



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 07.06.1999
COM(1999) 272 final

COMMUNICATION FROM THE COMMISSION
TO THE COUNCIL AND THE EUROPEAN PARLIAMENT

THE EUROPEAN UNION'S RELATIONS
WITH THE SOUTH CAUCASUS, UNDER THE PARTNERSHIP AND
COOPERATION AGREEMENTS

EXECUTIVE SUMMARY

THE EUROPEAN UNION'S RELATIONS WITH THE SOUTH CAUCASUS, UNDER THE PARTNERSHIP AND COOPERATION AGREEMENTS

Ratification of the EU's Partnership and Cooperation Agreements (PCAs) with Georgia, Armenia and Azerbaijan, which were signed in April 1996, is now complete. The Agreements are expected to enter into force on 1 July 1999. An inaugural meeting with the Presidents of the three republics is foreseen on 22 June in Luxembourg. A reassessment of the EU's strategy towards the South Caucasus region, and of the most effective use of its instruments under the PCAs, is therefore timely; this is the principal objective of this Communication.

The political and economic developments in the region are briefly summarised. The prospects for economic reform and the resumption of economic activity, given the effects of the "Russian crisis", and the links between these and internal political issues, in particular the lack of progress on conflict resolution and the ongoing barriers to regional communications, are explored (section 2).

EC assistance to date is reviewed. As the economies of the three republics develop, humanitarian aid is playing a less significant role in the Community's overall support. However, new instruments have been introduced in the form of exceptional financial assistance and rehabilitation; at the same time technical assistance through Tacis has become more focused on agreed policy objectives, with projects aiming at preparation for the entry into force of the PCAs and for WTO accession negotiations being systematically programmed. Interstate programmes, in particular Traceca and Inogate, have become important tools for promoting regional cooperation. The mix of instruments, and the debate concerning the renewal or modification of their legal bases, should reflect the EU's overall policy priorities. Europe as a whole should be able to benefit from the development of the South Caucasus, and from EC assistance to the region (section 3).

Furthermore, an analysis is made of what the EU can expect from its actions in the region under the PCAs. Despite the efforts of the three governments, progress on the introduction of the rule of law and the market economy has been slow and the management of central government finances requires further improvement. The business climate is not yet sufficiently attractive. At the same time, the threat to European security posed by instability in the Caucasus has if anything tended to increase. The root of many of the problems facing the three republics is the failure to resolve the ethnic conflicts; the present stalemate has aggravated humanitarian problems and has tended to impede the development of democratic institutions and of the market economy. This has reinforced the three republics' reliance on international assistance, while at the same time rendering that assistance less effective (section 4).

The Communication therefore suggests that the EU needs to fashion its policy under the PCAs in such a way as to ensure its actions and its assistance become an incentive to positive change. In the medium to long term, relationships in which aid and assistance play a primary role need to develop into "two way" ones with reciprocal benefits for the European partners.

In conclusion, actions aimed at enhancing regional cooperation and post-conflict reconstruction offer the best option for progress on both confidence-building and economic recovery. These need political support through CFSP, and in particular through the institutions set up under the PCAs. Over time, for the EC's assistance to be effective progress must be made on the resolution of conflicts and the normalisation of political and economic life in the region. The 22 June Presidential meeting will offer the three republics an important opportunity to demonstrate that the political will to make progress exists. Bilateral technical assistance programming under the new Tacis regulation should become increasingly targeted on strengthening the rule of law, reinforcing the use of EC and international norms, improving fiscal management and the administration of finances and improving the business climate (section 5).

INTRODUCTION

- 1.1 In its communication of May 1995¹, the Commission proposed a co-ordinated strategy to assist the three republics of the South Caucasus through what was expected to be a lengthy transitional period, and to set the conditions for sustained development.

It recommended that such a strategy should be based upon the negotiation, under appropriate conditions, of a Partnership and Cooperation Agreement (PCA) with each republic, supplemented by food and humanitarian assistance and support for post-war reconstruction. It noted that such a strategy would give the Union very substantial leverage in the pursuit of its overall objectives, including conflict resolution and the promotion of political and economic reform.

