

NAGORNO-KARABAKH: RISKING WAR

Europe Report N°187 – 14 November 2007

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NAGORNO-KARABAKH: RISKING WAR

EXECUTIVE SUMMARY AND RECOMMENDATIONS

Armenia and Azerbaijan have failed to resolve the Nagorno-Karabakh conflict, even though the framework for a fair settlement has been on the table since 2005. A comprehensive peace agreement before presidential elections in both countries in 2008 is now unlikely but the two sides still can and should agree before the polls to a document on basic principles, which if necessary clearly indicates the points that are still in dispute. Without at least such an agreement and while they engage in a dangerous arms race and belligerent rhetoric, there is a risk of increasing ceasefire violations in the next few years. By about 2012, after which its oil revenue is expected to begin to decline, Azerbaijan may be tempted to seek a military solution. The international community needs to lose its complacency and do more to encourage the leaderships to prepare their societies for compromise and peace.

In 2006 the co-chairs of the Minsk Group (France, Russia, the U.S.), authorised by the Organisation for Security and Cooperation in Europe (OSCE) to facilitate negotiations, proposed principles for settlement: renunciation of the use of force; Armenian withdrawal from parts of Azerbaijan surrounding Nagorno-Karabakh; an interim status for Nagorno-Karabakh, with substantial international aid, including peacekeepers; and mutual commitment to a vote on Nagorno-Karabakh's final status after the return of displaced Azeris. These principles, which were essentially identical to those proposed by Crisis Group a year earlier, still offer the best framework for a deal. Indeed, the sides have publicly said they generally agree with the concept but lack of political will to resolve the remaining key issues, especially the Lachin corridor, has undermined the process and turned stakeholder optimism into cynicism. None of the parties feels that there is any urgency to settle the conflict.

Azeri and Armenian leaders have also failed to engage their constituents in discussion of the merits of peace. The European Union (EU), the U.S. and Russia have not effectively employed political and economic pressure for a settlement. The anticipated focus on domestic politics in Yerevan and Baku as well as several of the Minsk Group countries in 2008 means that even the incremental diplomatic progress that has been made could well be lost.

Oil money has given Azerbaijan new self-confidence and the means to upgrade its armed forces. It seems to want to postpone any peace deal until the military balance has shifted decisively in its favour. Yerevan, which itself has done surprisingly well economically, has also become more intransigent and increased its own military expenditures. It believes that time is on its side, that Nagorno-Karabakh's de facto independence will become a reality increasingly difficult to ignore. Playing for time is dangerous for all concerned, however. The riskiest period could be around 2012, when Azerbaijan's oil money is likely to begin to dwindle, and a military adventure might seem a tempting way to distract citizens from economic crisis. Important oil and gas pipelines near Nagorno-Karabakh would likely be among the first casualties of a new war, something Europe and the U.S. in particular have an interest in avoiding.

The wider international community, not just Minsk Group co-chairs, should coordinate efforts to impress on Baku and Yerevan the need for progress, specifically early agreement on a basic principles document. Nagorno-Karabakh needs to be put at the centre of relations with both countries. The EU special representative in the region should become more active on the issue, and the EU should use the first reviews of its action plans with both countries to promote conflict resolution and the development of transparent, credible institutions which can underpin peace efforts. Engagement is needed now to avoid the danger of war in a few years.

RECOMMENDATIONS

To the Governments of Armenia and Azerbaijan:

1. Agree before the 2008 elections on a document of basic principles making provision for:
 - (a) security guarantees and the deployment of international peacekeepers;
 - (b) withdrawal of Armenian and Nagorno-Karabakh forces from all occupied territories adjacent to Nagorno-Karabakh, with special modalities for Kelbajar and Lachin;

- (c) return of displaced persons;
 - (d) Nagorno-Karabakh's final status to be determined eventually by a vote, with an interim status to be settled on until that time; and
 - (e) reopening of all transport and trade routes.
2. Failing consensus on a comprehensive document, agree what can be agreed and clearly identify the points still in dispute.
 3. Encourage politicians to make positive references to peace and the need for compromise in their 2008 election campaigns.
 10. Make public more information on the substance of negotiations and avoid artificially fuelling expectations by overly optimistic statements.
 11. In the case of the European Union:
 - (a) increase the role of the Special Representative for the South Caucasus (EUSR), who should observe the Minsk process, support direct contacts with all parties, travel to Nagorno-Karabakh, visit IDPs in Azerbaijan and, with the Commission, assess conflict-related funding needs; and
 - (b) use European Neighbourhood Policy (ENP) reviews and funding to promote confidence building, as well as institution building and respect for human rights and the rule of law.

To the Governments of Armenia and Azerbaijan and the De Facto Nagorno-Karabakh Authorities:

4. Respect the 1994 ceasefire, refrain from the use of force, halt the rise of defence budgets and cease belligerent and provocative rhetoric directed at the other.
5. Promote track two diplomacy and debate about compromise solutions, including on the above principles, encourage parliaments to lead these debates and facilitate contacts between Azeris and Armenians.
6. The de facto Nagorno-Karabakh authorities should end support for settlement of occupied territories with Armenians, including putting an end to privatisation, infrastructure development and establishment of local government structures in those areas;
7. Azerbaijan should allow Karabakh Azeris to elect the head of their community and make a concerted effort to increase transparency and reduce corruption so that oil revenues are used to benefit all citizens, particularly internally displaced persons (IDPs).

To the Minsk Group Co-Chairs (France, Russia, the U.S.) and the Wider International Community:

8. Make a renewed effort to secure agreement on basic principles, with remaining points of disagreement clearly indicated, in order to maintain continuity in the process and to provide a starting point for negotiations between the presidents of Armenia and Azerbaijan after the 2008 elections.
9. Raise the seniority of the co-chair representatives and make resolution of the Nagorno-Karabakh conflict a key element of bilateral and multilateral relations with Armenia and Azerbaijan.

Tbilisi/Brussels, 14 November 2007

NAGORNO-KARABAKH: RISKING WAR

I. INTRODUCTION

Conflict over Nagorno-Karabakh has existed since the end of the First World War¹ but it was only after the collapse of the Soviet Union in 1991 that the antagonism between Armenians and Azerbaijanis developed into an all-out war – causing some 22,000 to 25,000 deaths and more than one million refugees and IDPs in both countries.² Azerbaijan insists that the region is part of its territory; Armenia argues that the Armenian majority living there has the right to self-determination and independence.

The war resulted in occupation of most of Nagorno-Karabakh, as well as considerable adjacent Azerbaijani territory, by ethnic Armenian forces.³ Yerevan claims that the conflict began between Nagorno-Karabakh and Azerbaijan, that its own intervention was to protect ethnic Armenians' security and right of self-determination and that the occupation of additional territory was necessary to ensure a lifeline and "security belt" for the region. Baku

counters that Armenia seized Nagorno-Karabakh and the seven adjacent districts to satisfy territorial ambitions and has failed to implement four UN Security Council resolutions condemning the occupation in 1993.⁴

A ceasefire was signed in May 1994⁵ but is unstable, with frequent violations, including sniper incidents, and military and civilian casualties.⁶ Azerbaijan, which feels military defeat acutely and considers the status quo unacceptable, threatens war most vocally. Armenian and Nagorno-Karabakh statements are more reactive but increasingly intransigent.

New negotiations – the Prague process – have been facilitated since April 2004 by the Minsk Group of the Organization for Security and Cooperation in Europe (OSCE), led by France, Russia and the U.S.⁷ These follow ten years which produced at least three rejected peace plans.⁸ In 2004-2006 there was optimistic talk of a window of opportunity between election cycles,⁹ and in 2005 mediators proposed core principles to advance a

¹ Disputes over Nagorno-Karabakh started in 1918, when Armenia and Azerbaijan became independent from the Russian Empire. The history of the region before the Russian period is disputed by the countries' historians. In 1921, Soviet rule was implemented in the entire Caucasus. Predominantly Armenian-populated Nagorno-Karabakh was granted autonomous oblast status within the Azerbaijani Soviet Socialist Republic (SSR). The conflict resurfaced in February 1988 after the Nagorno-Karabakh Soviet passed a resolution asking for transfer to the Armenian SSR. When the Soviet Union collapsed, a referendum boycotted by most of the local Azeri population resulted in a declaration of independence which was never recognised internationally, including by Armenia. See Crisis Group Europe Report N°167, *Nagorno-Karabakh: A Plan for Peace*, 11 October 2005.

² 413,000 Armenian refugees from Azerbaijan and IDPs from areas bordering Azerbaijan were registered in 1994. 724,000 Azerbaijanis (and Kurds) were displaced from Armenia, Nagorno-Karabakh and surrounding districts; figures from political analyst Arif Yunus for Crisis Group Report, *Nagorno-Karabakh*, op.cit.

³ The territory consists of five Azerbaijani districts (Kelbajar, Lachin, Kubatly, Zangelan, Jebrail) and part of two others (Fizuli and Agdam) and has 7,409 sq. km. Nagorno-Karabakh authorities consider the Mardakert and Martuni districts (327 sq.km), which were part of the autonomous oblast, as well as the pre-war Shahumian district and Getashen settlement (701 sq.km) of Azerbaijan, as being under Azerbaijani "occupation".

⁴ Resolutions 822, 853, 874, and 884 (1993) demand withdrawal from the occupied areas of Azerbaijan and identify the occupiers as "local Armenian forces". Resolution 884 urges Armenia to "use its influence to achieve compliance by the Armenians of the Nagorno-Karabakh region of Azerbaijan". The resolutions also call for implementation of steps identified by the Minsk Group to which neither side has agreed.

⁵ In late 1993, Azerbaijan agreed to include the Nagorno-Karabakh de facto authorities in the peace talks. The three sides agreed, facilitated by Russia, to the cessation of hostilities on 12 May 1994.

⁶ Azerbaijan has lost some 3,000 soldiers and civilians since the 1994 ceasefire, figures from an independent military expert confirmed by the Azeri defence ministry. Crisis Group interviews, Uzeyir Jafarly, military expert, Baku, April-June, 2007. Armenia and Nagorno-Karabakh lost 873 soldiers from 1995 to 2005, Crisis Group phone interviews, press services of the Armenian defense ministry and Nagorno-Karabakh army, July 2007.

⁷ On 1 January 1997, France succeeded Finland as a co-chair. In response to Azerbaijan's displeasure, the U.S. was accepted as a third co-chair on 14 February 1997.

⁸ By Nagorno-Karabakh in 1997 and Azerbaijan in 1998. Official responses to proposals tabled at the failed 2001 negotiations in Key West are not available.

⁹ Between October 2005 parliamentary elections in Azerbaijan and the December 2005 constitutional referendum in Armenia and presidential elections in the two countries in 2008.

comprehensive settlement.¹⁰ But the mood soured after meetings in 2006 between Presidents Robert Kocharian of Armenia and Ilham Aliyev of Azerbaijan – in Rambouillet in February, Bucharest in June and Minsk in November – failed to reach agreement.¹¹ In 2007 the two foreign ministers have met four times but not since the presidents talked unproductively at the Commonwealth of Independent States (CIS) summit in St. Petersburg in June.

Nevertheless, this plan proposed by the Minsk Group (and recommended by Crisis Group) remains the best option. It is based on a compromise foreseeing withdrawal of Armenian forces from the occupied territories surrounding Nagorno-Karabakh and interim international security arrangements for the former Soviet oblast until a vote on status is held. That withdrawal, the status of the Lachin corridor and the modalities of the referendum/plebiscite are the main stumbling blocks.¹² The plan addresses all matters in dispute but leaves open the most controversial issues, including the core: Nagorno-Karabakh's status. The principles would outline the overall logic of a peace deal. Once settled, a more detailed agreement would be negotiated on their basis. They could also start a process on the ground which would help create confidence and build a favourable climate in which to negotiate the more sensitive postponed issues.

Mutual insecurity and lack of political will hamper progress. Mediators were candid in 2006 about their limited influence but their subsequent false optimism hurt the credibility of all involved when talks again came to nought. Today few in Azerbaijan or Armenia believe in a breakthrough. The most crucial ingredient is missing: nobody involved considers conflict resolution a pressing urgency.

¹⁰ The Minsk Group presented the first list of principles at the presidential summit in Kazan, August 2005. Crisis Group interview, diplomatic source, Yerevan, April 2007.

¹¹ More details on the 2006 negotiations are available in "Statement by the Minsk Group co-Chairs to the OSCE Permanent Council", Vienna, 22 June 2006; "Statement by the Minsk Group co-chairs", U.S. Embassy to Armenia news archives, 3 July 2006, at www.usa.am/news/2006/july/news070306.php.

