economic cooperation with Azerbaijan, Georgia maintains good relations with Armenia as well, providing Yerevan an important diplomatic partner and lifeline to

11. Siranush Ghazanchyan, "Aliyev Thanks Nazarbayev for Support at Eurasian Summit," Public Radio of Armenia, June 5, 2014, <http://www.armradio.am/en/2014/06/05/aliyev-thanks-nazarbayev-for-support-at-eurasian-summit/>; Nune Arevshatyan, "Ambassador of Kazakhstan about Reading of Ilham Aliyev's Letter by Nursultan Nazarbayev (Video)," *Aravot News*, October 25, 2014, <http://en.aravot.am/2014/10/25/167479/>; Casey Michel, "Eurasian Economic Union: Dead on Arrival?," *Diplomat*, January 5, 2015, <http://thediplomat.com/2015/01/eurasian-economic-union-dead-on-arrival/>.

12. Republic of Armenia, "The Military Doctrine of the Republic of Armenia," <http://www.mil.am/en/68/70/76>.

13. Larisa Deriglazova and Sergey Minasyan, *Nagorno-Karabakh: The Paradoxes of Strength and Weakness in an Asymmetric Conflict* (Yerevan: Caucasus Institute, June 2011), 99–100, http://dealingwiththepast.org/wp-content/uploads/2015/03/CI-2011_Nag-Kar-eng.pdf; Thomas Grove, "Russia Starts Delivering \$1 Billion Arms Package to Azerbaijan," *Reuters*, June 18, 2013, <http://www.reuters.com/article/2013/06/18/us-russia-azerbaijan-arms-idUSBRE95H0KM20130618?feedType=RSS>.

14. John C. K. Daly, "Azerbaijan's Defense Spending Hits \$4.8 Billion," *Silk Road Reporters*, November 25, 2014, <http://www.silkroadreporters.com/2014/11/25/azerbaijan-defense-spending-hits-4-8-billion/>.

Map 2.1. Nagorno-Karabakh



Source: https://commons.wikimedia.org/wiki/File:Caucasus-political_en.svg.

the outside world. According to figures from the International Monetary Fund (IMF), trade between the two countries increased from \$93.75 million in 2009 to more than \$156 million in 2014, and Georgia is Armenia's second-largest trade partner after Russia.¹⁵ Given the closure of Armenia's borders with Azerbaijan and Turkey, the Georgian port of Poti is also a critical hub for Armenian exports and imports.

15. International Monetary Fund (IMF), Direction of Trade Statistics (DOTS) database, <http://data.imf.org/?sk=9D6028D4-F14A-464C-A2F2-59B2CD424B85>.

Yerevan welcomes Georgia's pro-Western orientation, which Yerevan sees as an opportunity to deepen its own connection with Europe at a time when its dependence on Russia is growing. As several of our interlocutors noted, Yerevan similarly welcomes Georgia's close ties with NATO, as well as security and defense cooperation with the United States. Many Armenian officials and analysts believe that stronger Western involvement in Georgia helps promote stability and security for the entire region—including Armenia itself—though others note that it was Georgia's flirtation with the West that led to it losing South Ossetia and Abkhazia.

Yerevan is also relatively sanguine about Georgia's close relations with its long-standing foes Azerbaijan and Turkey, including the development of trilateral ties.¹⁶ Armenia is however attuned to the possibility that this trilateral cooperation could develop more of a military-security dimension. For Yerevan, the danger posed by the Baku-Tbilisi-Ankara axis is less of a direct threat from the three countries' forces than an escalation of tensions between them and Russia, which guarantees Armenia's security and opposes the presence of outside military forces in the region. In an environment of growing polarization between the major powers, Armenia could find itself on the front lines of a renewed confrontation. The June 2012 signing of the Trabzon Declaration among Azerbaijan, Georgia, and Turkey was followed by an increase in Russian military flights over Armenia.¹⁷ Similarly, Russian airborne forces stationed in Armenia also launched a three-day exercise in April 2015 timed with Georgia's offer to conduct joint military training with Azerbaijani and Turkish forces.¹⁸

Tbilisi and Yerevan are also sensitive about one another's ethno-territorial conflicts. Although Tbilisi supports the concept of territorial integrity in principle, it remains neutral on the Nagorno-Karabakh conflict, merely endorsing the Minsk Group's approach and urging its neighbors to find a peaceful solution to the conflict. Similarly, Armenia did not recognize the independence of the breakaway territories of South Ossetia and Abkhazia and remained neutral during the 2008 Russo-Georgian War, despite its close ties to Moscow. Armenian comments on the conflict were limited to calls for peaceful resolution in the interest of stability in the region.¹⁹

Another of Armenia's primary objectives in relations with Georgia is to maintain a transit route through Georgian territory to Russia and to the Black Sea.²⁰ Along with Iran, Georgia is Armenia's only connection to global markets, and all Russian imports come through Georgia.²¹ During the

16. Michael Hikari Cecire, "Turkey-Georgia-Azerbaijan: Trilateralism and the Future of Black Sea Regional Geopolitics," *Central Asia-Caucasus Analyst*, October 16, 2013, <http://www.cacianalyst.org/publications/analytical-articles/item/12837-turkey-georgia-azerbaijan-trilateralism-and-the-future-of-black-sea-regional-geopolitics.html>.

17. Giorg Lomsadze, "Russia to Double Troops in Armenia," *EurasiaNet.org*, June 20, 2012, <http://www.eurasianet.org/node/65579>; David Herszenhorn, "Russia Increases Military Flights over Armenia," *New York Times*, June 9, 2012, http://www.nytimes.com/2012/06/10/world/europe/russia-increases-military-flights-over-armenia.html?_r=0.

18. "Russian Air Base in Armenia Begins Tactical Flight Drills Involving MiG-29 Fighters," TASS, April 15, 2015, <http://tass.ru/en/russia/789432>.

19. Haroutiun Khachatrian, "Armenian Society Shares Common Views on Georgian-Russian War and Its Consequences," *Central Asia-Caucasus Analyst*, September 3, 2008, <http://old.cacianalyst.org/?q=node/4934/print>.

20. Embassy of Georgia, "Relations between Georgia and Republic of Armenia," 2006, http://embassy.mfa.gov.ge/?sec_id=432.

21. Glenn E. Curtis, *Georgia: A Country Study* (Washington, DC: GPO/Library of Congress, 1994), <http://countrystudies.us/georgia/>.

Map 2.2. Samtskhe-Javakheti



Source: https://upload.wikimedia.org/wikipedia/commons/thumb/9/98/Samtskhe-Javakheti_in_Georgia.svg/1715px-Samtskhe-Javakheti_in_Georgia.svg.png.

five days of the 2008 Russo-Georgian conflict, Armenia lost about \$670 million as a result of disruption of transit during military operations.²²

Georgia also hosts a large Armenian community (roughly 249,000 people, or 5.7 percent of the total population, making Armenians the second-largest minority group in Georgia).²³ Ethnic Armenians are largely concentrated in the Samtskhe-Javakheti region, which borders Armenia to the south (see Map 2.2).²⁴ Some Georgian politicians have raised concerns about the possibility of irredentism among the ethnic Armenian population of Samtskhe-Javakheti (fears exacerbated by the specter of Russian provocations). The Armenian and Georgian governments have conducted periodic consultations about the issue of minorities, and Yerevan is careful to avoid direct involvement with the Armenian community in Georgia so as not to disrupt relations with Tbilisi.²⁵

22. Emil Danielyan, "Armenia, Georgia to Boost Ties after South Ossetia War," *Jamestown Eurasia Daily Monitor* 5, no. 196, October 14, 2008, http://www.jamestown.org/programs/edm/single/?tx_ttnews%5Btt_news%5D=34018&tx_ttnews%5BbackPid%5D=166&no_cache=1#.VucDsOlrLcs.

23. CIA, "Georgia," *The World Factbook 2016–17* (Washington, DC: Central Intelligence Agency, 2016), <https://www.cia.gov/library/publications/the-world-factbook/geos/gg.html>.

24. International Crisis Group, "Georgia: The Javakheti Region's Integration Challenges," May 23, 2011, <http://www.crisisgroup.org/en/publication-type/media-releases/2011/europe/Georgia-the-javakheti-region-integration-challenges.aspx>.

25. Tatul Hakobyan, "Tbilisi Needs to Pay More Attention to Minority Rights," *Hetq*, December 4, 2006, <http://hetq.am/eng/news/12035/tbilisi-needs-to-pay-more-attention-to-minority-rights.html/>; Sergey Minasyan,

Challenges nevertheless remain, made worse by Armenia's joining the EEU even as Georgia implements its association agreement with the European Union. The association agreement required Tbilisi to tighten immigration standards in line with EU regulations. This more restrictive migration policy led to those holding dual Armenian-Georgian citizenship being classified as foreign nationals, requiring them to apply for visas even if they had lived in Georgia their entire lives.²⁶ Tbilisi and Yerevan are working to address this challenge, with Georgia agreeing to extend residency permits to dual citizens, though implementation remains slow.

IRAN

Iran and Armenia enjoy friendly relations characterized mostly by economic and energy cooperation, with indirect political benefits. Along with Georgia, Iran provides Armenia with access to the outside world, although sanctions on Iran over its nuclear program have largely prevented it from reexporting Armenian goods, limiting the overall value of imports from Armenia. In 2014, bilateral trade was around \$300 million, making Iran Armenia's fifth-largest trading partner.²⁷ In exchange for imports of Iranian natural gas, Armenia also provides electricity to Iran from Iranian-built power plants. Other projects connecting the two countries, including additional electricity transmission lines and a rail link, have been suspended by sanctions but could be revived following the nuclear deal between Tehran and the five permanent members of the UN Security Council plus Germany (the P5+1).

Iran provides critical diplomatic support in Armenia's long-standing confrontation with Azerbaijan, largely a result of ethnic and border tensions between Baku and Tehran. Iran, Armenia, and Russia have cooperated on a number of economic and security projects, providing a north-south analogue and rival to the emerging east-west axis of Azerbaijan, Georgia, and Turkey. Given the presence of international sanctions against Iran, Armenia provides Tehran access to EEU markets, and Iranian trucks are a frequent sight on Armenian highways. Iran consequently has turned to Armenia as an outlet for investments (including in the financial and banking sectors), trade agreements, and energy cooperation.²⁸ With the likely lifting of sanctions on Iran in the near future, both sides are anticipating adjustments.

"Armenian-Georgian Relations after 'Five Days' War," Noravank Foundation, October 15, 2009, http://www.noravank.am/eng/issues/detail.php?ELEMENT_ID=3461.

26. Arshaluis Mghdesyan, "Armenians in Georgia Want Secure Residence Rights," Institute for War and Peace Reporting, April 3, 2015, <https://iwpr.net/global-voices/armenians-georgia-want-secure-residence-rights>. Tighter immigration regulations, which largely existed before but were not reinforced vigorously, allow foreign nationals to stay in Georgia for ninety days only. This regulation now applies to Armenian migrants, business persons, as well as Georgian-born Armenians who hold dual citizenship. Although Tbilisi and Yerevan are discussing the situation, the implementation of the new regulations was postponed from January 1 to July 1, 2016 and there have been some cases of legal action in accordance to the new laws, so there is skepticism about a rapid solution to the issue.

27. European Commission Directorate-General for Trade, "European Union, Trade in Goods with Armenia," October 20, 2015, http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_113345.pdf.

28. Louis Charbonneau, "Iran Looks to Armenia to Skirt Bank Sanctions," Reuters, August 21, 2012, <http://www.reuters.com/article/2012/08/21/us-iran-sanctions-armenia-idUSBRE87K05420120821>.

With the impending relaxation of sanctions, Tehran has stepped up its efforts to strengthen economic cooperation with Yerevan. Visiting Yerevan in October 2015, Iranian First Vice President Eshaq Jahangiri called for boosting trade and reviving electricity and rail projects halted by the sanctions.²⁹ Anticipating the end of sanctions, Iran has begun building an oil compression station and discussed resuming construction of a hydroelectric plant, a high-voltage line, and a railway for export to Armenia and beyond, though concerns remain about Russia's—and indeed, Georgia's—willingness to let Armenia benefit from these projects.³⁰

A priority for both countries is the Southern Armenia Railway, a \$3.5 billion project to link the Iranian and Armenian rail networks, which would give Armenia access to the Persian Gulf via the International North-South Transport Corridor (NSTC), effectively circumventing the Azerbaijani-Turkish blockade. Although Yerevan is very interested in completing this railway, Russia's majority ownership of the Armenian railway network (discussed in a subsequent section) introduces an additional complication.

Though Iran has been an important strategic and economic partner for Armenia, it has taken a comparatively hands-off position toward the Nagorno-Karabakh conflict. Iran is generally unwilling to challenge Russia's role as the principal strategic broker in the South Caucasus. Concern about irredentism among its large ethnic Azeri population in the northwest also inclines Iran to step cautiously in its approach to the conflict between Baku and Yerevan.

TURKEY

Armenian-Turkish relations are generally poor. Although Turkey was quick to recognize Armenia when it became independent in 1991, the Nagorno-Karabakh conflict (especially the conquest of Azerbaijani territories outside the frontiers of Soviet-era Nagorno-Karabakh) led Ankara to close its border with Armenia and impose an economic blockade that persists to this day. Hanging over the relationship as well is the legacy of events surrounding the 1915 Armenian genocide, which remains a highly sensitive issue in the politics of both Turkey and Armenia, as well as among the Armenian diaspora.