Policy guidelines were subsequently endorsed by the General Affairs Council, on 17 July 1995.

- 1.2. The PCAs were negotiated in 1995 and signed at a ceremony in Luxembourg in April 1996, attended by Presidents Ter-Petrossian of Armenia, Aliev of Azerbaijan and Shevardnadze of Georgia.

Ratification of the Agreements is now complete and they are expected to enter into force on 1 July 1999. A second meeting with the Presidents of the three republics has been scheduled for Luxembourg, on 22 June 1999 to mark the occasion.

- 1.3. The reassessment of the EU's relations with the South Caucasus which is implied by the entry into force of the PCAs comes at an important juncture:

- Following the Presidential elections held in Armenia and Azerbaijan in the course of 1998, which gave rise to criticism on the part of OSCE/ODIHR² and other international observers, parliamentary elections will be held in 1999 in Armenia and Georgia.
- In late 1998 international efforts (UN and OSCE Minsk Group) to make progress in resolving the conflicts in Abkhazia, and Nagorno-Karabakh, failed to achieve a breakthrough.
- Progress was achieved in 1998 through EU technical initiatives aimed at enhancing regional cooperation, in particular the Traceca and Inogate programmes; but very little so far through political structures which the countries of the region have established (CIS, BSEC, ECO)³.
- As of September 1998, the economies of the countries of the region have been seriously affected by the Russian crisis and in particular by the

¹ COM (95)205 : "Towards a European Union Strategy for relations with the Transcaucasian Republics"

² The OSCE's Office for Democratic Institutions and Human Rights

³ All three republics are members of the CIS and of BSEC (Black Sea Economic Cooperation). Only Azerbaijan is a member of ECO (Economic Cooperation Organisation).

devaluation of the rouble. Azerbaijan and Georgia were also affected by lower than expected revenues for energy exports, due to low world prices.

- However, "early" Caspian oil is being exported via the Caucasian corridor, and the first pipeline to bring oil from Baku to Supsa, on the Black Sea, was officially opened in April 1999.
- The search for a regional solution to energy problems has been rendered still more urgent by the EU's insistence that the Medzamor nuclear power station in Armenia be closed. An EC-Armenia Working Group is mandated to draw up a report.
- It is hoped that Georgia and Armenia will complete negotiations for accession to the World Trade Organisation in the course of 1999.
- Georgia's application to join the Council of Europe has just been accepted.

1.4. Almost all the economic measures recommended in the 1995 Communication have since been progressively implemented. With the impending entry into force of the PCAs – which will for the first time offer the EU a common platform for dialogue on political, commercial and assistance issues – a further examination is required, which should go beyond an analysis of existing assistance instruments and their role in encouraging political and economic reform. This communication is therefore intended as a review of strategy, including an assessment of :

- the economic and political benefit the EU is deriving from its actions in the South Caucasus,
- whether the EU's means of intervention are appropriate to the circumstances,
- what new initiatives are required, in the broader context of the PCAs.

SUMMARY REVIEW OF DEVELOPMENTS IN THE SOUTH CAUCASUS

Armenia

- 2.1. Armenia has been able to capitalise on the homogeneity of its society and culture, and to draw on a reservoir of efficient (including a number of American or European-trained) administrators and business-people. The Government appears to remain committed to reform and to IMF-inspired policies. President Kocharian's intention is now to support Western-inspired regional cooperation initiatives.
- 2.2. The government has hitherto been able to protect itself, through strong fiscal and monetary policies, from a major outflow of resources in order to protect the Dram against the effects of the devaluation of the rouble. In this, Armenia has been notably more successful than its neighbours. The Prime Minister has made it clear that this success may be of short duration, but he appears confident that with international assistance, Armenia can balance its reform-oriented budget and this is the country's principal requirement at present.
- 2.3. Energy shortages have been a fundamental problem for successive Armenian administrations. The recommissioning of the Medzamor nuclear power station in 1995, with Russian assistance, has alleviated some of these problems. However, the EU has insisted that Armenia carry out its commitment to close the plant, on safety grounds, by the year 2004. The two sides agreed in December 1998 to establish a working group to prepare a comprehensive plan for the closure, as a basis for coordination with international donors. It is already clear that any plan must take into account the availability of new, reliable sources of conventional energy. This carries with it important implications for regional cooperation.
- 2.4. The Parliamentary elections set for 30 May 1999 will be an important indicator of the course Armenia will take in the coming years and of its ability to meet PCA and Council of Europe criteria.