¹² Crisis Group interview, London, September 2005.

II. NEGOTIATIONS: THE PRAGUE PROCESS

A. BASIC PRINCIPLES

The Prague process differs from past Nagorno-Karabakh negotiations by taking a long-term incremental approach, rather than seeking a comprehensive agreement. The co-chairs' submission of a settlement framework and later specific principles was an innovative attempt to get agreement on a "set of fair, balanced, and workable core principles that could pave the way for the two sides to draft a far-reaching settlement agreement".¹³ The focus on principles avoided old arguments over the merits of step-by-step or package methodology.¹⁴

The initial aim after the failure of the Key West talks (2001) and the 2003 elections in both countries was to "explore new possibilities through preliminary contacts at the ministerial level".¹⁵ The two presidents were to be invited to meet only after their foreign ministers had established a relationship of trust and examined many aspects of a potential settlement, and indeed the ministers did appear to develop a productive environment.

¹³ "Statement by the Minsk Group Co-Chairs to the OSCE Permanent Council", 22 June 2006, referring to a document suggested after the 2006 Bucharest summit. A diplomat privy to the negotiations said the Minsk Group tried to identify a fair deal, not solving everything but addressing issues which could be tackled now and so change the scale of the conflict. Crisis Group interview, diplomat, July 2007. "Predecessor co-chairmen have already proposed several drafts with tens of pages. Then one of the parties would say that it is not what they would like, and the whole draft would be abandoned. There is no sense to do so and nobody wants now to work this way. First, it is needed to agree on how it [the principles] will work and only after that to formulate [the agreement]". "Yuri Merzlyakov: Currently, The Image Of Azerbaijan-Armenia Agreement Is Unclear", *Regnum*, 22 December 2005.

¹⁴ The 1998-2003 negotiations between Presidents Kocharian and Heidar Aliyev sought a "package", a single agreement on status, security and consequences of the conflict (most importantly the return of refugees and IDPs, and blockades). The 1993-1997 "step-by-step" approach favoured postponing the decision on Nagorno-Karabakh's final legal status until after confidence had been built. Ilham Aliyev, who came to power after his father's death in 2003, rejected the "package" approach and allegations by the Armenian negotiators that some agreements had been reached between Kocharian and his father on "Paris principles" and refused to negotiate on the basis of the 2001 Key West proposal, which focused on status. He set Armenian withdrawal from occupied territories as a precondition for status negotiations. Crisis Group Report, *Nagorno-Karabakh*, op. cit.

¹⁵ Crisis Group interview, diplomat, July 2007.

The negotiation process was highly confidential until the co-chairs went public in June-July 2006 for the first time,¹⁶ in an effort to help launch a public debate on the principles, about which the two sides were reluctant.¹⁷ By opening up the negotiations, they also sought to close the gap between confidential statements at the negotiations and public ones at home. The co-chairs confirmed that the principles were based “on the redeployment of Armenian troops from Azerbaijani territories around Nagorno-Karabakh, with special modalities for Kelbajar and Lachin districts (including a corridor between Armenia and Nagorno-Karabakh), demilitarisation of those territories, and a referendum or a popular vote – at a date and in a manner to be decided through further negotiations – to determine the final legal status of Nagorno-Karabakh”.¹⁸

The agreement on principles would require both sides to make significant compromises. Armenia would have to consent to withdrawal from the occupied territories around Nagorno-Karabakh and IDP return to those territories. Azerbaijan would have to agree that a vote would determine Nagorno-Karabakh’s final status. The withdrawals should take place before determination of status but after some agreement on the mechanism for that determination. Problems arose in 2006, however, when the sides began to make linkages between principles and go back on previous understandings.¹⁹

The parties concur that until everything is agreed, nothing is final.²⁰ The Armenian foreign minister, Oskanian, affirmed on 30 June 2006 overall acceptance of the co-chairs’ proposal as a basis for future negotiations.²¹ Azerbaijan similarly called the proposal workable but Foreign Minister Mammadyarov stressed that “the devil is in the details”, and much depends on the modalities of a status referendum.²²

In 2006 when they believed that the sides were close to a deal, the Minsk Group co-chairs encouraged their capitals to press the sides.²³ President Jacques Chirac met with the Armenian and Azeri presidents before the Rambouillet talks; U.S. Secretary of State Condoleezza Rice phoned them; Russian President Vladimir Putin also intervened.²⁴ In May 2006 a mission from the co-chair countries visited the region “in order to make clear to the presidents of both countries that 2006 is the necessary window of opportunity for reaching an agreement on Nagorno-Karabakh”²⁵ and that the “three countries expected them to take advantage of this opportunity by reaching an agreement on core principles for a settlement”.²⁶

Since then, however, there have been no high-level interventions. The Minsk Group co-chairs – one does not even have ambassadorial rank – often seem to be the only external actors involved. Ultimately international resolve to challenge Baku and Yerevan on the lack of progress has been weak. The co-chairs have stated candidly:

We have reached the limits of our creativity in the identification, formulation, and finalisation of these principles. We do not believe additional alternatives

¹⁶ This was in sharp contrast with the situation in 1998, when first Armenian president Levon Ter-Petrosian requested co-chairs to allow him to publish details of the negotiated peace plan so he could defend his compromise stance publicly after he was accused by opponents of “selling Nagorno-Karabakh out”. The co-chairs rejected this, insisting confidentiality was crucial. Crisis Group interview, former Armenian official, Yerevan, August 2007.

¹⁷ Crisis Group interview, diplomat, July 2007; “Statement by the Minsk Group Co-Chairs to the OSCE Permanent Council”, 22 June 2006; “Statement by the Minsk Group Co-Chairs”, 3 July 2006. The first statement said, “it is our responsibility to you, Mr. Chairman, to this Council that has provided the funding for a very intensive series of negotiations, to the international community, and – perhaps most importantly – to the publics in Armenia and Azerbaijan, to acquaint you with the basic principles that we have put on the table for the consideration of the two Presidents”.

¹⁸ The principles also incorporated elements from previous proposals, such as an international peacekeeping force and international aid for de-mining and reconstruction of formerly occupied territories and the war-affected regions of Nagorno-Karabakh and for resettlement of IDPs there, “Statement by the Minsk Group Co-Chairs”, 3 July 2006.

¹⁹ No negotiation protocols are signed, opening space for dispute over what has actually been agreed.

²⁰ Crisis Group interview, senior Azeri official, Baku, June 2007.

²¹ Oskanian said, “this not a perfect document. For anyone. However, there are enough solid and balanced provisions, with the right trade-offs on the main issues – status, territories and security – that we are prepared to continue to negotiate on the basis of these principles”. “Minsk Group Plan Largely Acceptable To Armenia, Insists Oskanian”, *Armenia Liberty*, 30 June 2006.

²² FM Mammadyarov interview with daily 525th paper, www.525ci.com/new/2007/07/14/read=9204.

²³ Crisis Group interview, diplomat, July 2007, citing meetings between the presidents of the two sides and President Chirac at the start of the Rambouillet summit, and the involvement of the Minsk Group foreign ministers.

²⁴ He pledged to invite Kocharian to Moscow during his visit to Azerbaijan in late February 2006. “Russia Vows Fresh Push For Karabakh Settlement”, *Armenia Liberty*, 22 February 2006.

²⁵ The delegation included Russian Deputy Foreign Minister Grigory Karasin, U.S. Assistant Secretary of State Daniel Fried, and senior French diplomat Pierre Morel, representing political director Stanislaus de Laboulaye.

²⁶ “Statement by the Minsk Group Co-Chairs to the OSCE Permanent Council”, 22 June 2006. To make best use of the opportunity, the sides would have had to agree the principles in 2006, then start on a comprehensive agreement.

advanced by the mediators through additional meetings with the sides will produce a different result. If the two sides are unable to agree on those principles we have put forward, we believe it is now contingent upon them to work together to reach an alternative agreement that both find acceptable.²⁷

The talks have continued in 2007. A document on basic principles, with few remaining points of disagreement, is on the table. But the presidents have yet to take up the Minsk Group's call to "prepare their publics for peace and not for war...allowing their publics to engage in a robust discussion of the many viewpoints on these issues".²⁸ They are unwilling to make the necessary final compromises, as the long-term benefits of a settlement do not seem attractive enough to outweigh the domestic risks.

Even the incremental progress that has been made is at risk due to 2008 presidential elections in Armenia, Azerbaijan, the U.S. and Russia. While no change is expected in Azerbaijan, Armenia will have a new president. Prime Minister Serzh Sarkisian, who has the incumbent's backing and led his Republican party to victory in May 2007 parliamentary elections, is the main contender²⁹ and could be expected to maintain policy continuity. In July 2007 Nagorno-Karabakh elected a new de facto president, Bako Sahakian, replacing Arkady Ghukasian, who may want to change the negotiating format.³⁰

Especially since 2006, publicly declared optimism accompanying repeated failures has trapped the negotiations in what many in Armenia and Azerbaijan call an "imitation of the process".³¹ No formal protocols have been signed,³²

thus allowing differing interpretations of past discussions. To restore some dynamism to the process, the Minsk Group should consider officially proposing the most recent version of the basic principles, including a summary of the Aliyev-Kocharian negotiations, to serve as a starting point for the next stage of talks. The sides should agree to a document outlining the principles on which they agree and those on which disagreement remains. There is likely to be little movement in formal negotiations in 2008, when the focus will be on domestic politics, but publication of the document could allow the year to be used to foster sorely needed public debate.

B. KEY STICKING POINTS

Only a limited number of outstanding differences remain. The inability to bridge these is due more to lack of political will than an inability to devise compromise formulas.³³

1. Referendum, right of return, interim status

The final status of Nagorno-Karabakh, the main cause of the conflict, remains the biggest disagreement. While the entity seeks international recognition of its secession that Armenia formally endorsed in 1998,³⁴ Azerbaijan rejects any solution that would undermine its territorial integrity. The farthest it considers going is to grant Nagorno-Karabakh the "highest degree of autonomy existing in the world".³⁵ Because the positions on status seem irreconcilable, the co-chairs have suggested postponing a determination.

The suggestion has been to define status through "a referendum/plebiscite/popular vote in Nagorno-Karabakh, the modalities of which will be agreed in future negotiations between Armenia and Azerbaijan".³⁶ Any referendum would only occur in "a non-coercive environment in which well informed citizens have ample opportunity to consider

²⁷ Ibid.

²⁸ Ibid. In March 2005, Armenia held parliamentary hearings on Nagorno-Karabakh. Defence Minister Serzh Sarkisian said, "the problem's resolution will indeed be painful for both the Armenian and Azerbaijani peoples because mutual compromise means giving up some of what you have....We could make concessions on the condition that the Azerbaijani side gives clear guarantees of not restarting the war which would be certified by authoritative international organisations and states". "Sarkisian Says 'Painful' Concessions Needed For Karabakh Peace", *Armenia Liberty*, 30 March 2006. Armenian analysts claim this effort ceased because there was no constructive response from the Azerbaijani side.

²⁹ The only real challenger is Armenia's first president, Levon Ter-Petrosian (who resigned in 1998 over disagreements on Karabakh policies with Kocharian and Sarkisian), who has recently made a political comeback and is likely to stand on a platform critical of current Nagorno-Karabakh policies. Emil Danielyan, "Ter-Petrosian Declares Presidential Bid in Yerevan Rally", *Armenia Liberty*, 26 October 2007.

³⁰ Kocharian agreed informally with Ghukasian to represent Nagorno-Karabakh in dispute settlements.

³¹ Crisis Group interview, experts, Baku and Yerevan, June-July 2007.

³² Crisis Group interview, diplomat, August 2007.

³³ Statement of Minsk Group co-chairs, 13 July 2007. The present report focuses on the most difficult issues. For detailed discussion of all issues, see Crisis Group Report, *Nagorno-Karabakh*, op. cit.

³⁴ However, Yerevan does not recognise Nagorno-Karabakh's independence. Its official position on status from 1991 to 1998 was that it would agree to whatever was peacefully negotiated by Azerbaijan and Nagorno-Karabakh. After the former Nagorno-Karabakh president, Kocharian, replaced Ter-Petrosian in Yerevan, Armenia essentially adopted Nagorno-Karabakh's position, rejecting any status implying subordination to Azerbaijan.

³⁵ Crisis Group interview, senior presidential office official, Baku, April 2007. The outer limits of devolution would be marked by Nagorno-Karabakh not having its own currency and foreign policy.

