

# THE EUROPEAN GEOPOLITICAL FORUM

## **Exploring the Role of Economic Initiatives as Peace Building Tools in the Nagorno-Karabakh Context**

*A discussion paper  
for the EGF Tbilisi Seminar at the Holiday Inn, July 22, 2015*

*Reporting  
on the Workshop and Group Simulation  
which took place in Berlin, Germany, 7-8 July 2014*

## **Introduction**

This paper reports on a post-conflict scenario building workshop and group simulation which took place in Berlin (Germany) on 7-8 July 2014. The event occurred within the framework of the second stakeholder consultation round in EGF's ongoing research into the Nagorno-Karabakh (NK) conflict resolution processes. The aim of this workshop was to simulate a negotiation process in order to reflect a possible real life situation which may occur in the NK context at a future date, and to draw lessons learned during a feedback session.

The given (future, post-conflict) scenario was set in the year 2019. A few months had passed after a Peace Agreement (PA) based on the current Madrid Principles was reached between the imaginary Republics of Salandia and Oronia, which were engaged in years of fighting over the political status of the 'break-away territory' of Mordovia<sup>1</sup>.

Participants in the simulation were issued with instructions about engaging each other prior to commencing the simulation. The task of participants was to simulate negotiations of a bi-national Task Force, which in 2019 was mandated with drawing up a roadmap for implementation of the economic considerations of the (2019) PA.

Furthermore, the 'Task Force' was invited to propose additional economic projects that could act as confidence building measures by addressing the restoration of war-torn energy, transport and socio-economic infrastructure in NK, and the territories around it, by establishing, where possible, 'economic projects of common interest'. The end goal was to agree upon an 'official' roadmap document for regional economic development, which could be supported by both parties. The discussion was chaired, mediated and advised by international experts.

## **Role Play and Format of the Simulation Exercise**

Participants were split into three teams:

- A. Armenian participants (from both Armenia proper and from NK) formed the Oronian team. They proposed an initial draft for the timetable of implementation of the PA, and an action plan for restoring infrastructure in Mordovia.
- B. Azerbaijani participants formed the Salandian team and introduced an initial set of economic measures.
- C. The rest of the workshop participants played the role of the international secretariat which moderated the negotiations

In addition to the Armenian and Azerbaijani inputs as mentioned above, the EGF planners of this workshop also made suggestions on the initial draft of the timetable. They mainly highlighted the inextricable links of the economic measures with the security and governance agenda provided by the hypothetical PA.

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<sup>1</sup> The country profiles of Salandia and Oronia in 2019 were identical to those of Azerbaijan and Armenia of today, respectively, while the status of Mordovia was mirroring that of Karabakh.

The use of references to Armenia, Azerbaijan and NK were intentionally precluded by EGF planners to avoid entrenchment in national positions, and to encourage "out of the box" thinking. However, the realistic context created by the instructions, the information provided to the participants and the honest and dedicated simulated negotiations by all parties involved led to a highly stimulating event. This workshop eventually resulted in a highly constructive discussion on economic incentives as peace building tools in the NK conflict, whilst enabling participants to talk to each other in a constructive manner.

At the end of two sessions of intense and focused dialogue, Armenian and Azerbaijani participants succeeded, with few exceptions, in agreeing on a joint timetable on implementing the PA<sup>2</sup>. That said, the extensive discussions did not leave sufficient time in order to hold a planned mock press conference or a feedback session on the simulation event.

## **Results and Outcomes of the Workshop**

This workshop highlighted the inherent and mutually acknowledged interdependence of the political, economic and security agendas of Armenia and Azerbaijan (i.e. Oronia and Salandia, respectively). Moreover, it came out from the discussions that both countries would be prepared to invest jointly a considerable amount of both tangible and non-tangible resources in rebuilding a peaceful future for NK (i.e. Mordovia), provided a reasonable compromise on the status was reached.