Azerbaijan

- 2.5. Azerbaijan has from 1995 onwards, overcome the political instability which had dominated the early years of independence. It has, with considerable success, attracted investment from international oil companies, and has since 1995 reduced inflation to manageable levels and stabilised the currency. As a major beneficiary of EC aid, Azerbaijan has a close working relationship with the Union and its institutions.
- 2.6. However, this stability has been achieved at a price. The government of President Aliiev has imposed its authority by means which have been repeatedly criticised by international observers. Meanwhile, the oil sector has dominated the government's strategy for economic revival, to the detriment of development in other sectors which are as important as oil for Azerbaijan's future – or possibly even more so, for example in the case of agriculture.

- 2.7. The Presidential elections in October 1998 were widely considered to have taken place under conditions which did not fully comply OSCE criteria. However, although they were boycotted by a number of opposition figures, they did provide a platform for the future development of a credible opposition.
- 2.8. In part due to Azerbaijan's relative isolation from Russia (Chechen conflict, closure of frontier with Daghestan) the effects of the economic crisis are not yet fully apparent. However, Russia accounts for 20 % of Azerbaijan's trade and there are believed to be more than a million Azeris working there. The vast majority of Azeris are still extremely poor. There are more than 800,000 refugees and IDPs from Nagorno-Karabagh and the surrounding territories occupied by NK forces, many still living in deprived conditions in camps, and these represent a huge burden on the state.
- 2.9. Income from offshore concessions (estimated by Azerbaijan at more than \$ 30 bn) has provided an important cushion against revenue shortfalls. But prospects for the oil sector remain uncertain. Whereas prices have risen recently, and are currently above \$15 a barrel, wells in some concessions have proved barren (the CIPCO and NAOC consortia have already withdrawn) and there is still disagreement over the "main export pipeline". Azerbaijan expects to be completely self-supporting by 2005, but it is still unclear to what extent these hopes will be realised. Moreover, as yet only the AIOC⁴ has built, and will control, export pipelines to the West. This is a matter of considerable economic significance in view of Azerbaijan's efforts to maximise its export potential.
- 2.10. The Community and other donors have sought in recent years to overcome administrative, cultural and political impediments to the further modernisation of Azerbaijan's government apparatus and to the liberalisation of state-owned commercial enterprises. This process is vital for the development of a true market economy in a country where the introduction of new norms and practices has been difficult and slow.
- 2.11. Thus, there is a risk that the window of opportunity offered by Azerbaijan's potential oil wealth may, at least in the short term, close without major progress on any of the country's major objectives: alleviation of poverty, especially outside Baku and in the refugee camps; opening of borders following a settlement of the Nagorno-Karabagh conflict; return of the refugees; realisation of oil revenues in the short term; diversification of the economy; tackling corruption, and the major disincentives to trade and investment; improvement of administration and in particular its ability to manage central government finances; and realisation of Baku's potential as a communications hub.

⁴ Azerbaijan International Operating Company. The first and largest consortium to exploit offshore oil reserves in the Caspian.

Georgia

- 2.12. Georgia's recovery from the political and economic turmoil of the early 1990s has been remarkable. In 1993 the survival of the country was in question; by 1996 it had a freely elected president and parliament, a new constitution, and a convertible currency. Its efforts to create a genuinely democratic system have been more successful than those of many of its neighbours. In 1996-97 the economic growth rate was among the highest in the former Soviet Union, and it seemed as if the perennial problems of energy and food shortages were being overcome. In 1999 Georgia has acceded to the Council of Europe and is set to join the WTO.