³⁶ Crisis Group interview, diplomat, June 2007.

their positions after a vigorous debate in the public arena”.³⁷ Baku in principle agrees to a vote, provided that “due and equal account of views of both Azerbaijani and Armenian communities” is taken.³⁸ However, any option that would legitimise Karabakh’s secession continues to be unacceptable, and any vote which could potentially result in independence must – according to the Azeri constitution – be a nationwide referendum.³⁹ Yerevan argues that an agreement on principles must indicate that “the outcome [of the vote in Nagorno-Karabakh] can be any”, including independence.⁴⁰

The sides seem to tacitly agree that deferring final status determination is the only feasible option. Initially, negotiations revolved around discussion of a referendum to be held in ten or fifteen years.⁴¹ However, it soon became apparent that it was not possible at present to define modalities, as they could predetermine the outcome.⁴² The status determination debate has become one over how and when the issue should be addressed.

³⁷ “Statement by the Minsk Group Co-Chairs to the OSCE Permanent Council”, 22 June 2006.

³⁸ Baku insists the occupation of Azerbaijani territory adjacent to Nagorno-Karabakh must end first, forces be withdrawn and IDP return begin. Crisis Group interview, foreign ministry spokesman, Baku, May 2007. Foreign Minister Mamadyarov said, “the liberation of the occupied territories of Azerbaijan is the main prerequisite to make the whole thing possible”, at www.mfa.gov.az/eng/spee/23.shtml.

³⁹ According to Article 3 of Azerbaijan’s Constitution, any change in the country’s borders needs to be endorsed by a nationwide referendum. A vote within Nagorno-Karabakh would not itself have legal effect for Azerbaijan. Amendment of this provision would itself require a national vote. Officials and civil society agree that Azeris would never vote for a clause allowing Karabakh’s secession. Armenian analysts argue that a peace agreement based on determination of the status of Nagorno-Karabakh through a referendum would give Azerbaijan an international obligation to implement all necessary steps, including changing its constitution, if needed.

⁴⁰ Crisis Group interview, diplomat, July 2007. De facto Nagorno-Karabakh officials generally say that the entity has already voted for independence but the de facto president told Crisis Group, “Nagorno-Karabakh may consider another vote if that will help Azerbaijan to recognise the independence of the Nagorno-Karabakh Republic”, Stepanakert, June 2007.

⁴¹ See “Armenia, Azerbaijan ‘Close To Karabakh Deal’”, *Armenia Liberty*, 11 July 2005.

⁴² Modalities to be agreed upon include: who would vote and on what question; the options to be proposed in the referendum and whether secession from Azerbaijan would be included; who would be responsible for organising the referendum; whether the current Armenian population of Nagorno-Karabakh could vote, or only those initially from the entity; who from the Azeri community could vote and whether from current residences or only after return; whether the result of the vote would be based on simple majority or consensus between the communities; and how the voting would be supervised.

For now, it seems beyond the parties to identify a compromise on substance that gives Baku a sense of security the referendum will not necessarily result in Karabakh’s secession and Armenians some reason to believe Karabakh independence is a real possibility.

Baku continues to emphasise the right of Azeri IDPs to return to all territories, including Nagorno-Karabakh, before any vote. Yerevan insists that their return is a referendum modality to be negotiated. The international community has been unequivocal about protecting the right of return. Return to Nagorno-Karabakh is essential before any status determination but it is possible only after sufficient confidence has been built between Armenians and Azeris, and security has been assured.

While Baku and Yerevan discuss potential modalities of a referendum, the concept of interim status has been introduced. It would provide a temporary legal framework in which the population of Nagorno-Karabakh would have political rights, legally produce and trade goods, receive aid and travel.⁴³ Co-chair proposals include the right of the people of Nagorno-Karabakh “to protect and control their political and economic viability and security...to democratically elect officials to govern Nagorno-Karabakh ... to [enjoy] observer status at the OSCE⁴⁴...to [receive] aid from foreign countries and international donor organisations [and]...to direct foreign investment and [have] access to international markets”.⁴⁵ Interim arrangements would not prejudice final status determination but would help create the environment required for a referendum and together with implementation of security guarantees and IDP return would constitute significant progress.

2. Kelbajar and Lachin

The sides have agreed during the Prague process on the immediate return to Azerbaijan of five occupied districts adjacent to Nagorno-Karabakh, together with the deployment of peacekeepers and the separation of forces. However, Armenia has resisted withdrawal from the westernmost districts, Kelbajar and Lachin, without the prospect of final status determination. Withdrawal from Kelbajar was the main stumbling block in Rambouillet.⁴⁶

⁴³ Karabakhi Armenians can presently obtain Armenian travel documents.

⁴⁴ Armenia insists that Nagorno-Karabakh should be also represented in the United Nations.

⁴⁵ Crisis Group interview, diplomat, June 2007. According to the earlier “Statement by the Minsk Group Co-Chairs to the OSCE Permanent Council”, 22 June 2006, “Certain interim arrangements for Nagorno-Karabakh would allow for interaction with providers of international assistance”.

⁴⁶ “Minsk Group Plan Largely Acceptable To Armenia, Insists Oskanian”, *Armenia Liberty*, 30 June 2006. Rambouillet was 10-

Control over it is a high-priority security issue, and Armenia has insisted that it can be relinquished only after the status referendum.⁴⁷ Yerevan's main concern is that once Azerbaijan regains control over Kelbajar, it might not proceed with the referendum. A crucial bargaining chip would thus be lost, and Nagorno-Karabakh would be militarily disadvantaged.

Azerbaijan maintains that Kelbajar must not be held hostage to the referendum and the original 44,000 displaced from the district should be allowed to return immediately. It rejects any linkage between Kelbajar and implementation of the referendum⁴⁸ and says renunciation of the use of force and deployment of peacekeepers should satisfy Armenian security concerns. A diplomat privy to the negotiations said that when discussions over Kelbajar became confrontational, the issue of Lachin and the Lachin corridor was reopened.⁴⁹ At the Bucharest summit (June 2006), the Minsk Group proposed to decouple Kelbajar from the referendum and to link it instead to agreement on an interim status for Nagorno-Karabakh.⁵⁰ This now seems acceptable to both sides.⁵¹

Disagreement persists over the Lachin corridor, however.⁵² While there seems to be a shared understanding it should serve as a safe communication line between Nagorno-

11 February 2006. Kelbajar is a strategically important Azerbaijan district between Armenia and Nagorno-Karabakh. Giving it up would create an additional 200km of frontline, make the Lachin corridor vulnerable to Azerbaijani attack and reduce Nagorno-Karabakh's capacity to monitor military movements in the north, shell advancing troops or intercept aircraft; Azerbaijan argues the demilitarisation of Kelbajar and deployment of international peacekeepers should satisfy Armenian security concerns. See Crisis Group Report, *Nagorno-Karabakh*, op. cit., pp. 23-24.

⁴⁷ The foreign ministry said, "for Armenia, this also is clear: based on security concerns, Kelbajar can be returned only after the referendum is conducted and the final status of Nagorno-Karabakh is determined", "Minsk Group Plan Largely Acceptable To Armenia, Insists Oskanian", *Armenia Liberty*, 30 June 2006.

⁴⁸ Crisis Group interview, diplomat, June 2006.

⁴⁹ Crisis Group interview, diplomat, August 2005.

⁵⁰ The Minsk Group proposed groups to work on the three sets of issues not to be solved in the first phase: referendum modalities; the Lachin corridor; and withdrawal from Kelbajar coupled with interim arrangements for Nagorno-Karabakh to interact with the international community. Crisis Group interview, diplomat, July 2007.

⁵¹ However, the parties are still discussing how many years it may be before IDPs can return to their homes in the district. Crisis Group interview, diplomat, October 2007.

⁵² Crisis Group interview, expert, September 2007. The Lachin district, between Nagorno-Karabakh and Armenia, includes the main road linking the country and the conflict region and considered a lifeline for Nagorno-Karabakh. All previous peace plans envisaged Nagorno-Karabakh's control of the corridor., Crisis Group Report, *Nagorno-Karabakh*, op. cit., pp. 22-23.

Karabakh and Armenia, its status and width are disputed. Yerevan says "the very existence" of Nagorno-Karabakh can be guaranteed only if it has a secure land connection with Armenia, so insists the corridor have the same status as the entity, during the interim period and subsequently.

The co-chairs suggested the corridor's status await future negotiations.⁵³ This is unacceptable to Azerbaijan, which insists on Armenian withdrawal and IDP return without delay.⁵⁴ It has suggested "common use" for the Agdam-Lachin-Goris-Nakhichevan road. Since that road goes through Azerbaijani- and Armenian-controlled areas, it says both sides will be interested in its security.⁵⁵ The co-chairs apparently began to explore a new proposal in September 2007. One way out may be for the Lachin district to be officially returned, while a Lachin corridor of reasonable width would remain under Armenian control until dual use arrangements become possible.

Even without an agreement on Lachin, the sides could well begin with withdrawal from the territories adjacent to Nagorno-Karabakh, IDP return, security guarantees and deployment of peacekeepers. Such withdrawal is not directly related to Nagorno-Karabakh status and would not only begin implementation of Security Council resolutions against occupation but also serve as a significant confidence-building gesture. However, Armenia will not withdraw while Azerbaijan threatens to regain other territories militarily. Those threats and increasing military spending give Armenia a convenient excuse for delay and help ensure there is little public support for a withdrawal that would be viewed as a concession under pressure.⁵⁶

⁵³ This implies keeping the current regime in the Lachin corridor until Armenia and Azerbaijan agree on any changes after implementing the first phase of a peace deal. They have yet to fix the width of the corridor, which should take account of security considerations, including those related to the range of Azerbaijani artillery. See *ibid*, p. 22. The basic principles under negotiation cite "reasonable width" but details must be negotiated subsequently.

⁵⁴ Some 47,000 Azeris lived in the Lachin district before the war, most in Lachin town through which the main road linking Nagorno-Karabakh with Armenia passes.

⁵⁵ Armenia has rejected the proposal, arguing that once there is peace, all the roads in Armenia, Azerbaijan and Nagorno-Karabakh will be for "common use".

⁵⁶ Delay also creates a new reality on the ground, especially in the areas adjacent to Nagorno-Karabakh, where Armenians are settling; land, homes and businesses are being privatised and local administration and infrastructure are being put in place. See Crisis Group Europe Report N°166, *Nagorno-Karabakh: Viewing the Conflict from the Ground*, 14 September 2005, pp. 14-15.

C. THE INTERNATIONAL RESPONSE

International actors have not used sufficient leverage or provided satisfactory incentives to influence the parties.⁵⁷ There is no coordinated diplomatic pressure for a settlement. EU, U.S. and Russian leaderships need to display readiness to impose costs for lack of progress but they are hampered by divergent agendas. U.S. and Russian policies especially are influenced by domestic constituencies, which at times compete with other foreign policy considerations.⁵⁸ While it may be a challenge to establish benchmarks in a negotiating process that has little framework or transparency, it is essential to prepare the societies for compromise and to include a Karabakh component in strategies for bilateral relations and multilateral integration.

Most aid to Armenia and Azerbaijan since the ceasefire has avoided addressing the conflict; no conflict-related conditionality has been applied. Indeed, it is difficult to identify incentives strong enough to motivate change, especially in Azerbaijan, which has increasing oil revenue.⁵⁹ But major donors, including the EU, the U.S. Agency for International Development (USAID) and the Millennium Fund, should stop treating the Nagorno-Karabakh issue as the invisible elephant in the room.

The EU has mostly avoided the Nagorno-Karabakh issue in its relations with both countries. It should exhibit more political will and use the European Neighbourhood Policy (ENP) and its funding instrument to engage the sides on conflict-related issues.⁶⁰ Compared with other ENP action plans, such as those of Georgia and Moldova, Armenia's and Azerbaijan's are vague and do not link progress in the peace process to further EU aid.⁶¹ The Country Strategy Papers (CSP) – the basis for operational allocation of resources defined in the National Indicative Programs – have only very general references to the conflict and peace talks.

The EU Special Representative (EUSR) for the South Caucasus should become more active in the political process. The EU should pledge practical involvement. If and when a peace agreement is reached, it might become a guarantor, sending peacekeeping and policing units, and offer a large financial plan for rehabilitation and resettlement.⁶² Meanwhile, it should use the first review to hold the parties to their ENP action plan commitments and show its readiness for greater engagement.

