



Strategic Security Analysis

The Economic Benefits of Peace in the South Caucasus

A joint paper by experts from
Armenia and Azerbaijan





The Geneva Centre for Security Policy

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Strategic Security Analyses

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Key points

- The normalisation of Armenian-Azerbaijani relations would have a highly positive impact on these countries' economies by reducing military expenditure; attracting foreign investment; and ensuring other positive consequences for public finances, foreign trade, energy and transport.
- Thanks to the ongoing tensions, defence spending continues to be proportionally higher than in much of the world.
- Similarly, foreign direct investment has been adversely affected, particularly in Armenia. Normalisation would encourage the diversification of the various economic sectors and attract a greater variety of investors.
- Generally, ending conflicts can decrease interest rates by at least 1.5-2 percentage points across various sectors of a country's financial markets.
- The reopening of borders and the establishment of transportation corridors could have far-reaching implications for trade and connectivity in the region, leading to shorter and cheaper trade and transport routes that benefit both countries and the region as a whole.



Peace in the South Caucasus: Introduction

The Geneva Centre for Security Policy invited experts from Armenia and Azerbaijan to share their thoughts on how a durable peace treaty could benefit both countries. Both groups of experts agreed that the first product of their dialogue would be an article summarising their joint perspectives on how peace could benefit the South Caucasus.

While there are differences in perspective, emphasis and detail, there is a clear consensus that peace and the normalisation of economic relations would unlock significant economic benefits for both countries and for the broader region.

At present, and until a final peace settlement can be agreed, economic relations remain frozen, borders virtually impermeable, and investors cautious. The two societies retain ingrained suspicions of the other, and the possibility of further fighting cannot be ruled out.¹

War destroys lives and wastes public resources on armaments and on dealing with the fallout from conflict (physical reconstruction, social reintegration, psychological rehabilitation). It removes productive young people from the workplace, devalues currencies, deepens debt, and deters both domestic and foreign investors. The World Bank has estimated that prolonged wars can rob countries of as much as 30 years of gross domestic product (GDP) growth.²

While the economic trajectories of post-war societies are uncertain and subject to many variables,³ a well-managed post-war economic recovery programme can rapidly deliver considerable socio-economic benefits. A relevant example is Northern Ireland, where real GDP has grown by almost 400% since the 1998 Good Friday Agreement, boosted by an open border, economic integration with Ireland, a single energy market, renewed investor confidence and the availability of post-war reconstruction assistance.

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The Armenian perspective

The normalisation of Armenian-Azerbaijani relations and the establishment of a stable peace would have a highly positive impact on Armenia's economy. Key areas that would benefit include the following:

- **Military expenditure:** We calculate that peace could bring savings on military expenditure of up to 2.8% of GDP.
- **Investment:** The net inflow of foreign direct investment could increase by at least 20%, resulting in a 5-6% boost to GDP.
- **Public finances:** Lower risk perception would reduce interest rates on portfolio investments, cutting the government's annual debt burden by at least US\$20 million.
- **Foreign trade:** Armenia's trade with Turkey would expand, and trade with Azerbaijan would become possible; this would increase Armenia's share of trade with its neighbours from 7% today to 13% in the medium term.
- **Water and energy:** Armenia has water to spare, but is deficient in energy supplies; Azerbaijan presents the opposite profile. There are obvious benefits to Armenia if water/energy exchange or trade arrangements can be made.
- **Transport:** Armenia's current isolation from regional and global transportation routes carries significant costs both to the country itself and to the region, and a more efficient, cooperative transportation system would bring significant GDP benefits to both Armenia and its neighbours.

Military expenditure. During the course of the conflict between the two countries, both have committed large sums of money to their military forces. Over the past decade Armenian resources equivalent to at least 4% of GDP have been used for this purpose; in 2021, according to the World Bank, Armenia spent 4.2% of GDP on the military, and Azerbaijan 5.2%.⁴ This compares with an average of 1.8% for Central European and Baltic countries, and 1.7% for all upper middle-income countries. Furthermore, approximately 3.5-4.0 % of Armenia's active workforce is engaged in the military (in Azerbaijan, the total is approximately half of this), as compared to less than 1% in most countries that are at peace.⁵

These vast expenditures represent lost investments in human capital, infrastructure, technological research, etc. Prior to 2009, resources allocated to the military in Armenia were comparable to public expenditure on education, but a significant gap has emerged since: by 2020, military expenditure had risen from 4.2% of GDP to 5%, and educational expenditure had fallen from 3.9% to 2.7%. We believe that the resources that would be released from the military to civilian uses in the event of peace could amount to as much as 2.8 % of GDP.