The President has acknowledged the key role played by the Union, both in ensuring Georgia's survival in 1994-96 through food and humanitarian aid, and in helping to set the framework for ongoing reform through technical assistance. He has specified that Georgia's foreign policy must be based upon an intensification of relations with the EU and other European institutions.

- 2.13. In 1998, however, the Russian crisis demonstrated the scale of the problems which remain. The country has had to cope with a heavy refugee burden, the unresolved conflicts with Abkhazia and South Ossetia and the consequences of drought. It has thus had few resources with which to mitigate the social effects of devaluation of the Russian rouble. These are proving particularly serious given Georgia's reliance on trade with Russia (which accounted for 30 % of exports in 1997) and on remittances from Georgians working in Russia.
- 2.14. Moreover, the crisis has revealed serious underlying concerns which need to be tackled at source : pervasive corruption; strong resistance in the provinces to control from Tbilisi; and unreformed administration, especially in the revenue departments (tax, customs). Georgia's revenue collection rate was worryingly low in 1998, especially in the second half of the year, and is the lowest in the former USSR. This has led to a major loss of credibility with international financing institutions and has delayed disbursement of EC assistance linked to compliance with IMF programmes. As a result, President Shevardnadze's principal need is at the moment for additional financial support to pay salaries and pensions. He makes no secret of his fear that without this support, there may be a social explosion which could lead to the collapse of the Government.
- 2.15. The local elections of November 1998 showed that many voters have been alienated by the government's seeming inability to cope with Georgia's economic and internal political problems. The Parliamentary elections due in Autumn of 1999 will be an important test of the President's popularity. A wide range of interests inside Georgia oppose his efforts to modernise the state and to crack down on corruption and tax evasion, for reasons which range from the wish to preserve or acquire local autonomies to organised crime. It is undeniable that the failure to resolve the conflict in Abkhazia has encouraged local separatism, and that certain parts of the country are effectively outside central government control. Furthermore, it is widely believed in Georgia that certain forces in Russia are taking full advantage of this situation to interfere in Georgia's affairs, and the Georgian government has stated that it sees the continued presence of Russian

bases, without the agreement of the Georgian Parliament, as a destabilising element.

- 2.16. Thus despite his important achievements, President Shevardnadze – who is now over 70 and has survived assassination attempts in 1995 and 1998 – still faces many of the same centrifugal forces in 1999 as he did in 1993. Yet Georgia is Europe's gateway to the Caspian and Central Asia; it is the first Caucasian country to accede to the Council of Europe, and the only Newly Independent State which has already started the process of harmonising its legislation with European norms. Thus, developments there are of particular relevance to the EU's policy towards the region as a whole.

The conflicts

Nagorno-Karabakh

- 2.17. It has been an objective of Armenian diplomacy to persuade international mediators to put forward peace proposals without “preconditions” (a reference to the conclusions of the Lisbon OSCE Summit of December 1996, which inter alia reiterated the principle of Azerbaijani territorial integrity; these conclusions were not accepted by Armenia). The peace plan put forward by the co-chairmen of the OSCE Minsk Group (France, Russia and US) in 1997 would have instituted a normalisation process, including the demilitarisation of the occupied territories, while leaving the issues of political status and links with Armenia for later. Although the then President, Mr Ter Petrossian, was prepared to accept this as a basis for discussion, he thereby lost the support of those in Armenia who considered that it would preempt a settlement on the political status of Nagorno-Karabagh. Among these was the Prime Minister, Robert Kocharian, formerly “President” of Nagorno-Karabagh. When Mr Ter Petrossian resigned in February 1998, Mr Kocharian was elected President of Armenia.

The proposals put forward by the Minsk Group co-chairs in 1998 were based on a comprehensive package, and they secured the support of the Armenian government. However, the proposed definition of the enclave's status (“common state”) was rejected by Azerbaijan as going too far towards parity between Baku and Stepanakert. In February 1999, Russia confirmed that it has delivered surface to air missiles and fighter aircraft to Armenia; following this, President Aliiev appealed to the Presidents of France, Russia and the US to intervene personally in order to re-launch the peace process on a new basis.