In practical terms, the workshop eventually resulted in drafting a realistic, largely-agreed upon action plan based on the updated Madrid principles. This action plan was set into a timetable outlining a possible post-conflict roadmap for peace building in Karabakh. It appeared that this document may result in a solid basis for developing more robust post-conflict scenarios in the context of future simulations on building an economically integrated South Caucasus and developing regional cooperation.

Seen from the perspective of EGF's current research on NK, the items included in the timetable were enclosed into an Annex and may be considered as economic incentives that could be used as peace building tools in Karabakh. They resulted from the experts' extensive dialogue on proposals for common projects and inter-governmental measures submitted by the Armenian, Azerbaijani and international teams.

Consequently, the simulation event has helped EGF researchers outline three main categories of economic incentives:

- 1. *Mutually Agreeable Economic Incentives;***
- 2. *Economic Incentives Conditional to the NK final status;***
- 3. *Economic Incentives to Be Developed Further***

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<sup>2</sup> See Annex.

The next sections of this report will describe in some detail the economic incentives included in each of those categories, with a view to expanding on their substance in future simulated negotiations.

It should be added, however, that a more thorough analysis will be needed in order to validate the legal, economic and technical feasibility of these economic incentives, if they are to have any genuine impact in fostering change on the respective positions of the parties in relation to the NK conflict itself.

## **Economic incentive proposals: the Republic of Oronia (Armenia)**

The Armenian (Oronian) team stated its interest for nurturing lasting, durable peace in the region based on transparency and good neighbourly relations. They introduced a list of 15 proposals outlining their priorities to promote not only security and stability, but shared prosperity in the region:

- Seek investors and multilateral investment.
- Deliver increased per capita wealth and infrastructure rehabilitation, as well as international support thereof.
- Promote a new Free Trade Agreement with the EU, involving Armenia, Azerbaijan and Georgia.
- Seek flagship investments from Turkey, Russia, Iran, US, and the EU with the aim to ensure broader access to the Iranian market.
- Organize a Donor's Conference which would establish a Trust Fund for Development of SMEs with specific focus on R&D, and science and technology.
- De-commission weapons, start military demobilization, and the reconversion of the defence sectors to enable the access to peace dividends.
- Create a Re-settlement Fund to finance reparations, and the voluntary right of return of refugees and IDPs.
- Use the Diaspora for the mutual benefit by creating and selling peace bonds.
- Opening major banks and a joint financial management sector in Baku and Yerevan.
- Re-open airports for direct flights between the capitals with state budget support to promote lower cost and more competitive airlines.
- Foster cooperation among law enforcement, including information sharing and joint operations against organized crime, counter-narcotics and counter-proliferation.
- Create a small but sizeable free economic zone with a focus on SME development; open free trade offices in major financial centres of the world.
- Secure free access to Black Sea, f.i. Trabzon, and to Persian Gulf, i.e Bandar Abbas (Iran) ports.
- Focus on education allowing more investment in challenging the current narrative on peace building, and in guaranteeing social benefits and standing for the returnees and the local population.

## **Economic incentive proposals: the Republic of Salandia (Azerbaijan)**

The Azerbaijani (Salandian) team responded by pointing out the key geographical position of the region at the contact of three emerging trading blocs (Trans-Atlantic, Eurasian, and Chinese) as well as the economic and geographic interdependence of the two countries. They also set out their priorities as following:

- Open local markets in Shusha-Lachin, Asgeran- Aghdam, and Shusha-Khankendi in Kerkicahan to facilitate regional trade involving both communities.
- Build emergency shelters to facilitate future re-settlements in Karabakh (Mordovia).
- Repair historical monuments in NK and in the surrounding districts.
- Subsidize agriculture in NK and in the surrounding districts.
- Open the other parts of Azerbaijan to exports from NK.
- Repair the Sarsang water reservoir, which is critical for sustaining the development of agriculture in NK.
- Repair melioration and irrigation systems to allow improved water usage from Kalbajar to both lower Karabakh and Azerbaijan.
- Free movement between upper and lowland pastures from Azerbaijan, NK and Armenia.
- Grant the status of special economic zone to NK.
- Develop touristic clusters in NK.
- Create a city agglomeration in Shusha-Khankendi-Aghdam.
- Repair gas, energy and other infrastructure.
- Azerbaijan sells cheaper gas to Armenia for producing electric energy to be sold to Turkey, and further on the European markets.
- Build oil refining factories in NK and Armenia.
- Re-vitalize and integrate the North-South route (from Russia to India via Iran) with the East-West route of the New Silk Road, to transform the region into a logistic hub for Eurasia.

### **1. Mutually Agreeable Economic Incentives**

#### ***1.1. Call an International Donors' Conference. Set up a Trust Fund. Conclude a Bilateral Tax Treaty***

This was originally an Armenian proposal meant to involve foreign stakeholders in providing external guarantees for regional stability and security, and to facilitate flagship investments. The Donors' conference and the Trust Fund would provide economic incentives on behalf of third parties, including international governments and organizations, as well as multinational corporations. The Azerbaijani team agreed, in principle, on this proposal as two separate items: donor's conference, and trust fund. Subsequently, the Armenian team suggested adding a bilateral tax treaty to ensure a legal framework that would guarantee foreign investors' involvement, avoid double taxation and ensure the mobility of capital.

The Azerbaijani team agreed with this additional proposal with a view to attracting foreign investors by diminishing political risks, and avoiding double taxation. One international expert suggested to conduct a thorough analysis of the tax systems in Armenia and Azerbaijan, while noting that the Armenian membership of the World Trade Organization (WTO) might offer a more favourable business environment to foreign investors. She further expressed the hope that by 2019, Azerbaijan would have also joined the WTO.

### ***1.2. Compile a road map to revitalize the Great Silk Road and the North-South Route***

This Azerbaijani proposal was deemed by the Armenian team as “a common good which is fully shared”. Plans of the Asian Development Bank to develop a North-South modern highway in Armenia would offer additional interest by possibly broadening Armenia's regional significance.

### ***1.3. Start negotiations over bilateral Free Trade agreement***

The discussion on this economic incentive stemmed from a broader Armenian proposal to start negotiations with all three South Caucasus (SC) countries (including Georgia) for a joint free trade agreement with the EU. For Armenia, this was an option to overcome its current deadlock in concluding a FTA with the EU in the aftermath of the political decision to join the Eurasian Customs Union.

Both the Armenian team and the international experts brought arguments in favour: it would facilitate access to EU markets; sensitive sectors of the economy might be exempted; longer transition times might be allowed before opening SC countries' markets to EU products; it would be a step towards a blueprint for regional development in the SC; and it would facilitate foreign investment while allowing enhanced regional mobility of capital and goods.

However, it seemed that, at this stage, the Azerbaijani team was not interested in coordinating foreign trade policies against the EU with the other SC states. Russian hard feelings against such a proposal might also be a constraining factor for Baku (and Yerevan in their view). This is why they were not prepared to take up anything more than a bilateral FTA with Armenia, and preferred instead to focus on opening local markets in several places around Karabakh (see item 1.5).

### ***1.4. Building emergency shelters (with the intent of servicing the needs of a peacekeeping mission)***

Originally an Azerbaijani proposal to facilitate future re-settlements in Karabakh, it has been eventually turned into an agreement to build housing, catering and other service facilities for the peacekeeping mission to be deployed in Karabakh. Economic arguments in favour of this proposal consisted of: creating a business environment that would support confidence building, and promoting small companies and joint ventures among business people belonging to both communities that would create jobs and other sources of income for the local population. The Armenian team agreed on this proposal.