Perhaps most important, Armenia sees Turkey as a threat to its national security as a result of the consistent economic blockade and its support for Azerbaijan both during the conflict over Nagorno-Karabakh and in the years since the 1994 cease-fire. One of our Armenian interlocutors noted that while Yerevan was confident it could fend off an Azerbaijani offensive to retake Nagorno-Karabakh, it worried about the role Turkey could play in any such conflict. Given Turkey's size and military potency, not to mention the shadow of 1915 that hangs over Armenian-Turkish relations, many Armenians are inclined to see Turkey as an existential threat whose danger to the security of the state and its people necessitates a highly unequal partnership with Russia and the

29. Alireza Ramezani, "Iran Sets Its Sights on Armenia," *Al-Monitor*, November 9, 2015, <http://www.al-monitor.com/pulse/originals/2015/11/iran-armenia-cooperation.html#>.

30. Armen Grigoryan, "Armenia's Regional Energy and Transport Cooperation Squeezed by Russia," *Eurasia Daily Monitor* 12, no. 156 (September 1, 2015), http://www.jamestown.org/programs/edm/single/?tx_ttnews%5Btt_news%5D=44319&cHash=3a675c9a1da25dc82fa6e10c24297ea9#VuMJdPkrlDV.

stationing of Russian troops in Armenia. Despite its political and military support for Azerbaijan, Ankara has remained noncommittal about its possible response to renewed fighting between Armenian and Azerbaijani forces. Several Armenian observers worry that Ankara could use the prospect of additional Azerbaijani military activity against Armenia as a source of pressure on Moscow, following Turkey's downing of a Russian military jet that had violated its airspace in November 2015.³¹

There have been several attempts to normalize relations between Armenia and Turkey, none of which have succeeded. The Turkish Armenian Reconciliation Commission (TARC) was established in 2001 by members of Turkish and Armenian civil societies with financial backing from the governments of the United States and several European states.³² Its efforts focused on confidence-building measures, increasing people-to-people contacts, track 2 diplomacy, and working to understand the events of 1915 through a partnership with the International Center for Transitional Justice (ICTJ). TARC had some success in promoting freer movement of people (including visa liberalization) and limited expansion of trade through Georgia.³³ The resulting study on 1915 recognized that, while the events of that era could meet the modern definition of genocide, because the UN's Convention on the Prevention of Genocide was not in effect in 1915 and contained no provisions for retroactive application, today's Republic of Turkey was not subject to legal, financial, or territorial claims over the activities of the World War I-era Ottoman government.³⁴

A broader, government-level attempt at reconciliation began in 2008. Though President Sargsyan had invited his Turkish counterpart to visit Armenia earlier, then-Turkish president Abdullah Gül became the first Turkish head of state to visit Armenia in September 2008, in the aftermath of the Russo-Georgian War, which imperiled Armenia's access to global markets through Georgia and highlighted the dangers of excessive reliance on Russia at a time when Moscow's behavior appeared increasingly erratic. The ostensible purpose of Gül's visit was to attend a World Cup qualifying match between the Armenian and Turkish national soccer teams; Sargsyan made a reciprocal visit when the teams played in Turkey the following year.³⁵

With assistance from U.S. and Swiss diplomats, a set of protocols laying the groundwork for normalization was initialed in Zurich in October 2009. The Zurich protocols emphasized practical steps toward normalizing relations, while leaving aside the status of Nagorno-Karabakh and the

31. Gayane Abrahamyan, "Armenia: Stepping Gingerly around Russia-Turkey Feud," EurasiaNet.org, January 21, 2016, <http://www.eurasianet.org/node/76941>.

32. Turkish Armenian Reconciliation Commission (TARC), "Terms of Reference," <http://www1.american.edu/cgp/TARC/tor.htm>; Moorad Mooradian, "Reconciliation: A Case Study of the Turkish-Armenia Reconciliation Commission" (Working Paper 24, School for Conflict Analysis and Resolution, George Mason University, Arlington, VA, March 2004), 19, http://scar.gmu.edu/wp_24_mooradian.pdf.

33. Fiona Hill et al., *Retracing the Caucasian Circle: Considerations and Constraints for U.S., EU, and Turkish Engagement in the South Caucasus*, Turkey Project Policy Paper No. 6 (Washington, DC: Brookings, July 2015), 11, <http://www.brookings.edu/~media/research/files/reports/2015/07/south-caucasus-engagement/south-caucasus.pdf>.

34. David L. Phillips, *Diplomatic History: The Turkey-Armenia Protocols* (New York: Institute for the Study of Human Rights, Columbia University, March 2012), http://hrcolumbia.org/peacebuilding/diplomatic_history.pdf.

35. "Turkish President in Armenia Trip," BBC News, September 3, 2008, <http://news.bbc.co.uk/2/hi/europe/7596768.stm>.

question of whether to characterize the events of 1915 as a genocide.³⁶ This approach ultimately backfired, with Baku demanding that Ankara link any steps toward normalization with progress on Nagorno-Karabakh, and opposition parties in Armenia, as well as much of the Armenian diaspora, demanding that Ankara acknowledge the 1915 killings as genocide before there could be any reconciliation. These demands placed both Ankara and Yerevan in a difficult position. Bowing to pressure from Baku, then Turkish prime minister Recep Tayyip Erdoğan suspended the ratification process in April 2010, pending a resolution of the Nagorno-Karabakh conflict. Armenian President Sargsyan then suspended consideration of the protocols in Yerevan as well, eventually withdrawing them from consideration by the National Assembly in April 2015 on the hundredth anniversary of the arrests and executions of Armenian intellectuals that commenced the 1915 genocide.

Turkey's embargo on Armenia also extends to infrastructure. The Baku-Tbilisi-Ceyhan (BTC) pipeline from the Caspian Sea to Turkey's Black Sea coast entirely bypasses Armenian territory, even though the most direct route would be through Armenia. As officials in the region viewed BTC as a vehicle for promoting political and economic cooperation among the states along its course while reducing dependence on Russia, Armenia's exclusion has served to deepen its isolation and economic distress. That said, relations between Baku and Yerevan were difficult even in the Soviet period, and some of our Armenian interlocutors were skeptical that Azerbaijan, much less Turkey, would have agreed to cooperate with Yerevan on strategically important infrastructure even absent the Nagorno-Karabakh conflict. Armenia is similarly excluded from other trans-Caucasian infrastructure projects like the Baku-Tbilisi-Kars railway and regional electricity transmission projects.

RUSSIA

Armenia's most important bilateral relationship is with Russia. Given the Azerbaijani-Turkish transportation blockade on Armenia, Russia remains an indispensable partner for trade and investment, but one that has taken advantage of its leverage to assert control over an ever-widening segment of the Armenian economy. Russian military and security forces provide a security umbrella that helps Yerevan address its major vulnerabilities, though constraining Armenian sovereignty in the process. Russia also plays a central, though complex, role in managing the Nagorno-Karabakh conflict. Russia controls most of Armenia's energy infrastructure, has a monopoly on the supply of natural gas, and is the primary source of remittances from Armenian citizens working abroad. President Sargsyan's ruling Republican Party of Armenia (HHK) is aligned at least symbolically with Vladimir Putin's United Russia, as are some of the opposition parties in Armenia's semi-democratic political system.³⁷

These ties also extend to Armenia's participation in various Russian-led regional multilateral organizations, particularly the Collective Security Treaty Organization (CSTO) and the Eurasian Economic Union.³⁸ Our Armenian interlocutors understood that their vulnerable geopolitical position left

36. Phillips, *Diplomatic History*.

37. "Statement by Serzh Sargsyan at 15th Convention of Republican Party of Armenia," *Panorama*, May 24, 2014, http://www.panorama.am/en/current_topics/2014/05/24/serj-sargsyan-hhk/?sw. The HHK is also an observer to the European People's Party, the main center-right grouping in the European Union.

38. CIA, "Armenia," *The World Factbook*, <https://www.cia.gov/library/publications/the-world-factbook/geos/am.html>.

them little choice but to rely on the Russian economic and security umbrella, even as they sought to boost trade, investment, and security ties with outside partners to hedge their dependence on Moscow. As one Armenian official we spoke with noted, Yerevan's decision to ally with Russia was not a civilization choice, but rather a strategic necessity.

Russia maintains a large military presence in Armenia. The Russian 102nd military base, with about 5,000 personnel, is located at Gyumri, near the Armenian-Turkish border.³⁹ Armenia extended the lease for the 102nd base until 2049 in return for expansion of the perimeter of Russian army's operations to cover Armenia's entire territory (though like the rest of the international community, Russia does not acknowledge Nagorno-Karabakh as Armenian territory).⁴⁰ Russia also maintains the 3624th Air Base with sixteen MiG-29s at Erebuni Airport in Yerevan. In addition, Russia supplies the Armenian armed forces with weapons at the discounted rate available to CSTO members.⁴¹ With relations between Moscow and Ankara in crisis following Turkey's downing of a Russian military jet, Russia announced a new \$200 million credit for Armenia to acquire rocket launchers, air-defense systems, radar-jamming systems, sniper rifles, and armored vehicles in February 2016.⁴²

These subsidized weapons sales help Yerevan compensate for the fact that its defense budget is many times smaller than that of oil-rich Azerbaijan, which purchases billions of dollars' worth of advanced Russian arms, albeit at market prices. Indeed, Russia is the top supplier of weapons to both Armenia and Azerbaijan, contributing to doubts among some observers that Moscow has a real interest in settling the Nagorno-Karabakh conflict.

Additionally, Russian forces guard Armenia's 268-kilometer-long border with Turkey.⁴³ Indeed, Yerevan's security partnership with Moscow largely reflects the need for tangible security guarantees based on the perception of the threat posed by Azerbaijan and, more important, its ally Turkey. As several of our interlocutors noted, Russian security guarantees, and the resulting limits on Armenian sovereignty, are accepted by most Armenians because of what one of our interlocutors termed the "Turkish factor."

Moscow stepped up its military presence in Armenia following the downing of its military jet by the Turkish air force in November 2015, deploying combat helicopters and unmanned aerial vehicles (UAVs) and inaugurating a joint air-defense system with the Armenian military. Moscow also announced that it would deploy additional fighter jets to Armenia in the second half of 2016.⁴⁴

39. "102nd Military Base," GlobalSecurity.org, <http://www.globalsecurity.org/military/world/russia/102-military-base.htm>; "Russia to Deploy Combat Helicopters at Armenian Base," *Sputnik News*, October 18, 2013, http://en.ria.ru/military_news/20131018/184232826/Russia-to-Deploy-Combat-Helicopters-at-Armenian-Base.html.

40. Deriglazova and Minasyan, *Nagorno-Karabakh*, 63.

41. Ibid.

42. "Russia Provides Arms Loan to Armenia," Radio Free Europe/Radio Liberty, March 14, 2016, <http://www.rferl.org/content/russia-armenia-loan-arms/27561685.html>.

43. Jacob Resneck, "Ghosts of the Past Haunt Turkish-Armenian Border," *Deutsche Welle*, April 23, 2015, <http://www.dw.com/en/ghosts-of-the-past-haunt-turkish-armenian-border/a-18395546>.

44. Alina Nikoghosyan, "Message to Ankara: Russia Beefs up Its Military Presence in Armenia in Wake of Turkey Incident," *Armenia Now*, January 12, 2016, http://www.armenianow.com/news/region/69094/armenia_region_turkey_russia_deployment_border.

Russia's role in the Nagorno-Karabakh conflict is more ambiguous. Neither the security guarantees conferred through bilateral agreements between Yerevan and Moscow nor those of the CSTO explicitly cover Nagorno-Karabakh and, in the event of the conflict resuming over the disputed territory, our Armenian interlocutors assumed that Russian/CSTO forces would not intervene. Despite its alliance with Yerevan, Moscow is also one of the three Minsk Group cochair, along with France and the United States. Our contacts suggested that Russia would push for a resolution of the conflict, either in the Minsk Group or outside, only to the extent that doing so would reflect Moscow's strategic interests, which could in theory entail forcing a return of at least some of the Armenian-controlled territories to Azerbaijan, perhaps in exchange for a closer relationship between Baku and the Eurasian Economic Union. Many observers saw Russia deliberately keeping the conflict unresolved as a means of exerting leverage over both Baku and Yerevan. Notably, it was Russian mediation that produced the agreement ending the April 2016 fighting in Nagorno-Karabakh, with both Aliyev and Sargsyan traveling to Moscow to hammer out a ceasefire.

Yerevan justified its abrupt decision in September 2013 to cancel the signing of a planned association agreement with the European Union in favor of joining the Russian-led Eurasian Economic Union on Armenia's strategic needs. As President Sargsyan noted at the time, "When you are part of one system of military security it is impossible and ineffective to isolate yourself from a corresponding economic space."⁴⁵ Russia had exerted significant pressure on Armenia to choose the EEU: it raised gas prices, consummated a \$1 billion weapons deal with Azerbaijan, and threatened Yerevan with a "hot autumn" if it refused.⁴⁶

While Armenian officials are at pains to assert that joining the EEU will bring economic benefits, they also worry that membership will further compromise Armenian sovereignty.⁴⁷ In particular, they hope to see increased Russian investment. Yerevan is especially seeking investment from its EEU partners for a railroad from the Iranian border (even though such a railway could, in theory, lessen Armenia's economic dependence on Russia by boosting its access to Iran and the Gulf).⁴⁸

Even before Yerevan joined the customs union, Russia was also Armenia's largest single trade partner, with turnover of \$1.4 billion in 2013. The value of Russian net investment in Armenia is slightly more than \$3 billion, accounting for nearly half of Armenia's total inward foreign direct investment (FDI).⁴⁹ Around 500,000 Armenian nationals live and work in the Russian Federation. In 2014, their remittances amounted to \$2.03 billion, or around 17.4 percent of Armenia's gross

45. Emil Danielyan, "Sarkisian Opts for Russian-Led Unions," *Azatutyun.am*, September 3, 2013, <http://www.azatutyun.am/content/article/25094659.html>. Of course, it was Brussels that demanded Yerevan choose either the association agreement or membership in the EEU.