It would thus appear that in both 1997 and 1998, the Minsk Group co-chairmen have had difficulty in devising an approach which both sides could consider sufficiently balanced as to serve as a common basis for further negotiations. The Minsk Group's failure to achieve progress since 1994 has laid it open to criticism in the region and from the international community.

Abkhazia

- 2.18. The key points at issue in the Abkhazian conflict are the conditions for the return to their homes of some 300.000 ethnic Georgian refugees and IDPs, who were forced to leave the region in the 1992-93 war. They substantially outnumber other nationalities remaining in Abkhazia, and any solution to the conflict, defining Abkhazia's status within the internationally recognised borders of Georgia, would require the identity, rights and security of all ethnic groups to be protected. There is as yet no expectation that the Abkhazian authorities can be freely persuaded to accept Georgian territorial integrity as a principle, nor the return en masse of the refugees. The situation deteriorated in May 1998 when Abkhazian forces expelled 30.000-40.000 Georgians who had resettled in the Gali area. The Abkhaz authorities have begun processing the return of refugees themselves, as of March 1999, but in the absence of any agreement on the conditions under which this should take place. Face-to-face talks, complemented by a formal structure of committees on each of the key issues set up under the aegis of the UN and by conferences on confidence-building measures have continued. It was hoped that a protocol on the conditions for the return of refugees to Gali, brokered by the UN with Russia as "facilitator" and with the assistance of the group of "Friends of the UN Secretary-General", would be signed at the end of 1998, but this has not yet proved possible.

South Ossetia

- 2.19. The Georgian government's discussions with the South Ossetian authorities (and also those of the Russian republic of North Ossetia) have made progress on refugee return and on economic cooperation, with Russian participation. In February 1999, both parties agreed the text of an "Interim Document". Working groups have been created to develop proposals for its implementation, and the OSCE convened a session of the Joint Control Commission in March 1999. It remains to be seen whether this will lead directly to a political settlement on status issues.

THE EUROPEAN COMMUNITY'S ASSISTANCE TO DATE

- 3.1. The EU has spent very considerable sums of money in the region. EC grant aid alone amounts to € 845 million, from independence to the end of 1998 – even without counting regional programmes like Inogate and Traceca⁵. Much of this has been in the form of targeted emergency aid, direct food aid and rehabilitation whose purpose is essentially humanitarian and short term.
- 3.2. Since 1996, with the exception of the exceptional assistance foreseen in 1999 for countries affected by the Russian crisis (see para 3.11 below) humanitarian aid has played an increasingly less significant role in the EC's assistance programmes⁶. Direct food aid has been superseded by food security programmes aimed at enhancing sustainability. In parallel, the counterpart funds raised in 1995-96 by sales of EC food aid continue to be recycled in the form of loans to private farmers, and this has been one of the most effective forms of EC assistance. Food security programmes are subject to a number of conditionalities; this is particularly important given that they take the form of budgetary transfers. Clear accountability all along the chain is required (reforms in place; transfer into the budget, and from the budget to the agricultural sector, conformity with IMF programmes) which is why delays in disbursement have occurred in all three countries, and especially in Georgia and Azerbaijan.
- 3.3. In 1997 two new instruments became available. The Caucasus became eligible for support under the Rehabilitation regulation⁷, and the Council and the European Parliament approved exceptional financial assistance for Georgia and Armenia, which allowed them to contract new 15 year loans, with grant support, providing that all outstanding financial obligations towards the EC were settled and commitments taken on through IMF-supported reform programmes respected⁸. These countries are now fully current on their financial obligations towards the Community. The Budgetary Authority has however not been in a position to provide part of the grant finance foreseen in the Council Decision; this has led to problems with implementation and may thus delay the reduction of the Community's financial exposure.
- 3.4. The provision of exceptional EC financial assistance to Armenia and Georgia led Azerbaijan to request comparable treatment. In 1998 the Council endorsed the principle of additional assistance through existing EC instruments. This is now being implemented with Tacis funding. The 1998 10 Mecu special assistance programme for Azerbaijan is an innovative response to Azerbaijan's needs. Funds are transferred to a special bank account, from which tranches are released as and when viable projects are identified. The

⁵ It is difficult and misleading to try to break down the benefits of regional programmes between individual participating countries.