### ***1.5. Opening of local markets***

Building upon the model of the Georgian Sadakhlo market, the Azerbaijani team proposed opening local markets in Karabakh to facilitate local trade. In such places, traders from both communities would have the opportunity to do business together while increasing mutual trust. Asgeran-Aghdam, Shusha-Lachin, and Shusha-Khankhendi/Stepanakert in Kerkicahan were proposed as potential areas where such markets could be located. The Armenian team agreed in principle with this proposal, but requested that the concrete locations advanced by the Azerbaijanis were listed in the timetable just as examples.

### ***1.6. Repairing of historical monuments***

Although this is not a genuine economic incentive, the Azerbaijani proposal for inclusion of this measure into the Economic Section of the timetable for implementation of the PA was agreed upon. It was thought that such projects, in spite of their limited economic significance, may strengthen mutual trust between Armenian and Azerbaijani communities from Karabakh.

### ***1.7. Start discussions on a gas pipeline from Baku to Nakhichevan via NK and Armenia. Export natural gas from Azerbaijan to Armenia***

The first part of this proposal, originating from previous EGF research, was easily accepted by both parties in the shape of initiating a feasibility study. The Azerbaijani team stated that such a proposal might be extremely interesting for SOCAR, as it matched with their proposal to export gas at lower prices to Armenia and NK.

The Azerbaijani side has even explicitly stated that access to cheaper gas might be an important economic incentive offered to both Stepanakert and Yerevan when discussing the final status of NK. The Armenian team explained that their flexibility regarding the final status of NK is quite limited, and that the Armenian population in NK is unlikely to change its mind, regardless of Baku's cheap gas offer.

### ***1.8. Facilitating and simplifying trade between NK and other parts of Azerbaijan***

This Azerbaijani proposal was relatively easily agreed upon as soon as there was a common understanding of its meaning: easing trade restrictions, simplifying procedures for trade (registration of firms, border crossing of goods, etc.), and improving logistical arrangements.

### ***1.9. Start international talks on establishing a regional electricity grid in the South Caucasus***

As with the gas pipeline, this proposal ensued from previous EGF research and was easily taken on board by both parties with a view to initiating a regional feasibility study. However, the Azerbaijani side insisted on a general reference to the SC region instead of mentioning specific names of participating states. That was justified with a reluctance to involve specific neighbours in what was deemed as basically a bilateral commitment.

### ***1.10. Subsidizing agriculture***

This Azerbaijani proposal was agreed by the Armenians without any significant comments.

### ***1.11. Joint SMEs development: "Peace Entrepreneurs" project***

This Armenian proposal was agreed by the Azerbaijani team without any significant comments.

### ***1.12. Reconstruction of existing water reservoirs (for example Sarsang)***

The original proposal came from the Azerbaijani team, and was focused on the Sarsang reservoir. The Armenian team accepted this proposal provided it was broader in scope, i.e. not limited to Sarsang. However, they accepted the reference to Sarsang as an example of such projects.

### ***1.13. Repairing melioration and irrigation systems, including usage of water resources from Kalbajar***

This was, from a technical point of view, a follow up economic incentive to the previous item (1.12). It was agreed without any significant comments.

### ***1.14. Create an urban agglomeration in Shusha-Khankhendi/Stepanakert-Aghdam***

This project proposed by the Azerbaijani team could become an "economic engine" of the whole Karabakh region, while building economic interdependence, and, possibly, the germ of economic integration between Armenia, Azerbaijan and NK. The Armenian team embraced this proposal without further comments. Provided the details may be agreed, this economic incentive might be seen as a possible spearhead of Armenian-Azerbaijani post-conflict reconciliation.