46. Armen Grigoryan, "Armenia Chooses Customs Union over EU Association Agreement," *Central Asia–Caucasus Analyst*, September 18, 2013, <http://www.cacianalyst.org/publications/analytical-articles/item/12817-armenia-chooses-customs-union-over-eu-association-agreement.html>.

47. Panel discussion on Armenia's accession to the EEU, European Institute, Washington, DC, March 10, 2015.

48. Marianna Grigoryan, "Armenia: New Projects a Stab at Independence from Moscow?," *EurasiaNet.org*, October 16, 2008, <http://www.eurasianet.org/departments/insight/articles/eav101708.shtml>; Gayane Abrahamyan, "Could Russia Spoil Armenia's Iranian Investment Dreams?," *EurasiaNet.org*, July 17, 2015, <http://www.eurasianet.org/node/74286>.

49. National Statistical Service of the Republic of Armenia (ArmStat), *Statistical Yearbook of Armenia 2013* (Yerevan: ArmStat, 2013), 505, <http://www.armstat.am/file/doc/99477378.pdf>.

domestic product (GDP).⁵⁰ Russia's economic downturn along with tighter migration regulations have hit Armenia hard. Trade with Russia dropped by more than 20 percent during the first half of 2015, while remittances were down 25 percent in January 2015 from a year earlier.⁵¹

Russian state companies also own a substantial amount of Armenia's critical infrastructure. Gazprom Armenia (formerly ArmRosGaz) increased its share in Armenia's gas distribution system from 80 percent to 100 percent in December 2013, in exchange for granting Armenia a steep discount on its purchases of Russian gas following Sargsyan's agreement to join the EEU.⁵² The electricity distribution system, meanwhile, was bought by Russia's state-owned RAO-UES in 2005. RAO-UES's June 2015 demand for a 40 percent increase in electricity tariffs precipitated the "Electric Yerevan" protests and demands to reduce the Russian hold on Armenia's economy.⁵³ RAO-UES also operates the Metsamor nuclear plant (which receives all of its nuclear fuel from Russia) and the Hrazdan thermal plant. Russian Railways (RZhD) also secured a thirty-year concession to Russian Armenia's railway system in 2008 in exchange for a promise to modernize and upgrade the network.⁵⁴

UNITED STATES AND NATO

Relations between the United States and Armenia are generally cooperative, notwithstanding Yerevan's close partnership with Moscow. The large Armenian diaspora community in the United States has helped keep Armenian issues on the political agenda in Washington, even at times when the United States has pulled back from extensive involvement in Eurasia. Despite notable developments like the signing of a Trade and Investment Framework Agreement (TIFA) in May 2015, some U.S. officials are frustrated with what they see as Armenia's democratic backsliding and deference to Moscow at a time of difficult U.S.-Russian relations.

50. "Armenia Remittances: 2004–2016," Trading Economics, 2016, <http://www.tradingeconomics.com/armenia/remittances>.

51. Emil Danielyan, "Putin Concerned about Russia's Falling Trade with Armenia," Azatutyun.am, September 8, 2015, <http://www.azatutyun.am/content/article/27232340.html>; ArmStat, "External Trade Database: Russian Federation," 2016, <http://www.armstat.am/en/?nid=380>; Marianna Grigoryan, "Armenia Faces Cash-Crunch as Russian Remittances Slump," EurasiaNet.org, April 9, 2015, <http://www.eurasianet.org/node/72931>; "Armenia Remittances: 2004–2016," Trading Economics.

52. The gas deal gave Gazprom a monopoly over the management of the pipelines in Armenia until 2043, with an obligation from the Armenian government to recoup 9 percent of Gazprom's capital investment annually. In return, Gazprom offered a reduced supply price (paid at the border by the Armenian side) of US\$189 per thousand cubic meters (tcm)—down from \$270/tcm—and wrote off \$300 million in debt run up as a result of the gas price subsidies since 2011.

53. "Russian 'Profiteering' at Heart of Armenian Power Protests," Radio Free Europe/Radio Liberty, June 24, 2015, <http://www.rferl.org/content/armenia-russian-profiteering-at-heart-of-protests/27091644.html>.

54. Vladimir Socor, "Armenia's Economic Dependence on Russia Insurmountable by the European Union," *Eurasia Daily Monitor* 10, no. 221 (December 10, 2013), http://www.jamestown.org/regions/russia/single/?tx_ttnews%5Btt_news%5D=41740&tx_ttnews%5BbackPid%5D=48&cHash=408a5840473a1f08b45f64b8178116ba%20-%20.Vko5t3arQdV#.VuMc1fkrdV.

U.S. policy toward Armenia emphasizes cooperation, establishment of democratic governance, furthering human rights and rule of law, humanitarian issues, as well as social and economic development.⁵⁵ The U.S. Agency for International Development (USAID) plays a highly visible role in policy toward Armenia. USAID operates several projects in the country, with planned expenditures totaling \$23.1 million in 2016.⁵⁶ The largest share of these funds is targeted at economic development projects, but USAID also supports social programs, such as the Pension Reform Implementation Project, and works with the Armenian government on projects such as Support to the Armenian National Assembly (SANAP) aimed at improving Armenia's legislative procedures.⁵⁷

The United States is home to the most influential and second-largest Armenian diaspora in the world after the Russian Federation.⁵⁸ According to the official 2010 U.S. census, around half a million persons of Armenian descent live in the United States,⁵⁹ whereas unofficial data suggests a figure over a million.⁶⁰ This diaspora is well organized and politically active; the largest diaspora organization, the Armenian National Committee of America, spent around \$120,000 on lobbying activities in 2015.⁶¹ It is also important to Armenia's economy, although hard data is sparse.

Many Armenian-Americans are descended from survivors of the 1915 Armenian genocide, an event that continues to color the diaspora community's view of Turkey and Turkish-Armenian relations. Following Armenia's independence in 1991, several members of the U.S.-based diaspora returned to Yerevan to serve in high government positions. According to a former U.S. official, these diaspora figures consistently advocated a harder line on relations with Turkey, undercutting efforts by then president Levon Ter-Petrosyan to normalize ties with Ankara despite the Nagorno-Karabakh conflict. It was also diaspora Armenians in the United States (as well as France and elsewhere), much more than those living in Armenia itself, who demanded that Ankara acknowledge the genocide of 1915 as a condition of normalizing relations between Armenia and Turkey. Given the importance of the diaspora to Armenia's economy, Yerevan faced great pressure to reject the protocols (even if Baku's demand for progress on the Nagorno-Karabakh conflict initially scuttled the Zurich protocols).⁶²

55. Bureau of European and Eurasian Affairs, "U.S. Relations with Armenia," fact sheet, U.S. Department of State, March 20, 2015, <http://www.state.gov/r/pa/ei/bgn/5275.htm>.

56. "Map of Foreign Assistance Worldwide," ForeignAssistance.gov, 2016, <http://beta.foreignassistance.gov/explore>.

57. U.S. Agency for International Development (USAID), "Armenia: Economic Growth," September 29, 2015, <http://www.usaid.gov/armenia/economic-growth-and-trade>.

58. Nanore Barsoumian, "WikiLeaks: U.S. Ambassadors 'Decipher' Armenian American Diaspora," *Armenian Weekly*, September 15, 2011, <http://armenianweekly.com/2011/09/15/wikileaks-u-s-ambassadors-'decipher'-armenian-american-diaspora/>.

59. U.S. Census Bureau, "2011 American Community Survey 1-Year Estimates," December 22, 2012, <http://ia601608.us.archive.org/26/items/2011AmericanCommunitySurveyAncestry/2011Acs.pdf>.

60. HAIAS, "Armenian Population in the World," http://www.haias.net/news/_armenian-population.html.

61. Center for Responsive Politics, "Armenian National Cmte of America," 2016, <http://www.opensecrets.org/lobby/clientsum.php?id=D000047290&year=2015>.

62. A good indicator of this sentiment was Armenian Revolutionary Federation (ARF) opposition to the Zurich accords, which forced the party not to form a coalition with newly elected Serzh Sargsyan. The ARF is the only party in Armenia proper that includes Armenian diaspora members from around the globe.

The Armenian-American diaspora is the main locomotive behind the genocide recognition campaign in the United States, with several political organizations such as the Armenian National Committee of America and Armenian Assembly of America acting as a bridge between Armenia proper and the U.S.-based diaspora over both the genocide recognition and other issues. The Armenian diaspora was also instrumental in the passage and continued validity of Section 907 of the 1992 FREEDOM Support Act, which governs the provision of aid to the then–newly independent post-Soviet states and which prohibits U.S. assistance to Azerbaijan until it ends its blockade and use of force against Armenia and Nagorno-Karabakh. (Since 2001, U.S. presidents have issued an annual waiver to allow Azerbaijan to receive U.S. aid.)

Economic relations between the two countries are mainly regulated by the U.S.-Armenia Joint Economic Task Force, which discusses current trade relations and develops new frameworks for cooperation. The signing of the TIFA in May 2015 was an important step that created a new bilateral Council on Trade and Investment to develop new opportunities for economic cooperation. Bilateral trade turnover was \$153 million in 2014.⁶³ From January 2015, U.S. citizens can enter Armenia without a visa, while Armenian citizens are eligible to apply for ten-year multiple entry U.S. visas.

Yerevan also welcomes U.S. involvement in the Minsk Group's efforts to resolve the Nagorno-Karabakh conflict. Because of the ongoing negotiations, the U.S. government refrains from selling lethal military equipment to either party, an approach Yerevan supports for preventing further militarization of the region or exacerbating the disbalance between Azerbaijani and Armenian capabilities. One official we interviewed noted, however, that Yerevan would not oppose U.S. security assistance to both sides as long as it remains balanced and promotes stability. He suggested that additional U.S. military assistance would actually be a net benefit to the region in that it would cement Washington's interest in regional security. If anything, our interlocutors suggested that the perception that the South Caucasus is "off the U.S. radar" is discouraging for Yerevan. As it stands, Washington conducts sales of (nonlethal) defense equipment to the Armenian military and also provides services and training. Areas of emphasis include combating terrorism, global peace operations, de-mining, and professional military training. U.S. Foreign Military Financing (FMF) to Armenia has totaled around \$42 million since 2002, while Washington has provided an additional \$3.2 million in International Military Education and Training (IMET) funds since 2012.⁶⁴

Officials in Yerevan do not see Armenia's membership in the EEU as a barrier to cooperation with the United States. The widely held view is that the Russian-Armenian security partnership does not close the doors to cooperation with other partners around economic development and sociopolitical issues. That said, U.S. officials did not disguise their frustration with Yerevan's vote against a resolution in the UN General Assembly condemning the Russian annexation of Crimea.

63. Office of the U.S. Trade Representative, "United States and Armenia Sign Trade and Investment Framework Agreement," May 2015, <https://ustr.gov/about-us/policy-offices/press-office/press-releases/2015/may/united-states-and-armenia-sign-trade>.

64. Embassy of the United States in Armenia, "Offices of Defense Cooperation," 2016, <http://armenia.usembassy.gov/odc.html>.

Armenia and the United States also enjoy active security cooperation on issues such as countering terrorism and drug trafficking. Such cooperation also encompasses counterintelligence and security among would-be refugees at the Iranian border.

Despite its membership in the CSTO and close security relations with Russia, Armenia also maintains active cooperation with NATO. Relations are governed by an Individual Partnership Action Plan (IPAP) that provides a platform for political dialogue as well as cooperation on concrete security and defense issues. Armenia has 35 troops deployed in Kosovo with the NATO-led Kosovo Force (KFOR) and an additional 120 troops and five trainers serving with the International Security Assistance Force (ISAF) in Afghanistan. Yerevan is working with NATO to make its peacekeeping battalion fully interoperable with NATO forces and to develop professional military education opportunities.⁶⁵

The perception of democratic backsliding within Armenia has become an obstacle to closer relations with the United States. A former U.S. official we spoke with noted that Armenia performed better on most indicators of democracy and rule of law in the 1990s than today, and that the retreat from democratic practice had become a source of major concern within Washington policy circles as well as the Armenian diaspora in the United States. Most recently, U.S. officials expressed concern over the conduct of a December 2015 referendum to change Armenia's constitution from a semi-presidential to a parliamentary system, pointing to significant irregularities.⁶⁶

EUROPEAN UNION

Armenia and the European Union enjoy close relations, underpinned by the European Union's status as Armenia's largest trading partner and source of investment. The European Union remains interested in deepening ties with Yerevan, despite the failure of the association agreement at the end of 2013 and Armenia's subsequent decision to join the EEU. Yerevan has also sought to enhance its engagement with Brussels and to pursue an association agreement in all but name.

Armenia signed the European Neighbourhood Policy in 2004 and joined the Eastern Partnership in 2009.⁶⁷ After four years of negotiations, Armenia and the European Union were on the verge of signing an association agreement and a Deep and Comprehensive Free Trade Agreement (DCFTA) in mid-2013. According to a foreign diplomat we interviewed, Yerevan's preference was to both sign the association agreement and join the Russian-led EEU, but Brussels told Sargsyan in no uncertain terms that the two initiatives were incompatible and that he would have to choose one or the other. As the negotiations on the association agreement proceeded, Putin impressed on Sargsyan that Moscow would not approve the deal with Brussels, sealing Sargsyan's decision to backtrack.