Further ENP aid needs to be conditioned on rigorous review of benchmarks on human rights, rule of law and democratisation, so as to promote transparent, credible institutions which can ultimately guarantee peacebuilding efforts in both countries. Funding should directly address the conflict issue. The EUSR, together with the European Commission, should assess conflict-related needs in Nagorno-Karabakh and in areas with Azeri IDPs.⁶³ At least 10 per cent of funds should be allocated to conflict transformation activities, such as public debates, awareness raising, strengthening of civil society and cross-border media work. Projects promoting joint interests, such as pest control across the conflict divide, prevention of forest fires and water infrastructure rehabilitation should be supported. Any U.S. funding should also include a confidence-building component.

⁵⁷ A diplomat close to the negotiations expressed satisfaction with increased engagement, Crisis Group interview, Paris, July 2007.

⁵⁸ The U.S., for example, seeks to balance support for Armenia, pressed by Armenian-Americans, with strategic interests in Azerbaijan.

⁵⁹ Several Western diplomats said as much to Crisis Group, interviews, Baku, April 2007.

⁶⁰ ENP action plans for Armenia and Azerbaijan were adopted in November 2006; implementation began in January 2007. The ENP funding instrument is the European Neighbourhood and Partnership Instrument (ENPI).

⁶¹ They do not call for strengthened political dialogue and identification of areas of future cooperation and demilitarisation. The EU also does not include the issue in forums like its political dialogue with Russia.

⁶² See Crisis Group Europe Report N°173, *Conflict Resolution in the South Caucasus: The EU's Role*, 20 March 2006.

⁶³ Similar to an assessment carried out in Georgia, Abkhazia and South Ossetia in spring 2006.

III. WAR BUILD-UP AND ECONOMIC OUTLOOK

Azeri oil revenues and steady economic growth in Armenia reduce readiness for compromise. Baku has exponentially increased its military spending, to which Yerevan has responded with its own build-up. Azerbaijan's elites believe their country is becoming a regional power and will soon be able to dictate terms to Armenia.⁶⁴ A senior official told Crisis Group, "Armenia is in isolation, bypassed by almost all major energy and communication projects. This will ultimately bring Yerevan to the brink of accepting Azerbaijan's proposals for resolving the Karabakh conflict".⁶⁵ Baku should realise, however, that there is no guaranteed military solution to the conflict, and threats hamper resolution. Armenia and Nagorno-Karabakh must accept that intransigence significantly increases the risk of war.

A. AZERBAIJAN'S OIL CURSE

Its oil boom has made Azerbaijan less prone to compromise but unless it adroitly manages its new money and reduces corruption, it is likely to face an economic and political backlash after revenues begin to decline around 2012. At that time, when Baku's military and economic superiority is likely to be at its greatest, it may be tempted to push for a speedy Karabakh resolution, including by force.

Largely owing to the oil industry, Azerbaijan's GDP increased by 34.5 per cent in 2006,⁶⁶ making it the fastest growing economy on earth.⁶⁷ National income rose to \$1,240 per capita in 2005, from a post-independence low of \$470 in 1995.⁶⁸ Average salaries increased 25.6 per cent in 2007.⁶⁹ According to official statistics, the proportion of poor people nationwide fell from 44.6 per cent in 2002 to 24 per cent in 2005, while extreme poverty fell from 26.9 per cent to 9.2 per cent.⁷⁰ The proposed \$8.5 billion 2008

budget envisages a 34.7 per cent spending increase⁷¹ but sharp increases in public spending, with 15 per cent inflation in 2007, have raised macroeconomic stability concerns.⁷²

1. Oil production and revenue

Azerbaijan is one of the world's oldest oil-producers⁷³ with proven crude reserves of seven billion barrels, the third-largest in the former Soviet Union, behind Russia and Kazakhstan.⁷⁴ It is also rich in natural gas, though its production is relatively less important.⁷⁵ Until recently infrastructure was insufficient to bring the gas to market, and Azerbaijan was a net importer from Russia. Increased domestic gas production will enable self-sufficiency and some export to Georgia in 2008.⁷⁶

Oil is produced by two entities: the State Oil Company of Azerbaijan (SOCAR) and a consortium of international companies, the Azerbaijan International Operating Company (AIOC). BP operates AIOC, and SOCAR has a 10 per cent stake.⁷⁷ SOCAR was the monopoly producer in the early 1990s but foreign investment through AIOC revitalised the sector and developed the Baku-Tbilisi-Ceyhan (BTC) pipeline.⁷⁸ Flow rate on that pipeline was

⁶⁴ Crisis Group interview, Rasim Musabeyov, political analyst. Baku, March-April 2007.

⁶⁵ Crisis Group interview, senior presidential office official, Baku, April 2007.

⁶⁶ "Azerbaijan's GDP grew by 34.5% in 2006", *Today.Az*, 19 January 2007, at www.today.az/news/business/35150.html.

⁶⁷ "Azerbaijan leads in GDP growth rates", *Today.Az*, 14 November 2006, at www.today.az/news/business/32580.html.

⁶⁸ "Azerbaijan Country Partnership Strategy, FY07-10", World Bank, 8 November 2006, p. 1, <http://siteresources.worldbank.org/INTAZERBAIJAN/Resources/AzerbaijanCountryPartnershipStrategy.doc>.

⁶⁹ "Average salary rises 26% in Azerbaijan", *Today.Az*, 6 June 2007, at www.today.az/news/business/41685.html.

⁷⁰ World Bank, op. cit., p. 3.

⁷¹ "Draft budget-2008 of Azerbaijan has been submitted to Milli Majlis", *ANS Press*, 17 October 2007, at www.ans-dx.com/nid40839.html.

⁷² "Macroeconomic Forecast Azerbaijan", *Emerging Europe Monitor*, August 2007; at www.emergingeuropemonitor.com/file/48381/macroeconomic-forecast-azerbaijan.html.

⁷³ The world's first drilled oil well was there in 1846; its first oil boom was in the 1870s. Production stabilised in the 1920s and reached a peak in 1940 not exceeded until 2005, when new offshore fields were developed.

⁷⁴ According to both *Oil and Gas Journal* and the oil major BP, Azerbaijan's onshore reserves have been depleted; remaining reserves were estimated to be much lower until new offshore fields were included around 2000 when infrastructure and investment made them accessible.

⁷⁵ According to *Oil and Gas Journal*, the country has 850 billion cubic metres (Bcm) of proven gas reserves; according to BP 1,369Bcm. It has about the same percentage of world reserves as oil (0.6 per cent to 0.8 per cent).

⁷⁶ This was also achieved by the conversion of many gas-fired electric generation plants to fuel oil. The Baku-Tbilisi-Erzurum (BTE) gas pipeline is roughly parallel to much of the BTC pipeline; it enables Azerbaijan gas to be exported not only to Georgia but also to the main Turkish gas network. The first gas delivery flowed from Azerbaijan's Shah Deniz field through the BTE pipeline in January 2007.

⁷⁷ AIOC companies are BP, Chevron, ExxonMobil, SOCAR, Inpex (Japan), Statoil (Norway, partially state-owned), Devon Energy (U.S.), TPAO (Turkey, state-owned), Amerada Hess (U.S.) and Itochu (Japan).

⁷⁸ It removed export constraints from AIOC development of the offshore Azeri-Chirag-Guneshli (ACG) fields.

820,000 barrels per day (bbl/d) in April 2007⁷⁹ and has probably increased, as production from the ACG fields alone is now about 700,000 bbl/d.⁸⁰ The following table shows crude oil production in thousand barrels per day.⁸¹

	Total	SOCAR	AIOC
1997	181	179	2
1998	229	180	48
1999	276	181	97
2000	280	181	103
2001	299	181	119
2002	308	179	131
2003	309	178	130
2004	312	181	133
2005	445	181	265
2006	648	181	467
1st half 2006	582	181	405
1st half 2007	847	177	670

While SOCAR's production has remained steady, AIOC's output and export volume have increased substantially over the period, in which the per barrel average (nominal) crude oil price increased from \$26.12 in 2002 to \$66.02 in 2006,⁸² resulting in a dramatic revenue increase. Crude oil exports were up 77 per cent from the first quarter of 2006 to the first quarter of 2007. Oil products (mainly crude) were 90 per cent of Azerbaijan's exports (by value) in the first quarter of 2007.⁸³ Significant oil revenues and very strong real GDP growth rates have followed:⁸⁴

Million Manat	2003	2004	2005	2006	2007*
Nominal GDP	7.1	8.5	12.5	17.7	24.4
Real GDP growth rate (%)	11.2	10.2	26.4	34.5	20

⁷⁹ Crisis Group interview, BP, Baku, 17 April 2007. In addition to the BTC pipeline, some Azeri oil is exported through Baku-Novorossiysk (all SOCAR production) and by rail and pipeline to Georgian Black Sea ports.

⁸⁰ "Azerbaijan Eyes 8-15 Years of 1.2 mil b/d Plateau Output at ACG", *Platts Commodity News*, 10 June 2007.

⁸¹ Economist Intelligence Unit; Crisis Group conversion from metric tons to barrels.

⁸² West Texas Intermediate (WTI) spot average, U.S. Energy Information Administration. Every crude oil type has its own price but Azeri crudes will have increased by about the same percentage. Azerbaijan has benefited from dramatic oil price increases in the second half of 2007. According to the SOCAR website, the May 2007 barrel price for Azeri crude at Ceyhan averaged \$67.08, compared to a May 2007 WTI spot price of \$63.46.

⁸³ Economist Intelligence Unit.

⁸⁴ Ibid and International Monetary Fund (IMF) data.

Government Revenues	1,912	2,288	3,143	5,253	8,127
Oil Revenues	809	864	1,221	2,667	4,813

*forecast

The growth is enormous but the Azeri economy and government is now heavily oil dependent. Oil revenues in 2006 surpassed total 2004 government revenues (in nominal terms). In 2010, nominal oil revenues will equal total nominal GDP in 2006.⁸⁵ There is now a deficit in the government's non-oil fiscal balance.⁸⁶ About 70 per cent of expenditure is directly or indirectly financed by oil.⁸⁷

The boom, of course, cannot endure. Only few experts estimate that the fields' plateau will last eight years or more.⁸⁸ BP calculates production and revenue intake will peak around 2011-2012.⁸⁹ The IMF forecasts that oil revenue will peak at 46 per cent of GDP in 2009 and decline to 32.6 per cent by 2012.⁹⁰ In its scenario, real GDP would begin to decline slightly by 2011;⁹¹ the Oil Fund (State Oil Fund of Azerbaijan, SOFAZ)⁹² would peak that year at \$40.9 billion and decline to \$37 billion in 2012.⁹³ Azerbaijan should be able to continue to collect

⁸⁵ Gas revenues from Shah Deniz and other fields can be added, which could bring a further \$1 billion in revenues by 2010, depending on volumes and price.

⁸⁶ In terms of non-oil GDP, from -8.8 per cent in the 1998-2002 period to -32.6 per cent in 2006 and a projected -40.8 per cent in 2007. IMF Country Report no. 7/191 (Article IV Consultation), June 2007.

⁸⁷ Crisis Group interview, oil revenue expert, Baku, April 2007.

⁸⁸ "Azerbaijan Eyes 8-15 Years", op. cit.

⁸⁹ The ACG fields will ramp up to 1.2-1.3 million bbl/d by about 2010, with a two- or three-year plateau. Crisis Group interview, BP, Baku, 17 April 2007. This calculation assumes fairly constant real prices.

⁹⁰ That, in nominal figures, would be 17.34 billion manats (\$20.54 billion) and in 2012, 15.04 billion manats (\$17.81 billion). These exceed total GDP in 2005.

⁹¹ -0.8 per cent. The non-oil fiscal balance in non-oil GDP terms in this scenario reaches a deficit of about -60 per cent in 2011 and -65 per cent in 2012. By 2012, two years after peak revenues, a budget deficit of 5.4 per cent of GDP is envisaged, such that oil fund assets are likely to be used to offset the difference.

⁹² Created by late President Heydar Aliyev in 2000, the SOFAZ operates under presidential authority and is managed by an expert committee. The director is Shahlar Movsumov, former General Director of the National Bank.