## **2. Economic Incentives Conditional to the Final NK Status**

### ***2.1. Conduct land reforms through joint (Azerbaijan-NK) implementation of the reform process***

This Azerbaijani proposal addressing NK and the seven Azerbaijani districts around it was meant to settle the ownership of land, and to set joint rules for how land could be rented or sold. It was basically an expansion of a process started in Azerbaijan in 1997, and it was deemed as an essential aspect of establishing an appropriate business environment in Karabakh. While acknowledging the right of Azerbaijan to conduct such reforms in the seven districts around NK, the Armenian team clearly stated that the interim status of NK would not allow for Baku to impose land reforms on that territory.



However, as a compromise solution, the Armenian team accepted a joint Azerbaijani-NK effort to map the territory of NK with a view to establishing who owns what land. That would not only concern individuals, but a broader range of stakeholders, including self-government, municipalities, etc. This compromise solution was accepted by the Azerbaijani team with the common understanding that the rules for conducting the process should be subsequently agreed by relevant authorities from Baku and Stepanakert/Khankhendi.

## ***2.2. Establish a resettlement joint fund intended to guarantee social benefits for persons who became IDPs/refugees***

This was a concrete example of how a few words (in this case "voluntary return") with a major potential impact on the final status of NK may endanger the agreement on a proposal, which was otherwise basically acceptable to both parties. It came up as an Armenian suggestion for an economic incentive to support the right of return of IDPs and refugees to both NK and the seven surrounding districts. It was meant to offer special financial mechanisms to incentivize/ease the social transition of returnees by providing them with social benefits either in the form of an aid package or a voucher for a lump sum payment by the OSCE.

However, the Armenians insisted on the inclusion of the words "voluntary return" for fear of potentially having IDPs forced by the Azerbaijani authorities to return to NK in order to artificially shift the balance of the vote for the final status in their favour. The other side refused to add what they called a psychological obstacle to the return process, and an additional condition against the requirements of the PA. It appeared that the details of the implementation of this economic incentive would be difficult to negotiate and agree upon, given its tight connection with the sensitive final status of NK issue.

Eventually, the two parties agreed on a compromise solution by removing the reference to "voluntary return" for guaranteeing the social benefits for IDPs and refugees. However, they left unsettled the issue of possibly using this joint fund for providing additional support to those who chose to remain to live in Karabakh. One possible option on the table might involve that both Baku and Yerevan would have to deal with this issue separately, on a national basis. In this case, there could be high risk of renewed political tension stemming from uncoordinated policies on the return of IDPs.

## ***2.3. Ensure free movement of live-stock between lowland and upland pastures***

This was an Azerbaijani proposal questioned by the Armenian team, for it implied no border existed between Lower and Upper Karabakh. From an Armenian perspective that was unacceptable, for it seemed to be anticipating the political decision on the final status of NK.

## ***2.4. Create touristic clusters (e.g. in NK and in Azerbaijan)***

This proposal was introduced by the Azerbaijani team as an opportunity for NK to benefit from special funding provided by Baku to relevant regions of Azerbaijan. While declaring itself in favour, the Armenian team requested a broader approach for this

economic incentive, without specifically pointing at NK. That was the case for it otherwise might be interpreted as anticipating the political decision on the final status. Moreover, they suggested that the whole touristic infrastructure of Karabakh, Armenia and Azerbaijan should be integrated rather than approached as piece-meal. Eventually, the two teams agreed to go for a generic denomination of this economic incentive, while referring to NK and to a neighbouring district from Azerbaijan as examples of where it may be implemented.

### ***2.5. Re-open airports, establish direct flights from NK***

This Armenian proposal was only partly acceptable to the Azerbaijani team. The latter could only agree on re-opening NK airports for domestic flights to Baku and Yerevan. However, they could not accept direct flights from NK to international airports before final status was decided. Re-opening NK airports for international flights would have significant implications on the status issue, due to existing international regulations and actors involved in supporting such flights. In addition, this would be a sensitive topic for the Azerbaijani community originating from NK.