65. North Atlantic Treaty Organization (NATO), "NATO's Relations with Armenia," 2016, http://www.nato.int/cps/da/natohq/topics_48893.htm.

66. Embassy of the United States in Armenia, "U.S. Embassy Statement on Constitutional Referendum," December 8, 2015, <http://armenia.usembassy.gov/news120815.html>.

67. Yekaterina Poghosyan, "Armenia's Receding European Ambitions," Institute for War and Peace Reporting, October 18, 2013, <http://iwpr.net/report-news/armenias-receding-european-ambitions>.

Following his reversal, Sargsyan announced that Armenia would be joining the Russian-led customs union and Eurasian Economic Union. Armenian officials stressed that this surprising move did not necessarily preclude signing the EU association agreement under readjusted terms; yet in practice this adjustment has not proved possible.⁶⁸ In our interviews in Yerevan, government officials conveyed a desire to reach agreement with the European Union on a framework that would be substantively equivalent or similar to an association agreement in all but name. The EU Council subsequently agreed in October 2015 to open negotiations with Yerevan on a new partnership agreement that replicates much of the substance of the ill-fated association agreement, but without the DCFTA component. As such an agreement would be compatible with Armenia's membership in the Eurasian Economic Union, Russia has stated it does not object.⁶⁹ Negotiations on this bilateral framework agreement began in December 2015.

Notwithstanding Armenia's rejection of the association agreement, the European Union as a bloc represents its largest trading partner, with about \$1.27 billion in trade in 2014. The European Union also provided around \$300 million in investment in Armenia in 2013.⁷⁰

68. Andrew Rettman, "Armenia to Join Russia Trade Bloc, Surprises EU," *EU Observer*, September 3, 2013, <http://euobserver.com/foreign/121304>.

69. Delegation of the European Union to Armenia, "Opening of Negotiations of a Framework Agreement with Armenia," October 13, 2015, http://eeas.europa.eu/delegations/armenia/press_corner/all_news/news/2015/2015_10_13_en.htm; "Russia 'Not Against' New EU-Armenia Deal," *Asbarez*, October 26, 2015, <http://asbarez.com/141061/russia-not-against-new-eu-armenia-deal/>.

70. European Commission Directorate-General for Trade, "Armenia," October 20, 2015, http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_111471.pdf.

Armenia in a Reconnecting Eurasia

For landlocked, blockaded Armenia, enhancing connectivity to international markets and partner states is of vital importance. As one senior official noted in an interview, “We need more corridors” (though as a foreign diplomat mused, what many Armenians really believe is that “we need new neighbors”).

Armenia’s inability to participate in intra- and inter-regional connectivity projects such as the Baku-Tbilisi-Ceyhan pipeline and the Baku-Tbilisi-Kars railway limits the country’s integration with global and regional markets and contributes to the more general economic fragmentation of the South Caucasus. The fundamental principle characterizing Armenia’s foreign economic policy is “engagement,” which envisions Armenia as an equal participant in the post-Soviet as well as European integration processes, involving all the vectors of Armenia’s complementary foreign policy: the Commonwealth of Independent States (CIS), NATO, CSTO, EU, as well as bilateral relations with individual states.¹

In its pursuit of development and prosperity, Yerevan in 2014 introduced the *Armenian Development Strategy 2014–2020* (ADS) to address the fundamental structural weaknesses of the Armenian economy while seeking to expand and diversify trade and investment (see Box 3.1).² A key aim is to reduce Armenia’s trade deficit and increase exports to 35 percent of GDP by 2025.³

1. Office of the President of the Republic of Armenia, “Republic of Armenia National Security Strategy,” January 26, 2007.

2. Republic of Armenia Ministry of Finance, “Armenia Development Strategy for 2014–2025,” March 27, 2014, www.minfin.am/index.php?fl=78&lang=3.

3. IMF, *Republic of Armenia*, Country Report No. 14/89 (Washington, DC: IMF, March 2014), <http://www.imf.org/external/pubs/ft/scr/2014/cr1489.pdf>.

BOX 3.1. ADS 2014–2025 Key Priorities and Policies (brief)¹

Finances and Revenues

- Promotion of nonlending institutions such as insurance and stock markets; promotion of competition; eliminating entry barriers; increasing the role of the regulator State Commission for the Protection of Economic Competition (SCPEC)
- Expansion of the tax base, in the meantime improving the investment environment to protect primary consumer goods from increase of prices; increasing tax revenue as percent of GDP by 0.3 percent to 0.4 percent per annum, starting from 2016

Trade

- Liberalizing export policy and diversifying of export profile in terms of products and destinations; gradually changing the resource-based economy toward knowledge-based goods and services; creating incentives and a support structure for the promotion of the export industry
- Accelerated export policy to decrease the trade deficit to 4.5 percent of GDP in 2025 from 24.8 percent in 2012

Agriculture

- Increasing efficiency (productivity and labor efficiency) through a mixture of public spending and structural reforms; increasing land productivity and utilization; providing access to affordable financial resources; improving the administrative system of the sector

Labor Market

- Implementation of minimum wage policies in accordance with the dynamics of the average wage demand and supply equilibrium of the labor market
- Implementation of new taxation methods based on expanding the tax base and increasing the rates for non-distortionary taxes and labor market improvement training programs
- Increasing employment income and rates of the working-age population from 57.3 percent in 2014 to 71.1 percent by 2025; reducing unemployment from 17.2 percent in 2014 to 10 percent in 2025

Poverty Reduction and Social Protection

- Direct and indirect accelerated income enhancements through employment income increase and targeted social projects for the most vulnerable groups; increasing poverty line; increasing the recipients of the social assistance programs to 100 percent of those qualified; targeted poverty reduction to a rate of 13 percent by 2025 from 32.4 percent in 2012
- Implementation of a mandatory pension system

Public Administration

- Digitalization of the system and reduction of bureaucratic person-to-person procedures; strengthening transparency and accessibility of the justice system

BOX 3.1. (Continued)

- Risk-based inspection system; criminalization of corruption based on international practice
- Development strategies in health care, education, science, culture, and environmental policies

1. Republic of Armenia Ministry of Finance, "Armenia Development Strategy for 2014–2025."

TRADE

Armenia's economy is at once poorly integrated and heavily dependent on imports. Imports exceeded exports by \$2.88 billion in 2014, on total trade turnover of \$5.91 billion.⁴

Due to the ongoing economic blockade by Azerbaijan and Turkey, Armenia does not have direct access to the large Turkish market (though some trade is conducted via Georgia) and is isolated from the Caspian energy corridors. Sanctions against neighboring Iran also limit opportunities for Armenian-Iranian trade. The main sources of imports are thus EU countries, Russia, and China. In 2013, Armenia mainly imported manufactured goods, materials, and machinery.⁵ Russian exports to Armenia mainly consist of oil and gas (worth \$609.6 million), which constituted 55 percent of total Russian imports to Armenia, while more than three-quarters of Armenia's \$337 million in exports to Russia are foodstuffs (of which the majority is hard liquor).⁶

Armenia's exports to the European Union mainly consist of metals, metal ores, and minerals, while imports are comprised of machinery (25 percent of total EU imports), manufactured goods (33 percent), and chemicals (13 percent). China, the third-largest trade partner, is Armenia's main source of technological goods, chemicals, and other consumer products such as textiles.⁷ Exports to China mainly consist of minerals and metals (precious and nonprecious); around 21 percent of exports are foodstuffs.⁸ Overall, 34 percent of Armenia's exports go to the European Union, 23 percent to Russia, 6 percent to Iran, and 5 percent to China (see Table 3.1 and Figure 3.1).

Armenia's trade in its immediate neighborhood is limited to mostly imports from Georgia and some limited imports from Turkey. Despite the fact that Armenia is officially Georgia's

4. ArmStat, *Statistical Yearbook of Armenia 2015* (Yerevan: ArmStat, 2015), 442, <http://www.armstat.am/file/doc/99493858.pdf>.

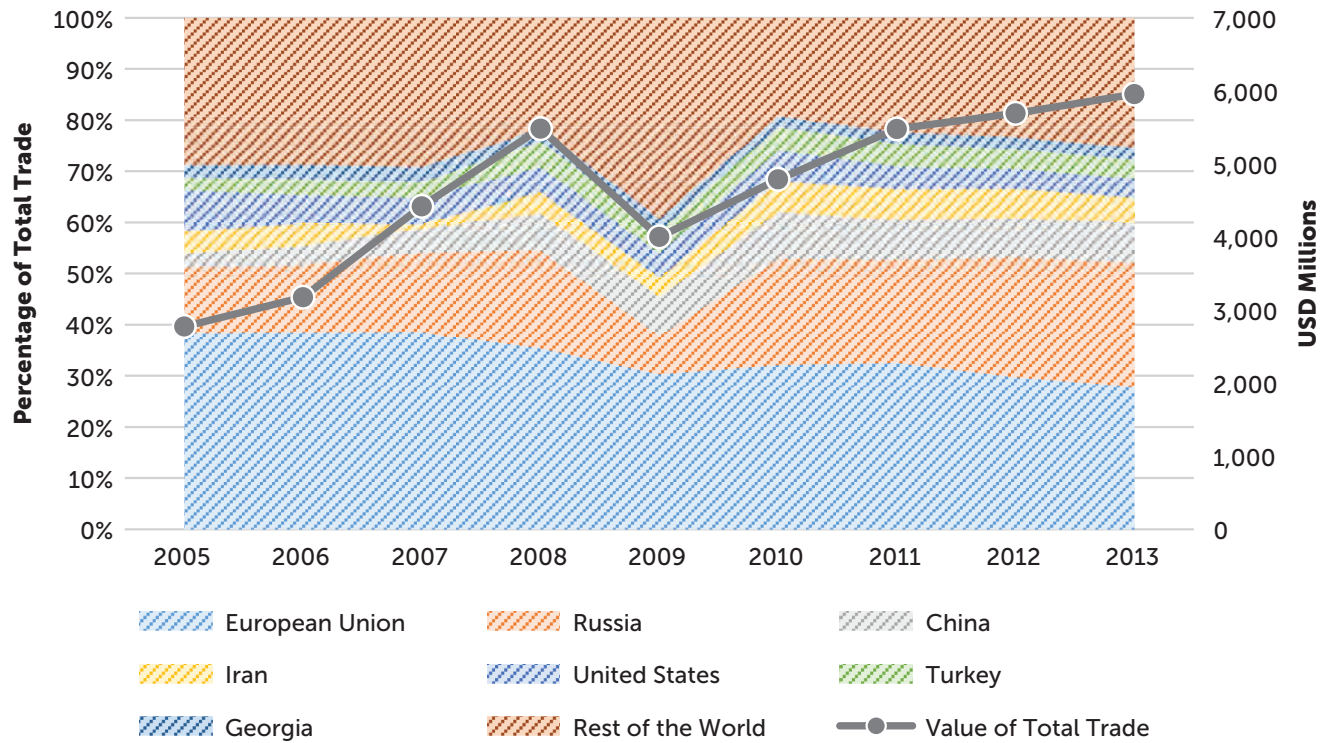
5. European Commission Directorate-General for Trade, "European Union, Trade in Goods with Armenia."

6. Ministry of Economic Development of the Russian Federation, "Обзор торговых отношений Армении с Россией в 2013 году," 2013, http://www.ved.gov.ru/files/images/kai/Armenia/TES_Armenia_Rus_2013.pdf; Observatory of Economic Complexity (OEC), "What does Armenia export to Russia?" 2013, http://atlas.media.mit.edu/en/visualize/tree_map/hs92/export/arm/rus/show/2013/.

7. OEC, "What Does Armenia Import from China?," 2012, https://atlas.media.mit.edu/en/explore/tree_map/hs/import/arm/chn/show/2012/.

8. ArmStat, *Statistical Yearbook of Armenia 2014* (Yerevan: ArmStat, 2014), <http://armstat.am/file/doc/99491328.pdf>.

Figure 3.1. Armenia's Total Trade by Partner Country/Group



Source: IMF DOTS (Direction of Trade Statistics database); author calculations.

second-largest export destination, only 1.2 percent of the products are Georgian.⁹ Rather, many Armenian companies have opened branches in Georgia in order to skirt the Turkish blockade and import Turkish goods as Georgian re-exports.¹⁰

Armenia's heavy dependence on Russian energy imports and heavy volumes of bilateral trade in general contributed to the 2013 decision to join the Russian-led Eurasian Economic Union. Government officials we spoke with stated that the decision to join EEU not only had a security dimension, but also was based on economic calculations. However, the new EEU tariffs are typically higher than the existing tariffs Armenia imposes as a member of the World Trade Organization (WTO). Thus in Armenia the most-favored-nation rate is 2.7 percent, whereas in the Customs Union (CU) it was 7.6 percent in 2013, 6.9 percent in 2014, and 6 percent in 2015 (see Table 3.2 for a tariff comparison).¹¹ Armenia does not have tariff quotas, and 73 percent of tariff lines are duty-free; most of the remaining tariffs are subject to 10 percent duty.¹² Since

9. Gayane Abrahamyan, "Armenia: Second-Hand Car Importers Worry That Customs Union Will Be a Lemon," EurasiaNet.org, March 14, 2014, <http://www.eurasianet.org/node/68149>.

10. Nino Patsuria, "Georgia: Armenian-Turkish Rapprochement Could Have Significant Economic Impact on Tbilisi," EurasiaNet.org, January 6, 2010, <http://www.eurasianet.org/departments/business/articles/eav010710.shtml>.

11. "Armenia and the Customs Union: Impact of Economic Integration," Eurasian Development Bank, Report 20, 2013, http://www.noravank.am/upload/pdf/doklad_20_en_preview.pdf.