⁹³ If Azerbaijan's oil production does not begin to decline in 2011 or 2012, the scenario would be different. There is speculation that the fields' plateau could last longer. See "Azerbaijan Eyes 8-15 Years", op. cit. In a more recent Crisis Group interview, a BP representative noted that engineers will try to find ways to extend the life of the fields, and slow decline rather than relatively steep decline is now forecast, London, 27 September 2007.

transit fees on gas and oil from Central Asia but this would not offset the decline in oil production.⁹⁴

The implications are that just as oil revenues begin to decline, so will real GDP growth. The non-oil fiscal balance in terms of non-oil GDP would reach a deficit of about 60 per cent in 2011 and 65 per cent in 2012. By 2012, just two years after peak revenues, oil fund assets would likely be needed to offset a budget deficit of 5.4 per cent of GDP. Combined with economic mismanagement and corruption, Azerbaijan could find itself in a difficult position in less than eight years.⁹⁵

2. Revenue management and spending

Though it has taken some measures to address the oil curse, Azerbaijan has many characteristics of an oil dependent state.⁹⁶ Overall budget spending has increased with the growth in oil revenues but much of the spending is ineffective, and some practices even hinder economic development.⁹⁷ The general budget is allocated according to executive branch directives.⁹⁸ All members of parliament

⁹⁴ Kazakhstan would be expected to use the available capacity to get its oil to Mediterranean markets. The transit revenues would be important, though nowhere those from Azerbaijan's own fields. If Azeri production does not decline, the transit revenues might still be available through an expansion of the BTC Pipeline. Azerbaijan might eventually obtain transit revenues on natural gas if a trans-Caspian pipeline is built. See Crisis Group Asia Report N°133, *Central Asia's Energy Risks*, 24 May 2007.

⁹⁵ The IMF commented: "By the mid-2010s, a sharp decline in oil production and revenue would necessitate a large fiscal adjustment and import compression, even if oil prices remained at about \$60 per barrel. The ensuing substantial expenditure cuts may lead to prolonged economic stagnation and a deterioration in living standards." IMF Country Report, op. cit.

⁹⁶ Azerbaijan participates in the Extractive Industries Transparency Initiative (EITI), which compares information collected by an independent auditor from oil companies on what they pay the government and from the government on what it receives. Once EITI secured participation of all companies, the process has worked well, with the exception of some issues pertaining to SOCAR. EITI does not require information on how funds are spent.

⁹⁷ In Transparency International's 2006 Corruption Perception Index, Azerbaijan ranked 130 out of 163 countries, placing it among the most corrupt, with the same score as Zimbabwe and only three tenths of a point above Equatorial Guinea and Uzbekistan. Crisis Group interviews, Baku, April 2007.

⁹⁸ Oil revenues reach the state budget in several ways. In 2006, a budget of about \$6 billion included all the revenues from profit taxes on foreign and privately-owned oil companies (\$1.4 billion), all SOCAR profits (\$1.3 billion) and a direct transfer from SOFAZ (\$800 million). SOFAZ receives all other oil revenues, such as royalties, profit oil and transit fees, but must transfer the difference to balance the budget. Crisis Group interviews, prominent economist and senior government official, Baku, April 2007.

(MPs) interviewed said they had no detailed information, say or oversight on the budget.⁹⁹

In 2006, the oil sector was 53 per cent of GDP and rising.¹⁰⁰ Like all economies where a single export commodity accounts for more than half of GDP, Azerbaijan is vulnerable to changes in price or a decline in production. A capital-intensive industry such as oil generates little employment – only 76,000 Azeris work in it out of a labour force of over four million. The economy is also afflicted by Dutch Disease, the phenomenon whereby an increase in revenue from a natural resource raises the exchange rate, making other export industries less competitive. Non-oil sectors such as agriculture and tradeables are not connected to Azerbaijan's oil and gas dynamo because of the manat's appreciation, and employment opportunities are limited despite the growth rate.¹⁰¹ Overall manufacturing growth outside the oil sector has been just 1.9 percent over the last three years due to a deteriorating investment climate afflicted by corruption, competition within the ruling elite and banking sector inadequacies.

Even in a country where public criticism is not well-tolerated,¹⁰² examples of corruption are easily found. For example, an expensive new international airport in Ganja is nearly unused because there is little demand. Owners report their medium-sized businesses cannot expand unless they give certain officials a share; in some cases, when a monopoly is threatened, expansion is simply not permitted.¹⁰³ In this way, political elites are involved in many large businesses in the country, and their monopolies increase prices.¹⁰⁴

Azerbaijan also shows growing signs of being a rentier state, with increasingly authoritarian elites more focused on

⁹⁹ Crisis Group interviews, Baku, 14 April 2007. During a 16 March 2006 debate, Prime Minister Artur Rasizade gave a positive assessment of economic trends over three years. Independent MP Husein Abdullayev called it a "fiction devoid of hard statistical data, full of lies and an insult to the Azerbaijani people". He was arrested after a scuffle with a pro-governmental, then released but stripped of his seat. Boyukaga Agayev, "Azerbaijan: Splits at the Top", Institute for War and Peace Reporting (IWPR), 29 March 2007.

¹⁰⁰ Crisis Group interview, Economic Research Centre, Baku, 14 April 2007.

¹⁰¹ Ibid. The manat appreciated 6.3 per cent against the U.S. dollar in 2005 and 5.5 per cent in 2006; it is forecast to appreciate 22 per cent in 2007. The tradeables sector is "collapsing", according to a leading Azerbaijan economist, while agriculture fell from 5 per cent of GDP in 2005 to 1 per cent in 2006.

¹⁰² There are often crackdowns on independent media and protestors.

¹⁰³ Crisis Group interviews, Baku, April 2007.

¹⁰⁴ Bananas and other imported fruits are two to three times more expensive than across the border in Russia.

getting a share of hydrocarbon revenues than promoting sustainable development. Recent elections have been judged not to be free and fair.¹⁰⁵ Critics argue the country's role as a major oil supplier has given President Aliyev confidence to act with impunity: "The Azerbaijani leadership has maintained its grip on power – and control over energy revenues – by stifling dissent and rigging elections".¹⁰⁶

One positive step was establishment of SOFAZ to promote macroeconomic stability and preserve revenues for the future, as no developing economy can absorb so much money so fast without serious problems.¹⁰⁷ SOFAZ is one of the better-run government institutions, by consensus of observers Crisis Group interviewed but it suffers from a lack of transparency and of parliamentary oversight. Its spending is by presidential decree on projects separate from the budget which are intended to increase long-term economic potential (infrastructure projects like the Oguz-Qabala-Baku water supply system) and to improve living conditions for IDPs.¹⁰⁸ It was set up to promote economic diversification from oil but according to its website, it advanced 298 million manat (approximately \$353 million) for the BTC pipeline in 2007.¹⁰⁹

SOFAZ planned to spend 309 million manat (\$360 million) on IDPs in 2007, up from 110 million manat (\$130 million) in 2006.¹¹⁰ Although officials told Crisis Group in 2005 that conditions for IDPs would improve substantially within two years, living conditions appear to be basically unchanged.¹¹¹ A senior official assured

Crisis Group again that within two years spending would ensure major improvement.¹¹² While SOFAZ is laying out more money, some IDPs alleged that local officials take a substantial cut.¹¹³

If oil production and revenues decline in less than eight years and the public concludes it has not experienced the anticipated improvements, the government may be tempted to adopt a radical nationalist agenda and even resume hostilities in order to divert displeasure. If not addressed more effectively soon, Dutch Disease and corruption are likely to significantly increase the risk of war.¹¹⁴

B. ECONOMIC DEVELOPMENTS IN ARMENIA AND NAGORNO-KARABAKH

Though it lacks oil and must cope with Azerbaijan's efforts to isolate it, Armenia's economy has done remarkably well during the past decade. In 2004 real GDP passed the 1990 level, driven by energy, metallurgy, food processing and construction.¹¹⁵ In 2006 it grew 13.3 per cent, the fifth consecutive double digit increase.¹¹⁶ Poverty has decreased from 56.1 per cent in 1999 to 29.8 per cent in 2005.¹¹⁷ The 2008 budget envisages \$2.5 billion in government spending, a 44 per cent increase from 2007.¹¹⁸

Limited regional cooperation resulting from the border closure Azerbaijan imposed in 1989 brings heavy costs.¹¹⁹

¹⁰⁵ See the OSCE report at www.osce.org/documents/html/pdf/tohtml/1151_en.pdf; and Crisis Group Europe Briefing N°40, *Azerbaijan's 2005 Elections: Lost Opportunity*, 21 November 2005.

¹⁰⁶ Including by arresting ex-senior officials – Ali Insanov (health minister), Farhad Aliyev (economy minister) and Rafiq Aliyev (head of state petrol retailer Azpetrol) – for alleged corruption. "Letter to Dick Cheney, Vice-President of the United States," Human Rights Watch, 30 May 2001.

¹⁰⁷ SOFAZ assets in August 2007 were \$2,017 billion, SOFAZ website, <http://www.oilfund.az/index.php?n=23>.

¹⁰⁸ Crisis Group interview, senior SOFAZ official, Baku, 18 April 2007. Independent analysts, though critical of various aspects, all said its projects were generally better run and more transparent than those of the regular budget.

¹⁰⁹ During the first half of 2006, SOFAZ had roughly \$412.3 million in revenue and spent about \$288.4 million. Approximately \$29.8 million was allocated to development projects, including housing. Over \$207 million was transferred to the state budget, with no further information. The bulk of the remainder went to Azerbaijan's share of the debt for BTC construction. Kenan Aliyev, "Whither Azerbaijan's oil profits?", *EurasiaNet*, 20 September 2006.

¹¹⁰ SOFAZ website, www.oilfund.az/index.php. There is also regular budget spending on IDPs, as noted.

¹¹¹ Crisis Group interviews and observations, Sabirabad, April 2007.

¹¹² Crisis Group interview, senior SOFAZ official, Baku, 18 April 2007.

¹¹³ Crisis Group interviews, Sabirabad, April 2007.

¹¹⁴ On Dutch Disease and spending see also below.

¹¹⁵ See "Armenia, Country Profile", Economist Intelligence Unit, 2007.

¹¹⁶ After an economic collapse and hyperinflation in the early 1990s, the Armenian economy stabilised by 1995 and grew at an average of 6 per cent from 1996 to 2000. A boom began in 2001, with real annual growth over 10 per cent. "Remittances in Armenia: Size, Impacts, and Measures to Enhance their Contribution to Development", study commissioned by USAID/Armenia, 2004, p. 14.

¹¹⁷ Extreme poverty has dropped more, from 21 per cent in 1999 to 4.6 per cent in 2005. "Republic of Armenia: Fourth Review under the Three-Year Arrangement under the Poverty Reduction and Growth Facility and Request for Waiver of Performance Criterion—Staff Report; and Press Release on the Executive Board Consideration", IMF, www.imf.org/external/pubs/ft/scr/2007/cr07181.pdf; also "Armenia Gets More World Bank Loans", *Armenia Liberty*, 9 March 2007; "Caucasian Tiger, Sustaining Economic Growth in Armenia", World Bank, 2007.

¹¹⁸ "Government Approves 2008 Budget", *Armenia Liberty*, 2 October 2007.

¹¹⁹ The Azerbaijan SSR closed rail and air links with Armenia in summer 1989; 8.5 per cent of goods used to be shipped to Armenia by rail through Azerbaijan. The only rail link between Turkey and Central Asia through Armenia was also closed,

In 1993 Turkey also closed all land communication. Access to markets has been seriously hurt, as land links to Iran and Georgia are of limited utility.¹²⁰ The direct cost of the blockade is estimated at 10 to 13 per cent of GDP.¹²¹ While Yerevan has lost rail and pipeline transit opportunities between Turkey and the Caspian region, neighbours have been damaged by the high cost of building infrastructure to circumvent Armenia; regional trade would be greater and transportation costs lower if links were reopened between Armenia and Azerbaijan and Armenia and Turkey.

Armenia's economic growth is also precarious because it depends on external inputs, including remittances which have not fostered export-oriented industry but have contributed to a significant appreciation of the Armenian dram.¹²² The European Bank for Reconstruction and Development (EBRD) warns that "without faster productivity gains, a further appreciation of the Armenian currency would threaten the country's competitiveness".¹²³ Since 1992 significant financial aid has been provided by the U.S. (some \$75 million in 2006 alone), the World Bank (40 programs worth \$935 million since 1992) and the EU (€385 million). The U.S. Armenian diaspora Lincy Foundation transferred \$75 million in 2002, \$150 million in 2003 and \$60 million in 2005.¹²⁴ U.S. aid now includes a further \$235 million under the Millennium Challenge Account.

Annual GDP growth in Nagorno-Karabakh over five years of 15 per cent is also diaspora-driven.¹²⁵ A construction boom is underway in Stepanakert.¹²⁶ A local analyst

which served as justification for the Armenia-Baku-Tbilisi-Kars-Akhalkalaki railroad.

¹²⁰ Closure of the Ergneti market in South Ossetia and of the only official border crossing between Russia and Georgia in 2006 curtailed the only land connection with Russia.