Investment. Foreign direct investment (FDI) in Armenia has declined significantly in recent years, from 8.8% of GDP in 2009 to a mere 0.5% in 2020, before rising to 5.1% in 2022,⁶ and has been concentrated in a limited number of sectors (with energy accounting for a quarter of total FDI, and mining, transport, and real estate a further 40% between 1988 and 2022⁷). The sources of FDI have also lacked diversity, with Russia accounting for 43.5% of gross inflows in the same period.⁸ Net portfolio investments from 2000 onwards have been predominantly negative.⁹

Peace, however, could transform this picture. A useful indicator of investment attractiveness is the density of new businesses per 1,000 inhabitants. Figures from 2020 show that Armenia, at 2.9 for this indicator, ranks above Azerbaijan (1.3), but well below Georgia (7.5), let alone Estonia (24.2).¹⁰ However, the



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Heritage Foundation's Index of Investment Freedom places Armenia at 30th out of 175 countries worldwide with 75/100 points,¹¹ and various analyses show that a score of over 50 is the fulcrum between economic stagnation and the potential for growth.¹² It is also worth referencing Armenia's policy reform climate as measured by the Bertelsmann Foundation (which assesses 17 criteria across 137 countries).¹³ Armenia's rankings provide strong grounds for optimism about the future: overall, Armenia scores 37th in the comprehensive assessment of transformations (39th in democracy, 40th in economics, 63rd in the management index). The mismatch between these two indices and actual investment performance is best explained by the negative influence of insecurity on investor behaviour.

Provided that serious efforts are made to diversify sources of investment and cultivate FDI inflows across the economy, we anticipate that peace in the region should lead to a short-term increase of at least 20% in net FDI inflows, and that this in turn would have a significant impact on GDP expansion: historical data on the impact of FDI on GDP in various countries between 1980 and 2014 suggests that a 20% net FDI increase could deliver a 5-6% increase in potential GDP.¹⁴

Public finances. It is calculated that ending regional or local conflicts can lead to an interest rate decrease of at least 1.5-2 percentage points across various sectors of a country's financial markets.¹⁵ As of May 2023, Armenian government debt exceeded US\$10 billion, with a weighted average interest rate of 6.8%.¹⁶ In our estimate, resolving the conflict could save approximately \$20 million annually in debt servicing costs.

Trade. From among its neighbours, Armenia only trades directly with Georgia and Iran, and this comprises only 7.1% of the value of the country's trade. Trade with Turkey is conducted indirectly through Georgia. There has been no trade relationship with Azerbaijan since the collapse of the Soviet Union. A maximum of 8% of Armenia's foreign trade turnover is directed towards its neighbours. By way of comparison, 18% of Georgia's exports and 24% of its imports are with Azerbaijan and Turkey.¹⁷

In the event of peace and the establishment of full trade and economic relations with Turkey, we project that Armenia's medium-term exports to that country (especially aluminum, leather goods, and plastic and glass products) could reach US\$200-250 million per annum (4-4.5% of current exports), and imports (especially of agricultural products, minerals, machinery, pharmaceutical products and finished metal goods) US\$550-650 million per annum (7-8% of current imports).¹⁸ As regards Azerbaijan, it is conceivable that exports could comprise 2-3% and imports some 2% of the future total. Potential exports to Azerbaijan could include tobacco, beverages, plastic and glass items, and products from specific sub-sectors of the textile industry.

Water and energy. The volume of renewable internal water resources in Armenia was 7 billion m³ in 2020, while Azerbaijan's was 8 billion m³ – but Armenia's annual water consumption was only 2.8 billion m³, while Azerbaijan consumed 12.6 billion m³.¹⁹ Azerbaijan, moreover, has been obliged to allocate 92% of its water to agriculture, an amount equivalent to about 60% of Armenia's untapped water resources.

In the energy sector the resource/use situation is almost reversed. Both countries consume a similar level of energy per capita, with individual electric energy usage hovering around 2,000 kW per year. However, 70% of Armenia's annual gross energy consumption must be met through imports, while Azerbaijan consumes only a quarter of the energy it produces.²⁰ Reflecting these relative endowments, petrol prices in Azerbaijan are among the lowest in the world – currently US\$0.59 per litre²¹ – while prices in Armenia are more than twice as high despite the bulk of imports coming from Russia,



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where internal prices are comparable to those in Azerbaijan. This difference is largely an issue of transport logistics.

These disparities in water and energy use/availability offer obvious scope for future cooperation between the two countries.