12. Ibid.

Table 3.1. Breakdown of Armenia's Exports and Imports

Armenian Exports			Armenian Imports		
	Mln USD	Share		Mln USD	Share
Product			Product		
Copper Ore	200.9	13%	Petroleum	278.3	7%
Hard Liquor	164.7	10%	Wheat	172.2	5%
Gold	144.9	9%	Cars	165.4	4%
Ferroalloys	120.2	8%	Medicaments	93.3	2%
Raw Copper	104.2	7%	Diamonds	91.9	2%
Aluminum Foil	81.8	5%	Petroleum Gas	80.7	2%
Diamonds	71.7	5%	Gold	76.4	2%
Destination			Source		
European Union	496.4	34%	EU	1,163.20	26%
Russia	334.5	23%	Russia	1,110.90	25%
Bulgaria	152.2	10%	China	386.5	9%
Belgium	131.1	9%	Germany	280.6	6%
Iran	95.5	6%	Ukraine	226.6	5%
United States	89	6%	Turkey	210.9	5%
Canada	87.4	6%	Iran	198.5	4%

Sources: Observatory of Economic Complexity, "Country Profile: Armenia," <http://atlas.media.mit.edu/en/profile/country/arm/>; IMF DOTS; author calculations.

Note: Product breakdown represents year 2012. Destinations show year 2013.

**Table 3.2. Customs Union and Republic of Armenia Tariff Comparison
(percentage tariff imposed)**

Categories	CU	Armenia	Categories	CU	Armenia
Animals	12.2	6.7	Chemicals	7.7	0
Fish and fish products	9.99	10	Plastics products	9.8	0
Dairy products	15.64	10	Leather, footwear	9	6.7
Fruit, vegetables, plants	10.8	10	Timber, paper	13.9	0
Tea, coffee	5.63	10	Cotton	10.7	0
Cereals	7.15	0	Textile	11	2
Other plant products	7	3.3	Clothing	13.1	10
Finished products	13.1	6	Stone, ceramic, and glass items	14.9	6.7
Sugar, confectionary	6.3	10	Pearls	17.8	0
Beverages, tobacco	22.4	5	Metals	9.8	2.5
Mineral products including fuel	4.7	0	Electric machinery	5.4	5
Pharmaceuticals	7	0	Transport	9.7	10
			Devices	5	0

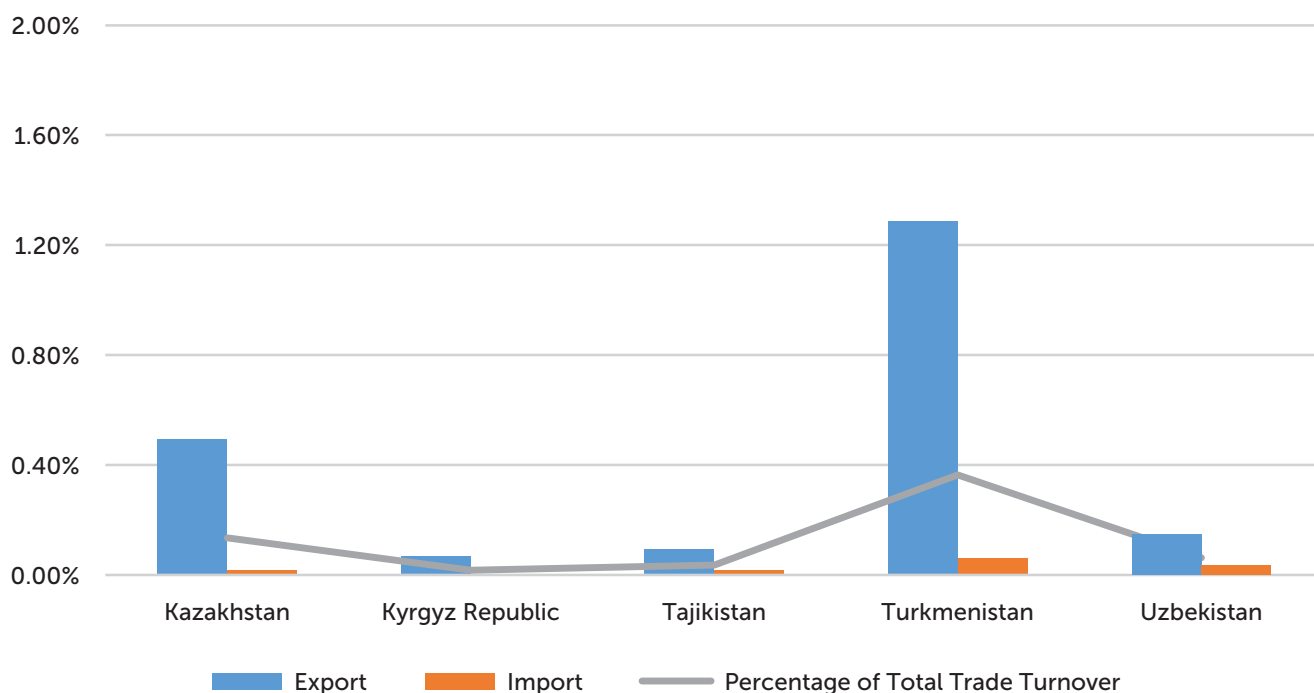
Source: "Armenia and the Customs Union: Impact of Economic Integration," Eurasian Development Bank, Report 20, 2013, http://www.noravank.am/upload/pdf/doklad_20_en_preview.pdf.

accession to the EEU, the average weighted bound tariff in Armenia is 8.5 percent (in Russia it is 10 percent).¹³

The trade data shows comparatively weak economic relations with other EEU member states (of course, Armenia also lacks a shared border with any of the other EEU members). Trade with Russia and Belarus has to cross through Georgia, while the shortest access to the Central Asian members, through Azerbaijan and the Caspian Sea, is closed off by the blockade (see Figures 3.2, Figure 3.3, and Table 3.3). The result is higher transportation costs due to the longer distances, limited access to alternative routes, and difficult climate conditions.

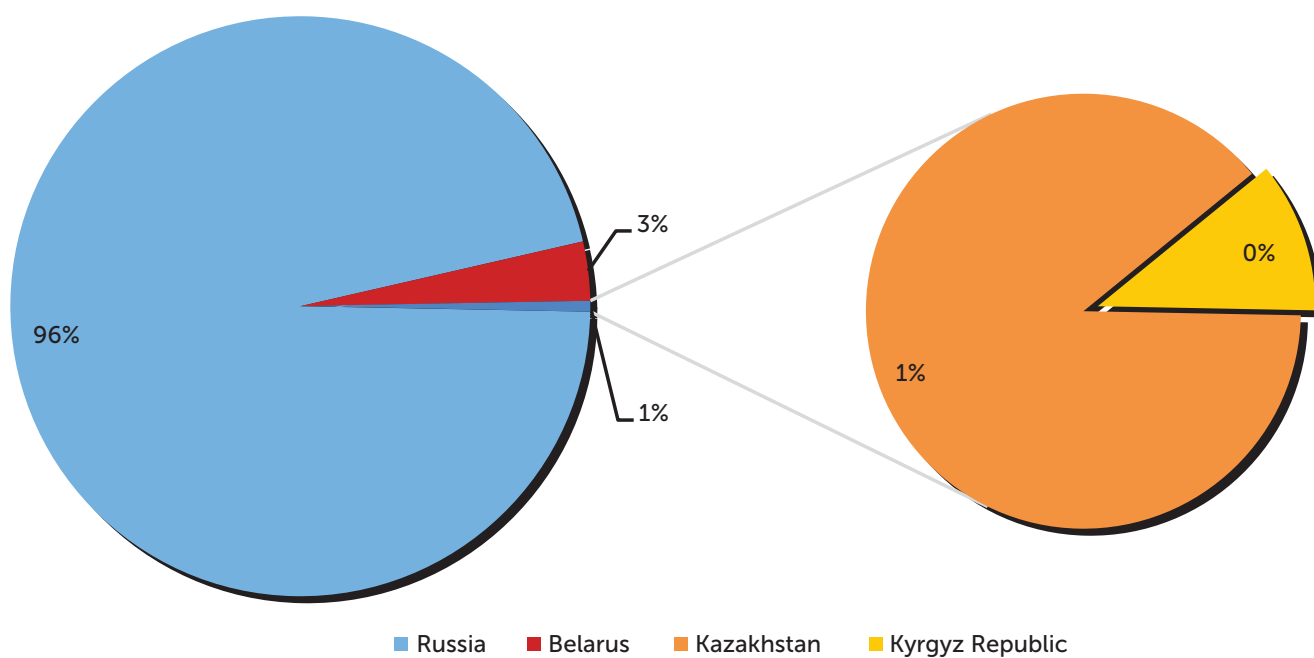
13. Ibid., 8.

Figure 3.2. Armenia's Trade with Central Asia as a Percentage of Total Trade



Source: IMF DOTS; author calculations.

Figure 3.3. Breakdown of Armenia's Trade with the Eurasian Economic Union, 2013



Source: IMF DOTS; author calculations.

Table 3.3. Annualized Growth in Armenia's Global Trade Ties, 2005–2013

Partner Country/Group	Value in 2005 (USD Millions)	Value in 2013 (USD Millions)	Growth Rate
China	75	458	25.21%
Middle East (minus Iran)	37	173	21.11%
Russia	361	1,445	18.91%
Turkey	69	212	15.01%
CIS	708	1,926	13.32%
Iran	117	294	12.13%
South Caucasus	66	151	10.98%
World	2,775	5,956	10.02%
Belarus, Moldova, Ukraine	158	292	7.98%
European Union	1,063	1,659	5.72%
United States	221	226	0.33%
Central Asia	122	365	–14.03%

Source: IMF DOTS; author calculations.

The economic benefits of EEU integration remain a subject of dispute within Armenian economic and political circles.¹⁴ The main concern is the EEU's high tariff regime, coupled with the delegation of decisionmaking authority to the Union, as well as the potential impediment membership poses to Armenia's prospects of deeper integration with Europe. Supporters of accession argue that joining the EEU will give Armenia access to an integrated market of 170 million people with a collective GDP of more than \$2.5 trillion. To ameliorate the consequences of higher EEU tariffs, Yerevan negotiated an agreement allowing it to maintain current tariff levels for 732 selected

14. Armen Grigoryan, "Armenia to Be Admitted into Eurasian Union," *Central Asia–Caucasus Analyst*, October 15, 2014, <http://www.cacianalyst.org/publications/analytical-articles/item/13065-armenia-to-be-admitted-into-eurasian-union.html>; "Armenia to Join Russian-Led Customs Union," Radio Free Europe/Radio Liberty, September 3, 2013, <http://www.rferl.org/content/armenia-customs-union/25094560.html>; "Opposition: Eurasian Union Offers Armenia Hypothetical Possibilities," *News.am*, January 7, 2015, <http://news.am/eng/news/245953.html>.

goods for periods ranging from one to eight years. The EEU will also allow Armenia to maintain its free-trade regime with nonmember Georgia, which remains the only corridor for goods to travel between Armenia and markets in other EEU member states.¹⁵ The IMF also estimates that EEU accession will increase the state's customs revenues from one percent of GDP currently to 2.5 percent.¹⁶ In any case, the overall effects of EEU accession largely depend on Russia's economic performance and political dynamics in the region.

Although Armenia's accession to the EEU cut the DCFTA negotiations short, Yerevan has put considerable effort into maintaining economic and trade relations with the European Union. On March 18, 2015, European Neighbourhood Policy Commissioner Johannes Hahn stated that the European Union and Armenia had completed a "scoping exercise" in order to find potential areas for cooperation that did not contradict Armenia's EEU agreements, while formal talks on a framework agreement began at the end of 2015.¹⁷

REMITTANCES

One of the major structural weakness of Armenia's economy is its high level of dependence on remittances coming from labor migrants. From 2007–2013, remittances averaged around 16 percent of Armenia's GDP, which is twice the volume of FDI inflows.¹⁸ More than 70 percent of these remittances originate from Russia (in second place is the United States, which contributes around 7 percent of the total). On the other hand, over 70 percent of remittances are spent on current consumption, influencing the domestic trade and economic activities in the country.¹⁹

The outflow of migrant workers also contributes to Armenia's serious demographic challenge. Armenia's population declined precipitously following the collapse of the Soviet Union due to outmigration as well as the problems of a low birth rate and high rates of premature death experienced by many post-Soviet countries. Unlike many of its neighbors, however, Armenia has not reversed this decline since the start of the twenty-first century. According to the 2011 census, Armenia's population fell to 2.87 million from 3.46 million a decade earlier. The decline

15. IMF, *Republic of Armenia*, Country Report No. 15/65 (Washington, DC: IMF, 2015), <http://www.imf.org/external/pubs/ft/scr/2015/cr1565.pdf>; "Free Trade Regime to Remain in Effect after Armenia's Joining EEU," Armenpress, October 15, 2014, <http://armenpress.am/eng/news/780187/free-trade-regime-to-remain-in-effect-after-armenia-s-joining-eeu.html>. Existing free-trade agreements of members Belarus and Kazakhstan with Georgia also remained in effect after the establishment of the EEU.

16. IMF, *Republic of Armenia*, Country Report No. 15/65.

17. Armen Karapetyan, "Armenia Seeks New Deal with EU," Institute for War and Peace Reporting, April 27, 2015, <https://iwpr.net/global-voices/armenia-seeks-new-deal-eu>.

18. Asian Development Bank (ADB), "Country Partnership Strategy: Armenia, 2014–2018: Economic Analysis (Summary)," <http://www.adb.org/sites/default/files/linked-documents/cps-arm-2014-2018-ea.pdf>.