¹²¹ Lev Frainkman, Evgeny Polyakov, Carolina Revenco, "Costs of Close Borders for Armenian Trade", *Economic Policy and Poverty*, no. 8, pp. 6-9, at www.edrc.am/user_files/70.pdf. Other researchers argue that 30 per cent may be a better cost estimate. Richard Beilock, "Raining On The Parade: A Critique in 1995-2002 and the Effect of Closed Perspective", *Armenian Journal of Public Policy*, vol. 2, no. 1 (September 2005), at www.aiprg.org/UserFiles/File/journal/AJPP_3_6.pdf.

¹²² It has gained more than 40 per cent in nominal value against the U.S. dollar in three years.

¹²³ "European Bank Warns Of Armenian Growth Pitfalls", *Armenia Liberty*, 19 June 2007. Other factors included "vulnerability to commodity prices," dependence on low-interest loans and donor grants and skyrocketing real estate prices.

¹²⁴ "Armenia, Country Profile", op. cit.

¹²⁵ The budget has doubled. Data of de facto National Statistical Service, in *Azat Atsakh* newspaper, 8 May 2007.

¹²⁶ New restaurants, internet cafes and shops represent investment and contribute to growing self-confidence, though development in the regions lags significantly. A new parliament, tens of multi-

explained: "Nagorno-Karabakh has become an all-Armenian project. It has been the focus of sympathy from Armenians all over the world, and there is a significant inflow of patriotic investment from the Armenian diaspora and Armenia itself".¹²⁷ The November 2006 annual telethon organised by the All-Armenian Fund "Hayastan" raised \$13,700,000 for rehabilitation projects.¹²⁸

While Armenia has certainly suffered from the lack of regional cooperation and border closures, its citizens believe the costs are not high enough to require compromise. The conviction prevails that the country has not only survived but developed against the odds and contrary to Azeri predictions. Armenians believe they cannot be forced into concessions.

C. MILITARY BUILD-UP

Baku's military expenses increased in 2004-2005 by a record 51 per cent and rose a further 82 per cent in 2006.¹²⁹ In December 2005 a presidential decree created a ministry for the defence industry responsible for military production, and in 2007 the military budget rose to \$1.1 billion as President Aliyev pledged to make it equal to Armenia's entire budget.¹³⁰

While the occupied areas remain under ethnic Armenian control, Azerbaijan's military expenditure is likely to keep rising until oil revenues peak. Still, capacity building takes time, and given the corruption, there is not necessarily a direct correlation between a budgetary increase and an improvement in capabilities.¹³¹ Today Baku seems more interested in maintaining the status quo than waging war¹³² but increased military expenditures boost its confidence and harden its negotiating position.

In 2004-2006 Azerbaijan is known to have acquired powerful weapons, including twelve "Smerch" multi-

storey structures and ten new hotels have been built since Crisis Group's 2005 visit, reflecting especially tourism investment.

¹²⁷ Crisis Group interview, Stepanakert, June 2007.

¹²⁸ "Annual Telethon Raises \$13.7 Million For Karabakh", *Armenia Liberty*, 24 November 2006.

¹²⁹ Stockholm International Peace Research Institute.

¹³⁰ \$912.8 million will be spent through the defense ministry, \$126 million through the defense industry ministry, "Azerbaijan Flexes Military Muscles", IWPR, 19 July 2007.

¹³¹ Crisis Group interviews, July 2007. Increased funding is earmarked for officer training and salaries. Experts point out that it may take several years before the effects of such measures are evident.

¹³² Crisis Group interviews, London, July 2007. Government officials suggest the buildup is meant to put psychological pressure on Armenia more than prepare for war. Crisis Group interview, Baku, 18 April 2007.

launch rocket systems; 85 120mm PM-38 artillery systems; 72 100mm MT-12 anti-tank guns; and 105 T-72 tanks.¹³³ In an effort to create a superior air force, it purchased in 2004-2005 six SU-25 fighter bombers and one SU-25UB fighter aircraft¹³⁴ and more recently fourteen Mig-29 fighters.¹³⁵ Seven aerodromes have been modernised.¹³⁶ It has allegedly tried to purchase advanced U.S. warplanes, such as the F-15, from third countries.¹³⁷

Armenia's military budget and declared acquisitions do not compare. The 2007 military budget is a record \$280 million but only about a quarter of Azerbaijan's.¹³⁸ Officials have repeatedly sought to dismiss Baku's purchases with claims that Yerevan can acquire armaments on much better terms from Russia and preserve the military balance due to its membership in the Collective Security Treaty.¹³⁹ In 2005 Armenia purchased ten SU-25s from Slovakia.¹⁴⁰ While no other major transfers of military equipment have been officially registered in recent years,¹⁴¹ the armed forces have benefited from the upgrading of Russia's military base in the country.¹⁴²

Armenian officials assert that Baku's military purchases violate the limits of the Conventional Armed Forces in Europe Treaty (CFE) by 1.5 to 2 times for tanks and armoured combat vehicles and by 2 to 2.5 times for artillery systems.¹⁴³ Azerbaijan responds that it is Armenia which violates the treaty by concealing forces above CFE limits in Nagorno-Karabakh, though it acknowledges that it may have exceeded the ceilings "while replacing...old weapons with new ones".¹⁴⁴ At a minimum, Baku has established a clear quantitative superiority over the combined forces of the Armenian army and Nagorno-Karabakh's de facto Defence Army (NKDA), though some Western and Russian military experts maintain the superiority does not extend to combat capability.¹⁴⁵ Over time, however, the three- to five-fold disparity in military budgets may change the on-ground balance of forces.¹⁴⁶

Military analysts argue that the current frontline's geography is Armenia's most important strategic advantage.¹⁴⁷ Its forces hold all important heights, and their positions are secured by the 4,000ft Mrov mountain range on the north¹⁴⁸ and the Arax River border with Iran on the south. The single exposed stretch of 120km from north to south

¹³³ Oleg Glashatov, "Azerbaijan readies for a war for Karabakh. Would it happen?", *Military Industrial Courier* (in Russian). UN Register of Conventional Arms, at <http://disarmament.un.org/>.

¹³⁴ "Azerbaijan shows MIG-29 fighter jets", *Today.az*, at www.today.az/news/politics/38475.html

¹³⁵ "Azerbaijan Air Force Confirmed as Recipient of MiG-29s as Economy, Defense Spending Grow", 3 April 2007, <http://alanpetersnewsbriefs.blogspot.com/2007/04/defense-foreign-affairs-analysis.html>.

¹³⁶ Glashatov, "Azerbaijan readies for war", op. cit.

¹³⁷ Crisis Group interview, expert, July 2007.

¹³⁸ Armenia planned a record 2007 budget, 558.7 billion drams (\$1.51 billion). "Parliament Approves Armenian Budget For 2007", *Armenia Liberty*, 29 November 2006.

¹³⁹ Russia and Armenia are allied in both a bilateral and multilateral framework, including cooperation within the Collective Security Treaty (CSTO, Armenia, Belarus, Kazakhstan, Kirgizstan, Russia, Tajikistan and Uzbekistan). The CSTO envisages favourable prices for Russian arms sales to member states; Russian President Putin said after the 6 October 2007 summit of the treaty states in Dushanbe, "CSTO members will now get special equipment at domestic Russian prices", at www.msnbc.msn.com/id/21162588.

¹⁴⁰ UN Register of Conventional Arms, op. cit.

¹⁴¹ Another major purchase, of four Chinese MLRS "WM-80" artillery systems, analogous to the "Smerch", dates to 1999, *ibid*.

¹⁴² In February 2007, when the commander-in-chief of Russia's air force declared that the Russian base would be re-equipped, the Armenian defence minister hinted that some weapons might be transferred. The deputy commander of the Russian air force has said Russia helped modernise Armenia's anti-aircraft capabilities in 2006, and Armenian specialists can now operate the Russian S-300 missile systems that were deployed there in the late 1990s. "Russia To Modernise Armenia Base", *Armenia Liberty*, 14 February 2007.

¹⁴³ Sergey Minasian, "Azerbaijan against RA and NKR: Military-political balance, estimates of military capacities and prospects of development of armed forces", *Studies on Strategy and Security*, Yerevan, 2007.

¹⁴⁴ Jasur Mamedov, "Azerbaijan Flexes Military Muscles", *IWPR*, 19 July 2007.

¹⁴⁵ Wayne Merry, "Diplomacy and War in Karabakh: An Unofficial American Perspective", Central Asia-Caucasus Institute, 25 October 2006. Merry is a senior associate at the American Foreign Policy Council and a former State Department and Pentagon Caucasus expert.

¹⁴⁶ Crisis Group interview, official, July 2007. "Compare \$2 billion per annum of Azerbaijani defense spending with the Armenian \$400 million in coming years – ultimately this will have an impact on the balance".

¹⁴⁷ According to Merry, "Diplomacy and War in Karabakh", op. cit., Azerbaijan's growing oil revenue would not give it sufficient advantage to resolve the issue militarily: "There are five main reasons for this: geography, firepower, reserves, military art, and strategic depth. Armenians have a clear geographic advantage, with their forces dug in on higher ground along most of the Line of Contact. This in turn creates an opportunity for a more effective use of firepower – even if both sides have similar military hardware. Armenians can also count on ample reserves of both combat veterans and ammunition. To put it bluntly, Azerbaijan would run out of young men before Armenians run out of ammunition. Further, the Armenian side has a proven ability to conduct military operations. Azerbaijan has armed forces, Armenia has a military. In terms of strategic depth, only Turkey is likely to support Azerbaijan. The four other major players, including Russia, Iran, United States, and the Europeans, have no interest in imposing an Azerbaijani solution on Armenians".

¹⁴⁸ See Crisis Group Report, *Nagorno-Karabakh*, op. cit., p. 23.

has been systematically fortified since the 1994 ceasefire.¹⁴⁹ A sense of strategic vulnerability resulting from Azerbaijan's build-up reinforces the Armenian conviction that this frontline should stay unchanged.¹⁵⁰ However, the de facto Nagorno-Karabakh president told Crisis Group: "If we find that Azerbaijan's actions pose a direct threat to the security of the people of Nagorno-Karabakh, we may launch a preventive military action to address the threat".¹⁵¹

IV. INTERNAL OBSTACLES TO PEACE

A profound flaw in the peace process is that it has not involved broad elements in society. Contacts between Armenians and Azerbaijanis are rare, and animosity is strong. In both countries the populations are as resistant to compromise as the leaders.

A. KARABAKH INSTRUMENTALISED

Since 1988 Nagorno-Karabakh has been a dominant domestic political issue with tremendous mobilising power in both Armenia and Azerbaijan. The leaderships use Karabakh issues to pursue domestic political agendas and discredit the opposition, carefully projecting the image that they alone can deliver results.¹⁵² Official Armenian propaganda pictures Kocharian and Prime Minister Serzh Sarkisian as heroes of the Karabakh war, hence the only ones who can be trusted with its resolution.¹⁵³ The Karabakh cause is also used to justify the army's political role and sometimes impunity. The Baku authorities use the loss of the war to discredit the former government, now the opposition. It is also used to distract attention from rule-of-law, human rights and democracy issues.¹⁵⁴

¹⁴⁹ Armenian entrenchments and fortifications are on higher grounds along most of the line of contact. Crisis Group interviews, international expert, July 2007.

¹⁵⁰ Armenian military experts argue that as the military balance shifts toward Azerbaijan, the current frontline is the most important guarantee of security. See David Simonyan, "Surrender of territories to Azerbaijan: strategic consequences for Armenia and Nagorno-Karabakh", *Regnum*, 27 July 2006.

¹⁵¹ Crisis Group interview, Stepanakert, June 2007. The BTC pipeline, which runs less than 20km from the frontline, might be a target for sabotage. Crisis Group interview, Stepanakert, June 2007. Armenian military analysts say the BTC's pumping stations could be destroyed by Armenia's Scud B missiles. Crisis Group interview, analyst, Yerevan, October 2007. The deputy speaker of the Armenian parliament, Vahan Hovhannisian, said, "[the] first thing that would be destroyed in case of Azerbaijani aggression is its oil capacities", "Statements of Azeri leaders are Conditioned by Oil Dollars", *Regnum*, 4 October 2007.

¹⁵² Crisis Group interviews, analysts, Baku, Yerevan, Tbilisi, and London, June-July 2007. When endorsing the ruling Republican Party in the recent parliamentary election campaign, President Kocharian asked rhetorically, "now let us think who is capable of coping with this threat... Those politicians who went through a war, who participated in the formation of our armed forces? Or those politicians who can't tell an [army] battalion from a company or a rifle from a machine gun?", Emil Danielyan, "Armenian Leaders Expect Tight Grip on New Parliament", *EurasiaNet*, 11 May 2007.