Transportation routes. Armenia's topography, location, and geopolitical context have caused immense difficulties in connecting the country to regional and global markets.²² The challenge of unblocking transport routes is of longstanding concern, with profound implications for Armenia's development. The closure of the Armenian-Turkish and Armenian-Azerbaijani borders has combined with Armenia's exclusion from major transportation initiatives – prominent examples being China's Belt and Road initiative (with Turkey promoting indirect connections through Georgia and Azerbaijan²³); the 2007 agreement among Turkey, Georgia and Azerbaijan on the construction of the Kars-Akhalkalaki-Tbilisi-Baku railway; and the construction of the Baku-Tbilisi-Ceyhan oil pipeline and the Baku-Tbilisi-Erzurum gas pipeline. At the same time, the Black Sea Ring Highway construction project, an initiative agreed by all 12 member countries of the Black Sea Economic Cooperation (which include Turkey, Russia, Georgia, Azerbaijan and Armenia) has failed to move forward despite strong Armenian support.²⁴

As a consequence of Armenia's isolation and recourse to long, uneconomic, and difficult road routes to Iran and to the access ports of Poti and Batumi in Georgia, transportation costs in Armenia are among the highest in the region (more than double those in Turkey²⁵). The World Bank's Logistics Performance Index – a comprehensive assessment of logistics capabilities – currently positions Armenia at a lowly 97th among 139 countries.²⁶

The resolution of the current political impediments would enhance regional economic integration, promote stability and engender mutually beneficial growth prospects for all the nations involved. The opening of the railway leading from Gyumri to the border of Turkey, for example, would unify the railway systems of Russia and Turkey, and would create an additional corridor for communication between Turkey and Azerbaijan – and a potential link to the "North-South" (Europe-Russia-Iran-India) transport corridor. According to Azerbaijani estimates, Turkey's share in Armenia's merchandise turnover could increase by 3-13%, and Azerbaijan's by up to 1%, while overall Azerbaijani exports could increase by over US\$700 million per annum.²⁷

For Armenia, the World Bank has suggested that the country's participation in the Belt and Road initiative alone could increase the value of its trade by as much as 910%.²⁸ Our own calculations also show that at least 35% of cargo now transported by road can be carried by rail, saving at least US\$38 million per year.

Bilateral economic benefits. Peace between Armenia and Azerbaijan would unlock considerable tourism potential. Peace would create a favourable environment for cross-border travel, attracting tourists from the region and around the world who wish to explore the rich cultural heritage, historical sites, and natural landscapes of both countries. This influx of tourists would generate revenue and create employment in the hospitality industry,²⁹ and promote cultural understanding and mutual appreciation.



The Azerbaijani perspective

The opportunity for a durable peace agreement offered by the current peace talks would provide important economic benefits to both countries in a number of domains.

Regional integration. The 2020 war between Armenia and Azerbaijan and the current Russia-Ukraine war have changed the geopolitical situation in the South Caucasus, making it important for both countries to take advantage of the connectivity opportunities now on offer. Traditional trade routes have lost their relevance, and much east-west cargo has been diverted southwards. Azerbaijan is already an active participant in the emerging east-west and north-south transport corridors, and peace in the South Caucasus should enhance the growth of cargo volumes in freight transportation along the Trans-Caspian International Transport Route/Middle Corridor (a multimodal transportation route connecting Europe with China via the Caspian Sea and the countries of Central Asia and South Caucasus) and the International North-South Transport Corridor (which connects India with Russia and Europe).

The reopening of borders and establishment of transportation corridors could have far-reaching implications for trade and connectivity in the region, leading to shorter and cheaper trade and transport routes that benefit both countries – but especially Armenia. Opening transportation channels will end Armenia’s economic isolation by restoring access to Russia and Iran, as well as to the markets of the Eurasian Economic Union.³⁰ Citing World Bank calculations,³¹ in 2021 Armenian economy minister Vahan Kerobyan anticipated that unblocking transport and economic connections could increase Armenia’s GDP by 30% over the course of two years.³² The same study estimated that Armenia could more than double its exports if the Turkish and Azerbaijani borders were opened, erasing between a third and a half of Armenia's trade deficit. While these figures need revisiting, the scale of potential benefits remains transformative.

On 3 June 2023, in the context of the ongoing peace talks, the trilateral working group of deputy prime ministers of the three countries dealing with connectivity – Russia, Armenia and Azerbaijan – met for the 12th time and reported reaching a “common understanding” concerning “the implementation of concrete steps for the restoration and organization of the railway connection on the Yeraskh-Julfa-Meghri-Horadiz route”.³³ All parties also reported “important progress” in talks about the “modality” of these transportation links, but without giving further details. Azerbaijan started building its section of the railroad from Horadiz to Aghbend in early 2021, and is now close to finalising construction.