19. Lili Karapetyan and Liana Harutyunyan, *The Development and the Side Effects of Remittances in CIS Countries: The Case of Armenia* (San Domenico di Fiesole, Italy: European University Institute, 2013), <http://cadmus.eui.eu/bitstream/handle/1814/27881/CARIM-East-RR-2013-24.pdf?sequence=2>.

from emigration during that period amounted to around 173,000 persons.²⁰ The shrinking population contributes to lower productivity, especially as working-age adults are the most likely to emigrate.

ENERGY

Lacking indigenous hydrocarbon reserves, Armenia needs access to reliable and inexpensive sources of energy, most of which comes from Russia, followed by Iran and European countries, primarily Romania. In 2012, production of primary energy (nonprocessed sources such as coal, gas, and wind) was 0.047 quadrillion British thermal units (Btu), while consumption totaled 0.229 quadrillion Btu, indicating Armenia needed to import more than five times as much energy as it produced domestically.²¹ While demand increased at a rate of around 2 percent per year from 2008 to 2012,²² the World Bank concluded in 2008 that Armenia could save around \$360 million annually, or around 4 percent of GDP, by boosting its energy efficiency.²³

Armenia imports 47,000 barrels of oil daily, mainly from Russia, with smaller quantities arriving from the Balkans via the Black Sea.²⁴ Armenia also imports 9 million cubic meters (mcm) of natural gas per day, or around 3.285 billion cubic meters (bcm) a year, two-thirds of which comes from Russia through pipelines, with the rest coming from Iran.²⁵ Under a 2009 energy swap arrangement, Armenia imports around 1.44 mcm of natural gas from Iran per day, providing in exchange three kilowatt-hours (kWh) of electricity for every cubic meter of received gas.²⁶

More than 50 percent of domestic energy consumption is satisfied through natural gas imports, mainly through the Mozdok-Tbilisi and the North Caucasus to Trans-Caucasus pipelines passing through Georgia.²⁷ Both are operated by Georgian Oil & Gas Corporation (Georgian section) and by Gazprom Armenia, which provided about two billion cubic meters of gas to Armenia in 2013.²⁸

Iranian gas reaches Armenia through the 140-kilometer Iran-Armenia Pipeline. Though the gas originates in Iran, around 20 kilometers of the pipeline is owned by Gazprom Armenia, which

20. "Armenia's Population Makes 3,285,767—Preliminary Census Results," News.am, February 7, 2012, <http://news.am/eng/news/92282.html>.

21. U.S. Energy Information Administration (EIA), "Total Petroleum and Other Liquids Production 2014: Armenia," <http://www.eia.gov/countries/country-data.cfm?fips=AM>.

22. World Bank, *Country Program Snapshot: World Bank Group—Armenia Partnership* (Washington, DC: World Bank, April 2015), 3, <http://www.worldbank.org/content/dam/Worldbank/document/Armenia-Snapshot.pdf>; Trigran Arzumanyan and Mikael Abovyan, *Country Report: Armenia* (Brussels: European Commission, November 2014), 5, http://www.ener2i.eu/page/34/attach/0_Armenia_Country_Report.pdf.

23. World Bank, *Country Program Snapshot: World Bank Group—Armenia Partnership*, 16.

24. Arzumanyan and Abovyan, *Country Report: Armenia*.

25. Ibid.

26. EIA, "Natural Gas Exports from Iran," October 2012, http://www.eia.gov/analysis/requests/ngexports_iran/pdf/full.pdf.

27. Arzumanyan and Abovyan, *Country Report: Armenia*, 5.

28. Georgian Oil & Gas Corporation, "Statistics," <http://www.gogc.ge/en/transporation-stats>.

pressured Yerevan to reduce the pipeline's diameter from the standard 1,420 millimeters to 700 millimeters, which would effectively prevent Iran from expanding its gas exports to third countries through Armenia.²⁹

Armenia produced 2.46 terawatt-hours (TWh) of nuclear power in 2014, or around 31.7 percent of total electricity production.³⁰ The largest domestic source of energy production is the Metsamor nuclear power plant, which satisfies around 34 percent of Armenia's electricity demand.³¹ It has two reactors, one of which was permanently shut down over safety concerns following the 1988 earthquake; the second reactor, which was only restarted in 1995, has an annual production capacity of 204.5 megawatts (MW).³² The fuel for this power plant comes from Russia, and Russian United Energy System (UES) operates the facility. It is scheduled to shut down in 2026 following the construction of a new reactor, for which Russia has pledged to cover one-third of the cost.³³

Armenia also has hydro and thermal power plants that provide energy for domestic use as well as some exports. Gas-powered thermal plants generated 3.29 TWh, or 42.5 percent of Armenia's total electricity production in 2014.³⁴ The largest thermal plant, Hrazdan, was transferred to Russia's UES in 2006 in payment for debts.³⁵

An additional 25.8 percent (2.0 TWh) of Armenia's electricity is provided by hydroelectric power. The largest hydropower plant, the Sevan-Hrazdan Cascade, is 90 percent owned by Russia's UES; in 2014 Armenia secured a deal with Russia for \$300 million for upgrades to extend the plant's lifetime for another 10 years.³⁶ The second-largest plant was purchased by U.S.-based Contour Global in 2014.³⁷ A joint Iranian-Armenian hydro power plant is currently under construction as well.³⁸

Despite the heavy dependence on primary energy sources, Armenia generates surplus electricity, allowing it to export around 314,000 megawatt-hours (MWh) per year. Armenia's nuclear,

29. Vladimir Socor, "Iran-Armenia Gas Pipeline: Far More than Meets the Eye," *Eurasia Daily Monitor* 4, no. 56 (March 21, 2007), http://www.jamestown.org/single/?no_cache=1&tx_ttnews%5Btt_news%5D=32607#.U5dU4_IdWSo.

30. International Atomic Energy Agency (IAEA), "Country Nuclear Power Profiles: Armenia," 2015, <https://cnpp.iaea.org/countryprofiles/Armenia/Armenia.htm>.

31. Ibid.

32. IAEA, "Country Nuclear Power Profiles: Armenia," 2013, http://www-pub.iaea.org/MTCD/publications/PDF/CNPP2013_CD/countryprofiles/Armenia/Armenia.htm; Nuclear Threat Initiative (NTI), "Armenia," March 2016, <http://www.nti.org/learn/countries/armenia/>.

33. "USA Supports New Nuclear Build in Armenia," *World Nuclear News*, November 23, 2007, <http://www.world-nuclear-news.org/newsarticle.aspx?id=14448>.

34. IAEA, "Country Nuclear Power Profiles: Armenia," 2015.

35. Emil Danielyan and Liz Fuller, "Analysis: Russian-Armenian Gas Talks Inconclusive," Radio Free Europe/Radio Liberty, May 23, 2008, <http://www.rferl.org/content/article/1117535.html>; Emil Danielyan and Tatevik Lazarian, "Armenia Inaugurates New Power Plant," *Azatutyun.am*, April 22, 2010, <http://www.azatutyun.am/content/article/2020632.html>.

36. World Nuclear Association, "Nuclear Power in Armenia," October 2015, <http://www.world-nuclear.org/information-library/country-profiles/countries-a-f/armenia.aspx>.

37. Arzumanyan and Abovyan, *Country Report: Armenia*.

38. Ibid., 5.

hydroelectric, and thermal plants, however, require modernization, which will also increase their capacity. The modernization of Armenia's energy sector and the possibility of diversification of energy sources through increasing the share of renewable energy production is one area where Yerevan is seeking to bring in additional foreign investment.

Armenia concluded a \$25 million deal with the European Bank for Reconstruction and Development (EBRD) to finance energy efficiency in the industrial sector and to develop renewable energy sources.³⁹ The Asian Development Bank (ADB) also provided \$85 million for Yerevan's Power Transmission Rehabilitation Project and Infrastructure Sustainability Support Program, designed to improve and rehabilitate supply infrastructure and management.⁴⁰

Another example of foreign cooperation in the energy field is Contour Global's takeover of the 404 MW Vorotan Hydro Cascade.⁴¹ The agreement signed in June 2015 obliged Contour Global to pay \$180 million for the Vorotan plant plus another \$70 million to modernize the facility over the next five years.⁴² President Sargsyan called the deal "the largest ever American investment in Armenia."⁴³

Regional electricity cooperation with Iran and Georgia is another strategic goal for Yerevan. One of our interlocutors pointed to the German Development Agency (BMZ) "Caucasus Initiative," which includes an emphasis on energy efficiency, promotion of renewable energy sources, and the creation of regional electricity grids.⁴⁴

This initiative includes Georgian-Armenian cooperation to build overhead electric lines, which will expand power transmission capacity with a parallel system to facilitate power exchange and to create resiliency against potential disruptions to the grid. However, as a senior official we spoke with noted, energy security is highly politicized due in large part to the Nagorno-Karabakh conflict.

FOREIGN INVESTMENT

One of Yerevan's top economic priorities is attracting additional foreign investment, including from a wider range of sources. To this end, the government adopted an "open door" policy for investment on the basis of the 1994 "On Foreign Investments" law, which aims to secure property rights and guarantees foreign investors the same rights extended to domestic investors.⁴⁵

39. IMF, *Republic of Armenia*, Country Report No. 15/65.

40. Ibid.

41. IAEA, "Country Nuclear Power Profiles: Armenia," 2013; Emil Danielyan, "U.S. Takeover of Armenian Power Plants 'Completed,'" *Azattyun.am*, May 8, 2015, <http://www.azattyun.am/content/article/27002502.html>.

42. Danielyan, "U.S. Takeover of Armenian Power Plants 'Completed.'"

43. Ibid.

44. German Federal Ministry for Economic Cooperation and Development, "Caucasus Initiative," https://www.bmz.de/en/what_we_do/countries_regions/Central-Eastern-and-South-Eastern-Europe/kaukasus/index.html.

45. Ministry of Economy of the Republic of Armenia, "Investment Policy," <http://www.mineconomy.am/eng/508/gortsaruyt.html>; Office of the President of the Republic of Armenia, "The Law of the Republic of Armenia on Foreign Investments," July 31, 1994, <http://www.parliament.am/legislation.php?sel=show&ID=1552&lang=eng>.

In 2014, total foreign direct investment in Armenia was \$840.9 million. The primary source of FDI was Russia, which accounted for \$618.4 million, or 73.5 percent of total FDI, followed by the European Union, Canada, and Lebanon.⁴⁶ The main sectors attracting investments in 2014 were transportation and communication, mining, real estate, manufacturing, infrastructure (including gas, electricity, and water), and construction.⁴⁷

In December 2011, Yerevan adopted a “Strategy of Export-Led Industrial Policy” to promote investment in prioritized industrial sectors, with the goal of boosting exports of processed goods (the current Armenian government is working on a new economic strategy to replace this 2011 version).⁴⁸ The new industrial policy focuses on 11 sectors, including manufacturing, pharmaceuticals and biotechnologies, and precision engineering. The policy aims as well to diversify Armenia’s mining industry, produce more high-value-added goods for export, and create more high salary jobs.⁴⁹ In implementing this strategy, Yerevan has taken several steps aimed at improving the investment climate. Investments of over 300 billion Armenian drams (AMD), around \$630 million, can delay value-added tax (VAT) payments for up to three years.⁵⁰

In May 2011 the government also created Free Economic Zones (FEZ) to foster investments in high-tech industrial, research, and development sectors and to promote export of high-value products.⁵¹ Businesses are virtually free of local taxation and in the meantime benefit from the terms of Armenia’s bilateral and multilateral economic agreements, such as WTO tariffs and the Generalized System of Preferences Plus (GSP+) trade regime with the European Union and United States.⁵² Currently two FEZs operate in Armenia: the “RAO Mars” Russian-owned high-tech electronic hardware production company and the Yerevan Computer Research and Development Institute (YCRDI), which undertakes advanced information technology (IT) research and development projects.⁵³

Armenia, however, faces several serious challenges in its campaign to boost FDI. Although Armenia’s Transparency International ranking of 94th was comparatively good for post-Soviet Eurasia, problems with the judicial system and corruption deter foreign investors.⁵⁴ Yerevan has implemented a number of policies to improve the investment environment through several tax reforms,

46. Ministry of Economy of the Republic of Armenia, “Flows of Foreign Investments into the Real Sector of RA Economy by Countries as of the End of 2014 (in thousand USD),” http://www.mineconomy.am/uploads/2_eng.pdf.

47. Ministry of Economy of the Republic of Armenia, “Statistics of Foreign Investments in the Real Sector of the RA Economy,” <http://www.mineconomy.am/eng/55/text.html>.

48. Ministry of Economy of the Republic of Armenia, “Industrial Policy,” <http://mineconomy.am/eng/35/gortsaruyt.html>.

49. Ibid.

50. Ibid.

51. Ministry of Economy of the Republic of Armenia, “Free Economic Zones in Armenia,” <http://www.mineconomy.am/uploads/20142402170607313.pdf>.

52. Ibid.

53. RAO Mars, “About Company,” <http://www.raomars.com/8/>; Yerevan Computer Research and Development Institute (YCRDI), <http://www.ycrdi.am/index.php/en>.