¹⁵³ Both were leaders in Nagorno-Karabakh. Kocharian led the state defence committee, then was the first elected de facto president (1992-1997). Sarkisian was de facto deputy defence minister (1992-1993). Both were in the Stepanakert Komsomol. Azerbaijan refuses to negotiate with Nagorno-Karabakh but Kocharian and, if he becomes president of Armenia in the March 2008 elections, Sarkisian allow informal participation of the region in the negotiating process. Crisis Group interview, analyst, June 2007.

¹⁵⁴ Demands are made, for example, that international critics address the rights of "one million refugees who suffered at the hands of Armenian aggressors", rather than the cases of a few domestic opposition activists. Ali Hasanov, the head of the presidential administration's socio-political department, recently called "Reporters Without Frontiers" a "pro-Armenian organisation". Analysts connected this to its support for an opposition journalist. The head of the presidential administration denied that journalists in Azerbaijan are pressured and said international organisations are "not objective" in their evaluations of Azerbaijan and adopt a "pro-Armenian position". A.

B. PARTIES AND PUBLIC OPINION

1. War rhetoric and increasing readiness for confrontation

For several years state propaganda in Armenia and Azerbaijan has worked against any compromise solution. In Baku there have been open calls for use of force to regain lost territories. In Yerevan for the first time since the 1994, there have been calls to take up the military challenge. Aliyev has repeatedly threatened an offensive to win back the occupied territories, should negotiations fail.¹⁵⁵ In May 2007 he said, “the enemy must know that we are capable of resolving the issue by military means at any time. Strengthening of the army, reinforcement of the army discipline, upgrade of [the] army’s supply base, procurement of modern weapons – all these are aimed at this purpose”.¹⁵⁶ Officials insist the rhetoric is justified as the country is “the victimised party, and this gives us the right to resolve the issue by any means. We must get ready, and the population must be mobilised”.¹⁵⁷

The media promotes hardline nationalist rhetoric and allows little scope for open discussion.¹⁵⁸ An influential television station, ANS, starts its daily news programme with the words “Armenia’s aggression towards Azerbaijan continues” and regularly refers to the “first Karabakh war”, implying the “second” is yet to come. State-owned AzTV airs crude Soviet-style war propaganda.

Armenian officials have largely refrained from such openly bellicose statements, while portraying Azerbaijan as a threatening but corrupt and weak state.¹⁵⁹ The defence ministry proclaims Baku will lose if it starts a war.¹⁶⁰

Hasanov’s speech on the “Pont of View” talk show, private ANS TV, 29 May 2007.

¹⁵⁵ “Tough-Talking Aliyev Threatens Renewed War with Armenia”, *Armenia Liberty*, 1 March 2006.

¹⁵⁶ President Aliyev’s speech on 28 May 2007, the Republic Day of Azerbaijan.

¹⁵⁷ “Tough-Talking Aliyev”, op. cit.

¹⁵⁸ Authorities have cracked down on independent media with renewed force over the past months. See Rovshan Ismayilov, “Azerbaijan Tops The Charts For Number Of Imprisoned Journalists”, *EurasiaNet*, 22 May 2007; Crisis Group interview, director, Institute of Reporter Freedom and Safety, Baku, May 2007.

¹⁵⁹ Crisis Group interviews, analyst and director of Yerevan Press Club, Yerevan, July 2007. The Yerevan Press Club, a non-governmental organisation (NGO), has recently been monitoring public statements of the parties and the mass media coverage in Armenia of the Nagorno-Karabakh problem and Azerbaijani-Armenian relations.

¹⁶⁰ “The Chief of the General Staff of the Armed Forces of Armenia: The Side, Which Will Launch War Will be Defeated”, *Regnum*, 6 July 2004. Armenian military analysts frequently

Nagorno-Karabakh elites do much the same, though it is becoming increasingly popular to advocate a pre-emptive strike.¹⁶¹ In February 2006 the Armenian authorities organised a large demonstration to mark the anniversary of the Sumgait massacre.¹⁶² Kocharian said on television Armenians should be prepared for the “worst-case scenario”, in which they would have to formally recognise Nagorno-Karabakh’s independence and its “responsibility for the security of the Karabakh people” and “reinforce the security zone” around the disputed enclave.¹⁶³ In October 2006 he visited the frontline in uniform.¹⁶⁴ In January 2007 the fifteenth anniversary of the army triggered a national campaign promoting it as “the best capable army in the South Caucasus”.

2. Advocates of war, advocates of peace.

There is no credible political movement with wide support that advocates a compromise in either society. There are few channels of communication between Armenians and Azeris. Frustration with the deadlocked negotiations is high and cynicism widespread. Many favour a military resolution of the conflict,¹⁶⁵ and there is next to no debate on the implications of a peace agreement or resumed war. The leaderships promote this unhealthy dynamic.

Azerbaijan

The government has repeatedly discouraged and even targeted activists who promote confidence building with

discuss war scenarios, and some recommend active warfare and seizure of new territory if Azerbaijan launches an offensive.

¹⁶¹ Crisis Group interviews, NGO activists, Stepanakert, June 2007; international analyst, London, July 2007.

¹⁶² Armenian public television, 28 February 2006. At least 26 Armenians and six Azeris were killed in Sumgait on 26-28 February 1988, and large numbers of Armenians fled the town.

¹⁶³ A televised statement in reaction to Aliyev’s March 2006 statements urging the Azeri army to be ready to regain Nagorno-Karabakh by force; “Kocharian Hopes For Karabakh Deal, Shrugs Off Azeri Oil Factor”, *Armenia Liberty*, 2 March 2006.

¹⁶⁴ “Kocharian Tours Armenian Frontline Positions”, *Armenia Liberty*, 25 October 2006.

¹⁶⁵ Crisis Group interview, expert, Baku, April 2007. A survey by the Baku-based Sociological Monitoring Centre PULS of 1,000 Azeris found 59.4 per cent did not accept any compromises on the conflict; 11.5 per cent supported cultural autonomy and local government powers for Nagorno-Karabakh; 9.5 percent agreed to a self determination model similar to Azerbaijan’s Nakhchivan Autonomous Republic; 11.1 per cent said status could be determined by referendum if Azeri IDPs returned; and 46.7 per cent expected “no war, no peace” to continue. Even surveys by independent NGOs are likely to be skewed; citizens may try to give responses close to what they think is the government line. Crisis Group interview, head of Public Opinion Centre, Baku, April 2007.

Armenians.¹⁶⁶ It argues that dialogue resembles “normalising relations with the occupiers of Azeri lands”¹⁶⁷ and is possible only after Armenian withdrawal and IDP return. There is a prevailing sense that Azerbaijan has been treated unjustly, also by the international community, which has failed to uphold its rights.¹⁶⁸ Except for a thin layer of Baku-based civil society, very few are bold enough to voice an alternative opinion.¹⁶⁹ A pro-government parliamentarian recently sought to introduce criminal responsibility for those who travel to or in any way deal with Armenia.¹⁷⁰

Among the most radical groups is the Karabakh Liberation Organisation (KLO), which rejects the peace process, criticises the government for failing to take resolute steps to return Karabakh and the international community for not calling Armenia the aggressor. With offices in Baku and key regions, it advocates war as the only acceptable way to regain the lost territories.¹⁷¹ Its core members are former combatants, families of war victims and IDPs from Karabakh and occupied territories.¹⁷² Some regard it as a “governmental” non-governmental organisation (GONGO), and it actively participates in harassment of civil society actors who have Armenian partners.¹⁷³

The government has portrayed the radicalisation of parts of society as readiness for war.¹⁷⁴ With sponsorship of friendly parliamentarians, it has set up GONGOs, which often defame outspoken activists, journalists and

organisations for “spying for Armenian secret services”.¹⁷⁵ A few of the latter, among them the Baku-based Helsinki Citizens Assembly and the Centre for Humanitarian Research, remain the main civil society advocates of public diplomacy and confidence building. In June 2007, however, an unprecedented initiative led by the Azerbaijani and Armenian ambassadors to Russia took Armenian and Azerbaijani intellectuals to Baku, Stepanakert and Yerevan for the first time since the 1994 ceasefire.¹⁷⁶ While Baku portrayed this as an “initiative of intellectuals”, it was clearly sanctioned by the leaderships on both sides.¹⁷⁷

The IDP/refugee community¹⁷⁸ has little participation in political and social life and scant access to information on domestic developments, let alone the peace process. Azerbaijan has a non-integration policy, mainly to make the point that the displacement is temporary. IDPs in camps are particularly vulnerable to political manipulation. The camps are typically isolated and tightly controlled, off limits to opposition or independent activists.¹⁷⁹ No effort is made to give IDPs any representation in the negotiations. There is no elected IDP representative, and IDP activists argue that the authorities fear a well-organised, vocal IDP movement could present a challenge.¹⁸⁰ The Minsk Group co-chairs occasionally consult with Nizami Bahmanov, head of the Shusha Executive Committee, who was appointed to represent the community in 1992 but is widely

¹⁶⁶ The only indications of a more nuanced approach have come from Foreign Minister Mammadyarov, who has said, “considering that Nagorno Karabakh is an inseparable part of Azerbaijan, I do not see a problem in the country’s representatives visiting the region. I think we have to overcome the barrier of hatred that exists between Azerbaijan and Armenia on some issues. We are neighbours, and we will have to deal with each other”, Elmar Mammadyarov: “We are rather speaking of a poll”, *Today.az*, 27 July 2006.

¹⁶⁷ Crisis Group interview, official, Baku, June 2007.

¹⁶⁸ Crisis Group interview, senior official, Baku, June 2007.

¹⁶⁹ An unprecedented meeting of a wide spectrum of civil society activists in June 2006 sought to convey to the government that civil society representatives were also not ready for a compromise. The meeting began with the Azeri anthem and a minute of silence for the conflict’s casualties.

¹⁷⁰ The proposal by Azay Guliyev was not passed by parliament.

¹⁷¹ See (in Azeri) www.azadqarabag.azerall.info/ts_gen/azl/2006/0302/aq1-6.htm.

¹⁷² KLO was established in 2000 and is led by Akif Nagi, a university professor from the occupied Agdam district.

¹⁷³ Crisis Group interview, NGO representative, Baku, April 2007. KLO organised protests after Arzu Abdullayeva, the chair of the Azerbaijan branch of the Helsinki Citizens’ Assembly, visited Karabakh and met with the de facto leadership, 28-30 July 2007.

¹⁷⁴ Crisis Group interview, NGO leaders, Baku, May 2007.

¹⁷⁵ Street demonstrations in front of offices of pro-dialogue activists, throwing eggs at them, undermining them by defamatory articles and programs in pro-governmental media are widespread practices. Pro-government youth unions, NAYORA and IRELI, and the NGO Forum, which unites some 400 pro-government groups, have sought to discredit journalists and NGO representatives open to dialogue with Armenia.

¹⁷⁶ Armenian Ambassador Armen Smbatian and Azerbaijani Ambassador Polad Byulbulogly, with cultural figures and academics from both countries, travelled on 28 June 2007 to Nagorno-Karabakh, then Yerevan and Baku.

¹⁷⁷ Crisis Group interview, diplomat, July 2006. The suggestion is that after their May 2007 St. Petersburg summit failed to produce any results, the presidents wanted a sign of goodwill, mainly for the international community. But the sides have not shown readiness for a more extensive confidence-building process. The infrequent examples of confidence building, on civil society and official levels, would not have been possible without external facilitation by international NGOs and the OSCE.

¹⁷⁸ According to official Azerbaijan statistics, at the end of 2005 there were 686,586 IDPs (578,545 from Nagorno-Karabakh and seven adjacent occupied districts, 108,041 resettled from areas near the Armenian border), at [www.internal-displacement.org/idmc/website/countries.nsf/\(httpEnvelopes\)/17D873CC377B6A54802570B8005A73AE?OpenDocument](http://www.internal-displacement.org/idmc/website/countries.nsf/(httpEnvelopes)/17D873CC377B6A54802570B8005A73AE?OpenDocument).

¹⁷⁹ Crisis Group interview, expert, Baku, June 2007.

¹⁸⁰ Crisis Group interview, IDPs from Shusha, Baku, May-July 2007.

discredited among IDPs.¹⁸¹ It is important for Baku to encourage IDP participation in the negotiations process.