Military expenditure. Since the 2020 war both Azerbaijan and Armenia have continued to increase their military expenditure. In 2022 Azerbaijan spent US\$2.64 billion on defence and national security,³⁴ and the 2023 budget allocates US\$3.1 billion to defence.³⁵ Armenia's US\$750 million 2022 security budget³⁶ represented an increase of more than 10% over 2021, while the 2023 national budget calls for a US\$1.28 billion allocation to defence and security, a further increase of 46%.³⁷ These figures reflect the lack of a final peace agreement thus far. The volatile geopolitical environment of the Caucasus suggests that defence spending will continue to be proportionally higher than in much of the world. Clearly, both countries would benefit enormously from reducing defence expenditure from the roughly 5% level of GDP and thereby releasing funds for productive human capital and infrastructure investment.

Foreign investment. Hostilities between Armenia and Azerbaijan have depressed financial markets for much of the past 30 years, with the threat

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The resolution of the Armenian-Azerbaijani conflict would create opportunities for cooperation on water resources.

of war creating a perception of high investor risk, especially for Armenia. Peace in the region should increase FDI flows to both countries, with foreign investors applying a much lower discount rate to potential projects. Among other things, this could assist with helping Azerbaijan diversify its economy into non-energy sectors. Higher FDI rates would also raise the GDP of both countries.³⁸

Energy. It is crucial for Azerbaijan to ensure energy security in the Nakhchivan Autonomous Republic (a landlocked exclave of Azerbaijan). Currently, Azerbaijan supplies natural gas to Nakhchivan via Iran. Under the current contract between Iran and Azerbaijan, Iran receives Azerbaijani gas and then transports it to Nakhchivan. Peace with Armenia would allow Azerbaijan to supply energy resources to Nakhchivan via Armenia.

Armenia is a net importer of natural gas and oil, with gas representing its main energy import. Its main supplier is Russia, via Georgia; Iran also exports gas to Armenia in return for electricity. Peace would open the possibility of importing natural gas and crude oil from Azerbaijan, thereby improving Armenia's energy security by diversifying its energy supply sources and routes.

A durable peace would allow Armenia, Azerbaijan, and Georgia to create a regional electricity market that could serve to reduce regional electricity prices and improve the region's environmental profile by increasing the proportion of hydropower in the energy mix. With peace, Armenia could make a significant contribution to regional renewable energy generation efforts. It is important to note that Azerbaijan, Georgia, Romania, and Hungary recently signed the Agreement on Strategic Partnership on Green Energy, which aims to link European and South Caucasian green and clean energy efforts.³⁹ The agreement would leverage Azerbaijan's considerable unexplored renewable energy resources, with a special focus on renewable hydrogen and other renewable gases as a means of curtailing greenhouse gas emissions in sectors and applications that are difficult to decarbonise (such as power generation and industrial processes).⁴⁰ Armenia could consider participating in this and other important renewable energy initiatives in the region.

Water. The resolution of the Armenian-Azerbaijani conflict would create opportunities for cooperation on water resources. Both countries face growing water scarcity challenges, and a regional approach has many potential benefits. Scientific studies have predicted water-related challenges caused by climate change in the territories of both countries: by 2040, Armenia can expect a 52% reduction in rainfall, while Azerbaijan faces an even graver situation, with a 77% decline in crop yields projected, making it the most severely climate-change-affected country in the region.⁴¹ Climate-driven impacts have already had a profound effect on the Kura-Arax basin, where river flows are at their lowest, while the demand for agricultural products remains at peak levels.

Local trade. Although the overall volume of trade between Azerbaijan and Armenia is likely to be modest under normalised relations, it could be important for communities close to the borders. Also, Armenia, Azerbaijan, and Georgia could consider creating free trade zones to foster investment and business opportunities.



Conclusion

The protracted conflict between Armenia and Azerbaijan has negatively impacted both countries on the human, social, economic, and financial levels. Considerable potential is being lost, with significant focus still turned towards security issues and military expenditure. The volatile situation between the countries is also impacting the broader region, because trade and communication routes are blocked and circumventing them is costly and inefficient.

Armenia and Azerbaijan occupy a unique central position in the emerging global trade and transit system, and a secure peace between the two countries would offer both the opportunity to maximise the blessings of their geographical locations and to benefit from differing comparative advantages in their economic relations with each other – Armenia drawing on its agricultural, water, and hydropower resources, and Azerbaijan on its energy endowments and industrial skills.

Regional stability would create a safer and more predictable business environment, encouraging FDI that could boost technology transfer, knowledge sharing, and the development of new industries adapted to emerging markets and the demands of climate change. The economic future could be a bright one – but this potential will not be realised until a mutually acceptable peace agreement has been concluded.

The potential economic advantages of normalisation listed above could therefore serve as a catalyst for bringing stability and prosperity not only to the two countries most directly affected, but also the broader region. Against a backdrop of increasing geopolitical fluidity, there is now a real window of opportunity to be exploited in the Caucasus, with mutual economic re-engagement as an important first step towards an even greater ambition: region-wide sustainable peace.

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