54. U.S. Department of State, “2013 Investment Climate Statement—Armenia,” February 2013, <http://www.state.gov/e/eb/rls/othr/ics/2013/204593.htm>.

the development of electronic governance tools, and reduced bureaucratic procedures for business operations, seeking to decrease opportunities for seeking bribes and kickbacks.⁵⁵ A more intractable challenge is the ongoing blockade of Armenia by two of its neighbors as well as the unresolved conflict over Nagorno-Karabakh. The conflict and the blockade limit Armenia's access to international trade routes, which, coupled with Armenia's own small and comparatively poor population, reduce the incentives for foreign companies to invest in the country. Similarly, external trade depends on routes through Georgia and, especially, Russia, leaving Armenia highly exposed to the fluctuations of its neighbors' economies and regional geopolitics.⁵⁶

INFRASTRUCTURE AND CONNECTIVITY

Armenia's transport infrastructure was designed and built as an integral part of the Soviet connectivity grid, which linked all the South Caucasus states to each other, to Russia, and to the Middle East. The old infrastructure still partially exists, though much of it has been disrupted by the geopolitical fragmentation of the South Caucasus and Armenia's isolation from its neighbors Azerbaijan and Turkey (see Table 3.4).⁵⁷

Armenia sits astride the shortest transit route from the Caspian Sea to Turkey. Yet all its border crossings with Turkey and Azerbaijan have been closed since 1993, isolating Armenia from most of the east-west traffic crossing the region and leading to the emergence of new transit routes that bypass Armenia. The blockade increases the cost of moving goods into and out of Armenia. Around 85 percent of Armenia's foreign trade passes through Georgia, with the remaining 15 percent transiting Iran.⁵⁸

In 2013 Armenia transported around 12.3 million tons of cargo, a slight increase over the previous year (21.1 million).⁵⁹ The lion's share of this cargo is moved into and out of Armenia by road (see Figure 3.4).

Although around 75 percent of the international roads in Armenia are in good or fair condition, 60 percent of local roads need rehabilitation, adding to the cost of transportation and transit.⁶⁰ In the World Bank's Logistics Performance Index for 2014, Armenia was ranked 92nd among 155

55. World Bank, *Doing Business 2016: Measuring Regulatory Quality and Efficiency*, 13th ed. (Washington, DC: World Bank, 2016), <http://www.doingbusiness.org/~media/giawb/doing%20business/documents/profiles/country/arm.pdf>.

56. IMF, *Republic of Armenia*, Country Report No. 15/65.

57. Thomas De Waal, "A Broken Region: The Persistent Failure of Integration Projects in the South Caucasus," *Europe-Asia Studies* 64, no. 9 (November 2012): 1709–1723, http://carnegieendowment.org/files/Broken_Region.pdf.

58. Amcham in Armenia, "Cargo Transportation," 2013, <http://www.amcham.am/business/doing-business3/cargo-transportation.html>.

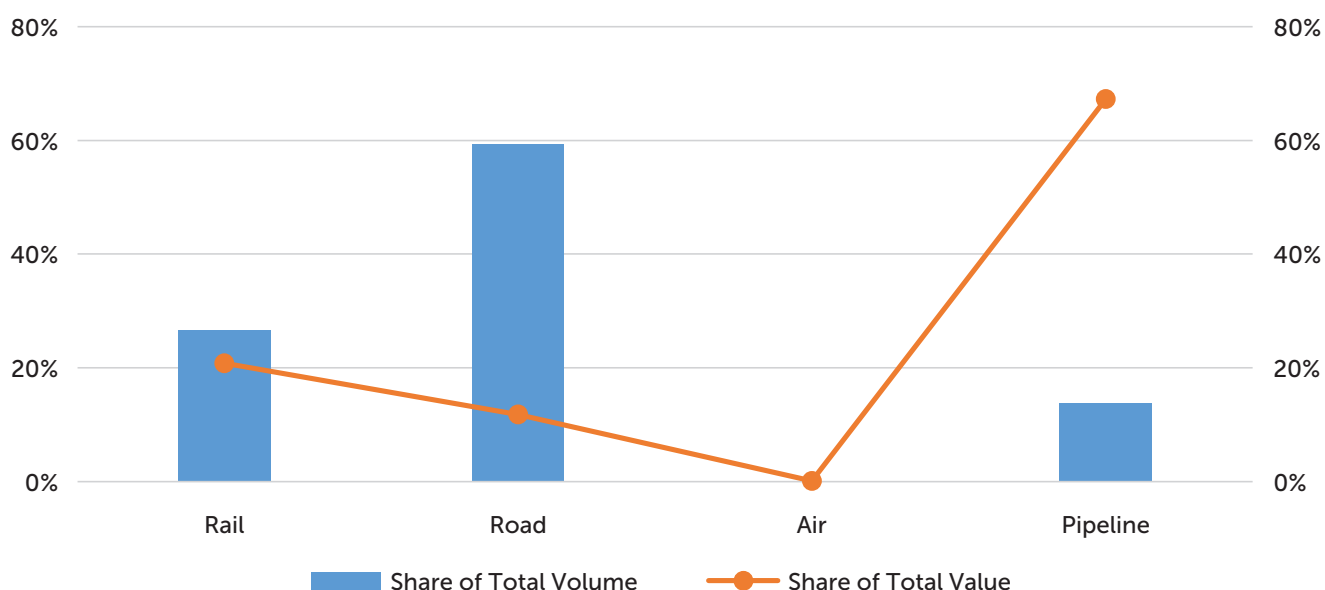
59. ArmStat, *Statistical Yearbook of Armenia 2014*, 324–345.

60. ADB, "Country Partnership Strategy: Armenia 2014–2018: Sector Assessment (Summary): Transport," <http://www.adb.org/sites/default/files/linked-documents/cps-arm-2014-2018-ssa-01.pdf>.

Table 3.4. Armenia's Road/Rail Connections to Its Neighbors

Border	Crossing	Type
Armenia-Georgia	Gogavan-Guguti	Road
	Bavra-Ninotsminda	Road
	Bagratashen-Sadakhlo	Road
	Airum-Sadakhlo	Railway
Armenia-Iran	Agarak-Tabriz	Road

Figure 3.4. Cargo Transportation in Armenia, 2013



Source: <http://armstat.am/file/doc/99489243.pdf>.

countries, a slight improvement from its 2012 ranking of 100.⁶¹ In addition to the poor quality of many roads, Armenia struggles with poor coordination across its borders, difficult topography in many areas, and severe weather especially at higher elevations.

Transit costs to Georgia are high, despite the fact that Georgia and Armenia have had a free-trade agreement in place since 1995, which eliminates customs duties on bilateral trade.⁶² Because of

61. World Bank, "Logistics Performance Index: Country Score Card: Armenia 2014," <http://lpi.worldbank.org/international/scorecard/line/254/C/ARM/2014#chartarea>.

62. Ministry of Foreign Affairs of the Republic of Armenia, "Free Trade Agreement between Georgia and Armenia," August 14, 1995, http://www.wipo.int/edocs/lexdocs/treaties/en/am-ge/trt_am_ge.pdf.

the topography and generally poor roads, shipments take a comparatively long time to reach their destination. Nevertheless, Armenia improved its Doing Business ranking substantially in the past year. The time needed for goods from Armenia to reach a port in Georgia improved from an average of six to seven days in 2014 to three to four days (79 hours) in 2015, thanks to improvements in Armenia's border and documentary compliance.⁶³

The government plans to increase public expenditure on roads to 1.4 percent to 1.5 percent of GDP by 2025, of which 85 percent will be spent directly on rebuilding and rehabilitating around 7 percent of the entire road network annually.⁶⁴ The most prominent project is the ongoing construction of the 556-kilometer North-South Highway (Meghri to Yerevan to Bavra), which is designed to connect Iran with Georgia through the shortest possible route. The construction of the project is financed by multilateral organizations as part of the Transport Corridor Europe-Caucasus-Asia (TRACECA) initiative. The North-South Highway has critical strategic importance for Armenia, enabling connectivity of Armenia's northern and southern borders and opening a direct route from the Persian Gulf to the Black Sea through a further connection to the Georgian East-West Highway.⁶⁵

Another important initiative focuses on modernizing border crossings, upgrading physical facilities, and introducing Integrated Border Management (IBM) systems to enhance capabilities and synchronize customs control procedures. The Bavra-Ninotsminda (Georgia) crossing was upgraded with an IBM system thanks to a two-year, \$291 million EU-financed project ending in 2014.⁶⁶ Facilities on both sides of the border received new equipment and a coordinated management system was introduced to better exchange information. The project sought to more than triple traffic volume through the crossing point by 2015.⁶⁷

A similar project was launched in 2014 for the Bagratashen-Sadakhlo border crossing, with a budget of 4.3 million euros and financing from the European Bank for Reconstruction and Development (EBRD).⁶⁸ In the context of the North-South Transport Corridor project, another major infrastructure project was launched in 2013 with a 10.3 million euro EBRD loan to construct a new

63. World Bank, "Doing Business: Trading across Borders in Armenia," June 2015, <http://www.doingbusiness.org/data/exploreeconomies/armenia/trading-across-borders/>; World Bank, "Doing Business: Trading across Borders," June 2015, <http://www.doingbusiness.org/data/exploretopics/trading-across-borders>. This figure is calculated by adding together the inland transportation time, border compliance time, and documentary compliance time in both countries. The improvement reflects solely reforms initiated on the Armenian side.

64. Republic of Armenia Ministry of Finance, "Armenia Development Strategy for 2014–2025."

65. UN Economic Commission for Europe, "Transport Infrastructure," http://www.unece.org/fileadmin/DAM/transport/main/temterm/2ndJoint_Doc3.pdf.

66. UN Development Programme, "Enhancement of Border Management Capacities of Bavra-Ninotsminda BCPs between Armenia and Georgia," http://www.am.undp.org/content/armenia/en/home/operations/projects/democratic_governance/enhancement-of-border-management-capacities-of-bavra-ninotsminda.html.

67. UN Development Programme, "Georgia Project Document," http://www.ge.undp.org/content/dam/georgia/docs/prodocs/GE_nbibm_prodoc_2012_2013.pdf.

68. UN Development Programme, "A New Project to Upgrade Bagratashen-Sadakhlo Border Crossing Point," April 11, 2014, <http://www.am.undp.org/content/armenia/en/home/presscenter/pressreleases/2014/04/11/a-new-project-to-upgrade-bagratashen-sadakhlo-border-crossing-point-.html>.

bridge over the Debed River connecting the borders of Armenia and Georgia.⁶⁹ There are also plans to implement a similar infrastructure and management project for the Gogavan-Guguti crossing.

Yerevan announced an “open sky” policy in 2013, in response to the repeated failure to establish a national air carrier.⁷⁰ This policy allowed foreign carriers, so far from Russia and the United Arab Emirates (UAE), to enter the market, leading to a 20 percent increase in passenger traffic to Yerevan between 2013 and 2014.⁷¹

The government also plans to build an international regional logistics center and FEZ in the Zvartnots International Airport in Yerevan to increase trade as well as develop intermodal transport. The international logistics center will be incorporated into the TRACECA project, an intermodal network running from Bulgaria through Ukraine and Romania to Georgia’s Black Sea ports, across the Caucasus and the Caspian Sea, and then from the ports of Aktau, Kazakhstan and Turkmenbashi, Turkmenistan by rail across Central Asia to Afghanistan and China.⁷²

After roads, railroad is the second most important method of cargo transportation in Armenia. Due to the border closures, only 726 kilometers of the total 1,328.6-kilometer-long railroad system are operational.⁷³ The Soviet-built South Caucasus railroad network linked Sukhumi-Yerevan-Nakhichevan and Ijevan-Kazakh-Tbilisi, establishing connectivity between the three South Caucasus republics with an extended Kars-Gyumri-Tbilisi link with Turkey in the west.⁷⁴ Currently, only the northern section of the international rail route connecting Armenia and Georgia is operating. This route is used for both passenger and cargo transportation and is the only railroad linking Armenia to international maritime trade traffic through Georgia’s Black Sea ports.⁷⁵ Although much is in need of rehabilitation and reconstruction, the infrastructure still exists (see Maps 3.1 and 3.2) and provides a potential for restoring connectivity between Russia, Iran, Turkey, and the Caspian Sea comparatively easily in the event that the blockades are ended.⁷⁶

Yerevan’s transportation strategy aims to enhance connectivity, diversify the transportation sector, and ease the effects of the blockade. Armenia has developed several programs to upgrade the

69. North-South Road Corridor Investment Program, <http://northsouth.am/en/bagratashen-board>.

70. “Armenia Passes to Open Sky Policy,” Armenpress, June 6, 2013, <http://armenpress.am/eng/news/721609/>.

71. Daniel Saslavsky, “Lessons Learned from Armenia’s Open Skies,” *The Trade Post* (blog), January 15, 2015, <http://blogs.worldbank.org/trade/lessons-learned-armenias-open-skies>.

72. TRACECA, “Transport Infrastructures to Approximate the Yerevan International Airport ‘Zvartnots’” (presentation at TRACECA Investment Forum, Brussels, February 28, 2012), http://www.traceca-org.org/fileadmin/fm-dam/Investment_Forum/ARM1_Yerevan_Logistics_Centre.pdf.

73. UN Economic Commission for Europe, *Euro-Asian Transport Linkages: Paving the Way for a More Efficient Euro-Asian Transport* (New York: United Nations, 2012), 521, http://www.unece.org/fileadmin/DAM/trans/main/eatl/docs/EATL_Report_Phase_II.pdf.

74. De Waal, “A Broken Region.”

75. TRACECA, *Logistics Processes and Motorways of the Sea II: LOGMOS Master Plan—Annex 9.1: Country Profile: Armenia* (Brussels: TRACECA, October 2013), 25, http://www.traceca-org.org/fileadmin/fm-dam/TAREP/65ta/Master_Plan/MPA9.1AM.pdf.