The Armenian team insisted that governments from Baku and Yerevan should subsidize flights between Baku, Yerevan and Stepanakert/Khankhedi, while low cost airlines should be allowed to operate international flights from NK airports for economic reasons. Eventually, it was agreed to include this economic incentive at the end of the timetable, after the final status of NK had been decided. However, there was a tacit understanding to proceed with the implementation of this economic incentive earlier, if possible.

### ***2.6. Start preliminary on-site visits and dialogue on re-opening the Baku-Fizuli-Megri-Nakhichevan-(Yerevan)-Gyumry-Kars railway***

This proposal stemmed from an international study run by the International Alert which had just been published (and distributed to participants) at the time of the Berlin Workshop. In principle, both teams agreed with this proposal, but not with its timelines. The Armenian team wished to proceed with the implementation as soon as possible, for it looked at it as the start of what was expected to be a lengthier process.

However, the Azerbaijani team sought to move it down in the timetable in order to synchronize it with the signing and ratification of bilateral agreements ensuring the free movement of goods and people between Armenia and NK through Azerbaijani territory (SD+30<sup>3</sup>). It may be assumed that this economic incentive could be an Azerbaijani bargaining chip linked to the issue of the final status of NK, for the study demonstrated that it was Armenia (and Turkey) who would reap most economic benefits from its operation.

The international secretariat eventually suggested that the implementation of this economic incentive might start anytime within the window delimited by the two timelines supported by the parties, as it would have been subsequently agreed.

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<sup>3</sup> SD+30 = 30 months after the date of signature of the PA.

### **3. Economic Incentives to Be Developed Further**

#### ***3.1. Use of the Azerbaijani State Oil Fund to co-finance infrastructure projects***

Proposed by the Armenians as a state financing mechanism for infrastructure projects meant to supplement foreign investors' resources, the Azerbaijani team stopped short of accepting it. However, they stressed that, in a post-conflict scenario, Armenians from NK may also benefit from the Azerbaijani State Oil Fund (which is currently capitalizing 50 billion USD) as every other Azerbaijani citizen, mainly as fiscal stimulus for jobs creation, welfare transfers, etc.

#### ***3.2. Negotiations over Black Sea port access, Trabzon port as priority***

The Armenian team depicted this proposal as a "first concrete/tangible deliverable needed by the Armenian population, which could be offered by Turkey". It would help overcoming the current semi-isolation of Armenia, who would get access to an alternative Black Sea port, so that they are not so dependent on the Georgian port of Poti. In addition, the implementation of this proposal would turn Armenia into a key transit hub for Azerbaijani exports to Europe and a significant source for mutual confidence building.

One Armenian participant signalled that there has been interest from a top Turkish businessman to build a modern, fully equipped, highway from Trabzon to Yerevan. The Azerbaijanis argued that the involvement of a third party (in this particular case Turkey) into the current bilateral dialogue would complicate the situation, and preferred to shift it as a sub-item of the broader discussion on revitalizing the Great Silk Road (item 1.2).

#### ***3.3. Contraction of Military Budgets. "Peace Dividends"***

This Armenian proposal was to explore mutual opportunities arising out of the envisaged contraction of military budgets due to demobilization and the decommissioning of weapons. From an Armenian perspective it had an economic aspect, given that it aimed at drawing "peace dividends" from cutting defence budgets and shifting the surplus to other parts of national budgets. The Azerbaijani team did not accept this standpoint, for it deemed this was a purely security issue, which could not be addressed in the realm of economic measures. However, they wanted to give assurances to their Armenian colleagues that after signing a PA, Baku would definitely downsize its military expenditures.

#### ***3.4. Build oil refinery factories in NK and Armenia***

This Azerbaijani proposal stemmed from the observation that Armenia imported large quantities of manufactured oil products from other countries, which significantly raised the costs for local consumers. Instead, Azerbaijan's SOCAR might invest in building such refineries that may lead to lower prices for Armenian consumers. The Armenian team thought that this proposal was worth further experts' discussion since the technical details might be quite significant.