There are several IDP organisations in the capital but most are very weak. An Assembly of Nagorno-Karabakh Azerbaijanis was started in May 2007 to give the community an alternative voice and create a legitimate representative structure.¹⁸² It seeks a peaceful settlement and co-existence with Armenia, with Azerbaijan's territorial integrity as a precondition.¹⁸³ There has been little improvement in social and economic rights since the early 1990s, however, despite the oil money.¹⁸⁴ 61 per cent of IDPs and refugees in rural areas are at or below the poverty level.¹⁸⁵ Health care is inadequate and work migration indicators high. Authorities say they have sought to improve social conditions since 2001. As oil money started filling the State Oil Fund,¹⁸⁶ the government in 2006 allocated \$240.9 million for health and social care but no significant effect is visible.¹⁸⁷ Analysts and many in the camps say corruption is rampant, and money often does not reach the intended destination.¹⁸⁸

The government demolished four camp towns in 2006 and built thirteen new settlements. Seven camps, home to 30,000 IDPs, are to be dismantled in 2007. Much of

the new housing is built close to the front line.¹⁸⁹ Baku uses this fact to argue it has no military intentions, since it is resettling IDPs where there they would be vulnerable if fighting resumed. Yet, IDPs do not seem convinced in light of the belligerent rhetoric. They also question the degree to which Baku has their interests at heart, as the new settlements are in "geographically remote, economically unviable and otherwise unsuitable locations, leading to segregation and isolation".¹⁹⁰

Armenia

The most powerful hardline force is the Karabakh lobby,¹⁹¹ which holds the posts of president, prime minister, army chief of staff, chairman of the parliamentary defence commission and many others. Karabakh Armenians have strong feeling of cohesion and well-developed patronage networks.¹⁹²

The hardline positions of President Kocharian and Prime Minister Sarkisian are strengthened by two nationalist parties, the Republican,¹⁹³ with 66 of the 131 parliament seats, and the Armenian Revolutionary Federation (Dashnaksutyun) with sixteen.¹⁹⁴ Both oppose concessions; the Dashnaks have called for further resettlement of occupied territories by ethnic Armenians.¹⁹⁵ The army has political weight in both Armenia and Nagorno-Karabakh and is revered as one of the most trustworthy

¹⁸¹ "The position of Karabakh Azeris is the same as Azerbaijan government's, so we do not seek a place at the negotiations table at this stage". Crisis Group interview, Nizami Bahmanov, head of the Azeri community of Nagorno-Karabakh, Baku, May 2007.

¹⁸² The Assembly of Nagorno Karabakh Azeris was created in May 2006; its first session was on 7 May 2007. The authorities immediately created an alternative, the Public Union of [the] Azeri community of Nagorno-Karabakh, under Bahmanov. Crisis Group interview, Kerim Kerimli, member of the Assembly of Nagorno-Karabakh Azeris, Baku, August 2007.

¹⁸³ Crisis Group interview, members of the Assembly of Nagorno-Karabakh Azeris, Baku, August 2007.

¹⁸⁴ "Azerbaijan – Displaced then Discriminated Against: the Plight of the Internally Displaced Population", Amnesty International, 2007.

¹⁸⁵ The highest poverty level is among IDPs/refugees in rural settlements (60.6 per cent); those in urban areas have a poverty rate (41.2 per cent) slightly lower than local residents (44.4 per cent), Azerbaijan data cited by Internal Displacement Monitoring Centre, official Azerbaijan statistics, op. cit.

¹⁸⁶ Created by the late President Heydar Aliyev in 2000, SOFAZ operates under presidential authority and is managed by an experts committee. The current director is Shahlar Movsumov, former general director of the National Bank. In 2006, the State Oil Fund totalled \$1.6 billion, with \$120 million used for IDPs and refugees, compared to \$44 million in 2005, Trend News Agency.

¹⁸⁷ \$91 million was from the state budget, \$119.9 million from the State Oil Fund, \$30 million from international agencies. SOFAZ funds are primarily allocated for building housing, public and health infrastructure.

¹⁸⁸ Crisis Group interview, Sabirabad IDPs camp, June 2007.

¹⁸⁹ IDPs complained that some new houses in Bilasuvar district are unsafe, due to corruption and materials mismanagement during construction. Some, they say, are built on salty land where farming is nearly impossible; new settlements in Agdam are within kilometres of the frontline, and IDPs have raised security concerns. Crisis Group interviews, Sabirabad and Saatli IDP camps, April-May 2007.

¹⁹⁰ "Azerbaijan: Displaced Then Discriminated Against", op. cit., p. 2.

¹⁹¹ Estimates for Armenians of Nagorno-Karabakh origin currently in Armenia range from 200,000 to 800,000. Crisis Group interviews, Nagorno-Karabakh representation in Armenia and Karabakh-friendly associations, Yerevan, July 2007; phone communication, former de facto head, Nagorno-Karabakh migration department. 200,000-250,000 seems realistic, though there are no statistics on origin.

¹⁹² Perceptions of Karabakhi cronyism cause resentment among average Armenians but elites agree there is no collective responsibility for corruption and nepotism.

¹⁹³ Following the death of Prime Minister Andranik Markarian in March 2007, then Defence Minister Serzh Sarkisian, who had joined the RPA a year earlier, became party leader and, on 4 April 2007, prime minister.

¹⁹⁴ The ARFD, a nationalist and socialist party, considers Karabakh historic Armenian land.

¹⁹⁵ "Dashnaks against land concessions to Azerbaijan", *Armenia Liberty*, 25 June 2007.

institutions.¹⁹⁶ It has strong affiliations with several Karabakh veterans associations.¹⁹⁷

Prominent war veterans recently warned Armenia's leaders that giving up any territory would be tantamount to treason.¹⁹⁸ Publication of the Prague process principles triggered strong reactions. Once an important part of Kocharian's base, the leaders of the Organisation for Defence of Liberated Territories (ODLT) campaigned against "treacherous" concessions. The authorities are increasingly concerned by the threat from these forces: on 10 December 2006 they arrested two ODLT leaders for plotting violent overthrow of the government.¹⁹⁹

Mainstream opposition to withdrawal is based mostly on security considerations. Some military analysts argue that it would undermine Nagorno-Karabakh's safety against an Azerbaijani offensive.²⁰⁰ Analysts and public opinion in both Armenia and Nagorno-Karabakh are highly sceptical of peacekeeper guarantees.²⁰¹ Public opinion hardened further after a video was circulated in December 2006 of massive destruction of 6,000 ancient Armenian carved cross-stones in Nakhichevan, Azerbaijan.²⁰² Pro-peace groups – mostly supporting the views of former President Ter-Petrosian on a political settlement – have been

marginalised by a decade of state-sponsored hardline propaganda.²⁰³

Securing Nagorno-Karabakh's consent to a peace plan is likely to be the biggest challenge. War memories dampen any willingness to consider concessions.²⁰⁴ Recalling the blockade by Azerbaijan in 1991, bombardment of the Lachin lifeline in 1992 and indiscriminate shelling of settlements in 1992 from heights in the occupied territories, Karabakh Armenians argue they cannot accept any plan which does not give them control over the Lachin district and preserve a security belt.²⁰⁵

Its non-recognised status and Azerbaijan's rhetoric deepen Nagorno-Karabakh's insecurity and reluctance to change the security situation.²⁰⁶ Public opinion has hardened, while the region's de facto leaders have not participated in the negotiations since 1997, so do not bear responsibility for decisions made in the peace process and can comfortably stake out hardline positions.²⁰⁷ It is vital to bring them into the negotiating process in order to give them a sense of ownership and responsibility for any deal.

¹⁹⁶ 83 per cent of the Armenian population has more confidence in the army than in the Church (77 per cent), the president's office (35 per cent) and the parliament (31 per cent), according to an "Armenian National Voter Study" poll conducted by International Republican Institute, Baltic Surveys Ltd./The Gallup Organisation, and Armenian Sociological Association with USAID funding, 30 April-7 May 2006.

¹⁹⁷ The most influential among them, "Yerkrapah", was founded by late prime minister and former Defence Minister Vazgen Sarkisian and has numerous members in the government and in the military.

¹⁹⁸ See "Karabakh War Vets Reject Armenian Land Concessions", *Armenia Liberty*, 4 July 2006.

¹⁹⁹ "Ex-Karabakh Commander 'Facing Eviction From Armenia'", *Armenia Liberty*, 12 December 2006.

²⁰⁰ For example, David Simonyan, "The Surrender of Territories to Azerbaijan: Strategic Consequences for Armenia and Nagorno-Karabakh", *Regnum*, 25 July 2006.

²⁰¹ They cite the fate of Serbian Krajina and the inefficiency of the NATO-led KFOR in protecting Serbs in the 2004 unrest in Kosovo. Crisis Group interviews, Yerevan and Stepanakert, June 2007.

²⁰² "Historic graveyard is victim of war", *The Times*, 21 April 2006, at www.timesonline.co.uk/tol/news/world/europe/article707673.ece. Armenians perceived this as desecration and an indication Azerbaijan is preparing for war. Azerbaijan dismisses this as "lies". The European Parliament condemned the destruction "taking place in the context of the suspended conflict", when "there might soon be a favorable outcome to the negotiations on Nagorno-Karabakh", resolution on cultural heritage in Azerbaijan, 16 February 2006, at www.europarl.europa.eu/.

²⁰³ None cleared the 5 per cent barrier in the 1999, 2003 and 2007 parliamentary elections. Ter-Petrosian's 1997 article "Peace or War?", calling for reconciliation and compromise with Azerbaijan, is widely considered by Armenian pro-peace forces as the basic manifesto on the need for normalisation of relations with Azerbaijan.

²⁰⁴ Almost every Nagorno-Karabakh family has lost members. The death toll of the Armenian population of Nagorno-Karabakh from the war is 6,000, 4 per cent of the population. Crisis Group interviews, NGO activists, Stepanakert, June-July 2007.

²⁰⁵ *Ibid.*

²⁰⁶ Crisis Group interviews, politicians and activists, Stepanakert, June 2007.

²⁰⁷ Disagreement over who is a party to the conflict continues. Nagorno-Karabakh authorities argue that no Armenia-Azerbaijan agreement can be implemented without their concurrence. Crisis Group interview, senior Nagorno-Karabakh de facto official, Stepanakert, June 2007. The Minsk Group co-chairs have said Nagorno-Karabakh should be able to work on the comprehensive agreement once basic principles are agreed. The OSCE has accepted Nagorno-Karabakh as a party to the conflict, "Towards a Genuine Partnership in a New Era", Budapest document, p. 17, 1994. Baku rules out the participation in the negotiations of Nagorno-Karabakh de facto authorities. Crisis Group Report, *Nagorno-Karabakh*, op. cit.

V. CONCLUSION

Over the past two years, hopes for diplomatic progress have been repeatedly dashed, undermined by the parties' lack of political will and insufficient international community resolve. As military expenditures have soared and belligerent rhetoric increased, the leaderships of both countries have turned their public opinion increasingly against compromise. Nevertheless, the Prague process still provides what can become the framework for a negotiated settlement. Electoral politics in both Azerbaijan and Armenia will complicate the political environment in the coming year. Ideally the sides should agree on a document of basic principles, even one that also specifies where disagreements remain, before the polls but it is essential at least to maintain the process during the year.

There is a real risk the conflict will heat up at some point in the next several years, while the oil boom and extensive military development in Azerbaijan and steady economic growth in Armenia suggest that neither will feel compelled to compromise. More numerous ceasefire violations are likely, though not all-out war. The risks may reach a new level around 2012, however, when Azerbaijan's oil revenues are expected to begin to decline. At that point, Baku might be tempted to conclude that the balance of power was at its most favourable and that an appeal to extreme nationalism could counteract popular disenchantment with the regime.

Before this happens, the international community needs to lose its complacency and lobby with all available pressure for peace. Conditionality should be used with financial aid instruments, and active diplomacy should focus both sides on the costs of continued stalemate and confrontation, which far outweigh those of an early compromise. While a comprehensive solution to the conflict is probably not achievable at present, small steps can be taken. Confidence building and people-to-people contact should be started, especially during the election cycles, when political propaganda may otherwise alienate the societies even further. Increased confidence and security should ultimately make possible the more sensitive but crucial start of withdrawal from occupied territories as a first step towards implementation of the principles.

Tbilisi/Brussels, 14 November 2007

APPENDIX A

MAP OF SOUTH CAUCASUS



This map is for reference only and should not be taken to imply political endorsement of its content.

APPENDIX B

MAP OF NAGORNO-KARABAKH AND SURROUNDING SEVEN DISTRICTS



This map is for reference only and should not be taken to imply political endorsement of its content.

APPENDIX C

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