76. De Waal, “A Broken Region.”

Map 3.1. Rail and Road Infrastructure in Armenia

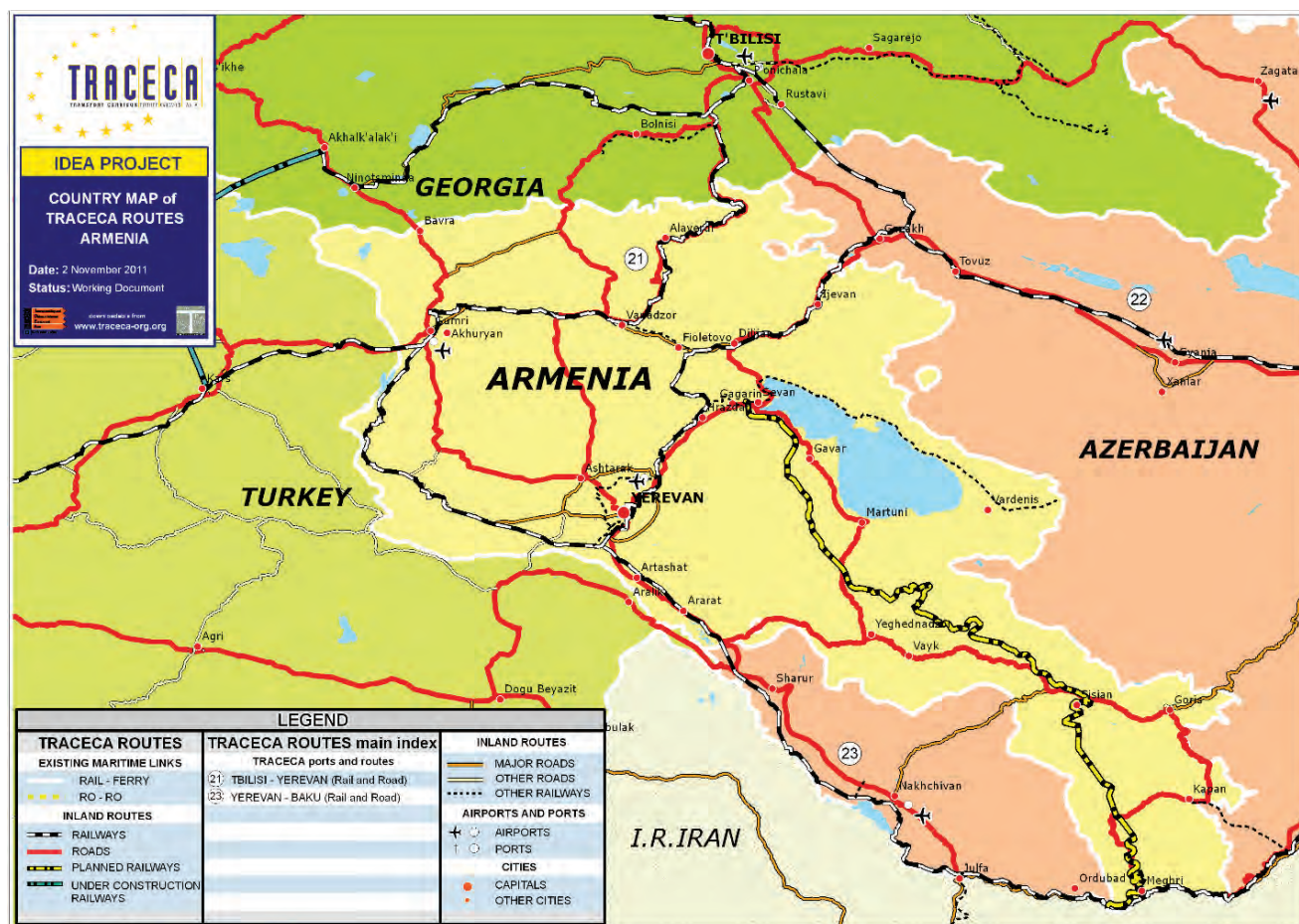


Source: https://en.wikipedia.org/wiki/Armenian_Railways.

existing railroad infrastructure and construct two new railroads, including the Southern Armenia Railway. This line would run from Gagarin to Agarak and have an annual capacity of 25 million tons. It would also complete the shortest route between the Black Sea and Persian Gulf along the NSTC and give Iran direct access to the Eurasian Economic Union. Yerevan has sought to bring in Chinese companies to work on the project in line with Beijing's planned Silk Road Economic Belt, and to attract Russian investment, but Moscow has been noncommittal, in part likely because it is interested in several competing projects across Azerbaijan and Turkey.⁷⁷ Other international financing is unlikely because without a direct link to Russia or to the newly completed

77. Yuriy Rox, "Ереван прорубит окно в Персидский залив," *Nezavisimaya Gazeta*, June 19, 2015, http://www.ng.ru/cis/2015-06-19/1_erevan.html.

Map 3.2. Armenia and TRACECA



Source: TRACECA.

Baku-Tbilisi-Kars line (which the blockade prevents), the economic impact of the Southern Armenia Railway is likely to be limited.⁷⁸

Another strategically important railroad is being built linking Vanadzor with Dilijan. This 32-kilometer-long railway will reduce the length of the Yerevan-Tbilisi route by 112 kilometers.⁷⁹ Russian Railways' (RZhD) South Caucasus Railways subsidiary, which has operated Armenia's railroad system since 2008, announced the project in 2013 with an estimated budget ranging from \$250 million to \$500 million.⁸⁰

78. Armen Grigoryan, "Iran-Armenia Railway Project Remains Controversial," *Eurasia Daily Monitor* 12, no. 118 (June 24, 2015), [http://www.jamestown.org/single/?tx_ttnews\[tt_news\]=44075&tx_ttnews\[backPid\]=13&cHash=bb872b3e1cc4590b19769143fad68f21#.VubsqPkrdV](http://www.jamestown.org/single/?tx_ttnews[tt_news]=44075&tx_ttnews[backPid]=13&cHash=bb872b3e1cc4590b19769143fad68f21#.VubsqPkrdV).

79. TRACECA, *Logistics Processes and Motorways of the Sea II*.

80. "Construction of Vanadzor-Fioletovo Railroad Is Feasible—SCR CEO Says," ARKA News Agency, December 19, 2013, http://arka.am/en/news/economy/construction_of_vanadzor_fioletovo_railroad_is_feasible_scr_ceo_says/; UN Economic Commission for Europe, *Euro-Asian Transport Linkages*, 521.

The Armenian-Turkish normalization process of 2009, which aimed to open the border and establish diplomatic relations between the countries, would have had a significant positive impact on the connectivity of the region and would have significantly reduced logistical costs by opening trade routes through Turkey. Open borders with Turkey would allow Armenia to gain access to international trade routes via the Turkish Black Sea port of Trabzon and the port of Mersin on the Mediterranean Sea, as well as access to the relatively advanced Turkish transit infrastructure, including faster highways and a more extensive rail network.⁸¹

A 2010 analysis suggested that opening the Turkish-Armenian border would cut transportation costs for Armenia around 45 percent, in turn facilitating a significant increase in Armenia's trade traffic.⁸² The study also estimated that Armenia-bound cargo traffic from Georgia would drop by 40 percent if the Turkish border were opened, indicating the scope of the economic distortions the blockade imposes.⁸³

The opening of Armenia's border with Azerbaijan would meanwhile revive the South Caucasus's natural role in international and regional trade and transit routes, allowing for more efficient connections between Turkey and the Caspian Sea, as well as establishing a direct connection between "mainland" Azerbaijan and the Nakhichevan exclave.

Broader east-west connectivity could be reestablished primarily through rehabilitation of the Soviet-era Kars-Gyumri-Nakhichevan-Meghri-Baku (KGNMB) railway. The competing Baku-Tbilisi-Kars (BTK) railway project is nearing completion and now scheduled to open sometime in 2016. BTK bypasses Armenia, is more costly to use, and strategically less favorable compared to the KGNMB route. According to some estimates, rehabilitation of the KGNMB route will cost around \$433.7 million, whereas the construction of the BTK line has already exceeded \$600 million and the project is not concluded yet.⁸⁴ Even though they are participants in the BTK project, Azerbaijan and Turkey would also likely favor the reconstruction and rehabilitation of the KGNMB line once their blockade of Armenia ends. Rehabilitating KGNMB would allow Azerbaijan to improve communications with Nakhichevan, while regions of Turkey far from the BTK line would also benefit.

81. Patsuria, "Georgia."

82. Davit Narmania and Sargis Grigoryan, "Cross-Border Co-operation between Georgia and the Republic of Armenia: Existing Problems and Challenges," CARE International in the Caucasus, August 2010, http://www.entwicklung.at/uploads/media/20101115_Cross_Border_Study__FINAL.pdf.

83. Patsuria, "Georgia."

84. Natalia Mirimanova, *Rehabilitation of the Railways in the South Caucasus: Assessment of the Potential Economic Benefits: Volume 2: Kars-Gyumri-Nakhchivan-Meghri-Baku Railway* (London: International Alert, July 2014), http://www.international-alert.org/sites/default/files/Caucasus_RailwaysRehabilitationPt2_EN_2013.pdf.

Conclusion

Like many other post-Soviet states in the South Caucasus and Central Asia, Armenia would like to diversify its international engagements to enhance its sovereignty and benefit from the emergence of new trade and transit connections. Armenia's options remain more constrained than those of most of its post-Soviet counterparts because of its strategic and economic dependence on Russia, a result in turn of the Azerbaijani and Turkish blockades. Moscow provides Yerevan a lifeline and a security umbrella that it desperately needs, but at the price of keeping Armenia almost wholly in its orbit. Armenian elites understand this dilemma and, while not aiming to challenge Russia's dominant role, are seeking opportunities to engage new partners in Europe, the Middle East, Asia, and the United States. This outreach represents a delicate balancing act, especially at a time of deepening confrontation between Russia and much of the outside world.

Armenia would be among the biggest beneficiaries of a negotiated solution to the Nagorno-Karabakh conflict, which would presumably be accompanied by an end to the Turkish and Azerbaijani blockades that have crippled Armenia's development over the past two decades. Ending the conflict would allow Armenia to develop economic relations with all of its neighbors and would also make Yerevan's dependence on Moscow less comprehensive. As the conflict also plays a major role in the geopolitical fragmentation of the South Caucasus, limiting opportunities for the emergence of profitable and secure transit routes through the region, many outside powers also have an interest in a resolution. As new transit routes through the South Caucasus open up, Armenia risks finding itself ever more isolated and dependent on its lifeline to Russia as long as the conflict remains unresolved. That said, some of our Armenian interlocutors emphasized the depth of mistrust that continues to exist, expressing skepticism that even a resolution of the Nagorno-Karabakh conflict would be sufficient for Armenia's neighbors to accept it and agree to economic cooperation with it.

The mobilization of nationalist sentiment in both Armenia and Azerbaijan as well as Russia's ambivalent stance on the conflict make prospects of a resolution seemingly remote for the time being. If anything, the danger of renewed conflict between Baku and Yerevan appears to be

growing, with both sides turning to heavier weapons, and with a generation growing up in both countries with no experience of the coexistence that was the norm during the Soviet period. While Armenia retains some advantages despite Azerbaijan's massive defense spending, a return to war would likely be disastrous for both sides. While the Minsk Group continues to promote a settlement, Armenians as well as Azerbaijanis seem increasingly skeptical that it will prove capable of untying the Nagorno-Karabakh knot.

Russia's status as one of the Minsk Group cochairs remains an additional obstacle, insofar as Moscow seeks to cement its status as the principal power broker in the South Caucasus. Keeping the Nagorno-Karabakh conflict smoldering allows Moscow to maintain its military deployments in Armenia and to use the prospect of a settlement as a carrot for keeping Azerbaijan from drifting too far outside its orbit. Russia may not oppose a resolution of the conflict in principle, but it remains at best an open question whether a settlement on Moscow's terms would also prove acceptable to the other cochairs, not to mention Turkey.

The formal establishment of the Eurasian Economic Union at the start of 2015 adds a new dimension to this puzzle. Armenia is already a member, and Russia would also like to incorporate Azerbaijan, notwithstanding Baku's long-standing efforts to deepen ties with the West. Azerbaijan remains skeptical, but several of our interlocutors in both Baku and Yerevan noted that the prospect of recovering Nagorno-Karabakh, or at least some of the surrounding territories, could be sufficient inducement for Azerbaijan to swallow its doubts about the EEU, especially at a time of worsening relations with the United States and European Union. Such an arrangement would, of course, require territorial concessions that Yerevan could find difficult to countenance. Yet if accompanied by an end to the blockade and a normalization of relations with Azerbaijan and Turkey, the benefits for Armenia could be substantial. The success of this scenario requires a number of pieces to fall into place, and for now at least, the armed standoff along the Line of Contact is likely to endure.

For the United States, the challenge is to develop mechanisms for engaging Yerevan, in spite of an increasingly fraught relationship with Moscow, while continuing to push for a peaceful resolution of the Nagorno-Karabakh conflict. Notwithstanding—indeed because of—its close ties to Russia, Armenia remains very much interested in deepening ties with the United States and its European allies. In the aftermath of the Euromaidan protests in Kyiv and subsequent ouster of the Ukrainian government, followed by Russia's invasion, Armenia, ironically, may be the only state in the South Caucasus whose interest in integration with the West is growing. Yerevan's interest in an economic partnership with the European Union represents a particular opportunity; even if this partnership falls short of the association agreement Yerevan and Brussels were negotiating until 2013, a more comprehensive economic partnership can help promote transparency, openness, and the rule of law in Armenia, all of which will help attract foreign investment and create a wider range of stakeholders in Armenia's success. Success, though, will require Yerevan to reverse some of negative trends in its domestic political environment, which have accelerated even as Armenia's regional security environment becomes increasingly perilous.

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