⁶ Despite ECHO's interventions in 1998, in Georgia following the expulsions from Gali and in Azerbaijan following the earthquake in the Lerik and Yardimli regions.

⁷ Council regulation 2258/96 of 22.11.1996

⁸ Council Decision 97/787/EC of 17.11.97

projects must be coherently linked with the Tacis Indicative Programme and with EC activities under the Rehabilitation Regulation. Contracts are awarded locally.

The Commission has proposed that the new "Tacis" regulation include the possibility of special support programmes in the event of unforeseen political or economic crises. Such programmes would not take the form of macro-financial assistance, but could be used to help reduce the burden of local expenditure for humanitarian projects or for the continued functioning of essential services. This kind of project would be seen, as the 1998 special programme in Azerbaijan is seen, as making a direct contribution to the local economy while simultaneously conferring high visibility upon the EC.

- 3.5. Although the EU has no instruments directly addressing conflict resolution, it has launched rehabilitation projects in Georgia and Azerbaijan whose purpose is to begin the process of post-conflict reconstruction. The Commission is currently seeking to accelerate the implementation of the projects the EC has launched in South Ossetia and at the Inguri dam and power station, on the border between Abkhazia and the rest of Georgia. It has also sponsored meetings between Georgian and Abkhazian academics where issues relating to the conflict and to federal structures have been discussed in a non-confrontational atmosphere. In Azerbaijan, the Fizuli and Agdam projects are perhaps the most visible and effective of all EC initiatives in the country.
- 3.6. Tacis is the only form of financial assistance which is explicitly foreseen in the PCAs. Since 1996 Tacis has been used increasingly to meet policy objectives, in particular those endorsed by the Council in July 1995. Thus projects now exist in all three countries which foresee the progressive establishment of European Policy and Legal Advice Centres, aimed at the transposition into national legislation of international commitments taken on through the PCAs and WTO membership. The EPLACs' work on the PCAs is concentrating on three broad priority areas: the OSCE and UN principles, which are incorporated by reference; European norms, referred to in the legislative approximation article; and investment-related provisions (establishment and operation of companies, protection of intellectual property, and movement of capital). Major projects have also been launched which aim at strengthening democratic institutions and the rule of law. These include projects on the training of judges (Georgia and Armenia) assisting parliament (Georgia) and reform of central and local government administrations.
- 3.7. Tacis has already launched a number of important initiatives in *regional cooperation* which have made progress in 1998. It has:
- facilitated the negotiation of the Basic Multilateral International Transport Agreement (MTA) which fixes tariffs and facilitates procedures for trade on the Traceca route. This was endorsed in Baku last September. Traceca has thus moved forward from the technical assistance phase to the phase of support for the implementation of the MTA, which was signed by the heads of state or government of twelve countries, including the Prime Minister of Armenia.
 - used Inogate to promote an "umbrella agreement" creating a framework for settling disputes on jurisdiction over pipelines, especially where they cross borders. This is essential in order to attract investment. Participants initialled the

UA on 17 February 1999 at the Inogate Conference, and Heads of State are expected to sign the document in Kiev on 22 July 1999. The EC's Synergy programme, in cooperation with the Energy Charter Secretariat, has also launched a project focusing on the implementation of the transit provisions of the Energy Charter Treaty.

- prepared a feasibility study on Transcaspien pipelines.
- launched projects in the field of Justice and Home Affairs, including drug trafficking, in Central Asia; these could, as appropriate, be complemented by projects in the South Caucasus.
- The region has also benefited from environmental projects, including projects on mitigating pollution in the Black and Caspian Seas and on developing common environmental policies. A Regional Environment Centre is to be established in Tbilisi, with EC support.

3.8. Three new initiatives are under consideration :

- the possibility of using Traceca to help rehabilitate the Baku-Nakhichevan and Yerevan-Julfa railways. This is still under discussion.
- the construction of a fibre-optic telecommunications network along the main rail axes in the Caucasus (Baku-Tbilisi and Tbilisi-Yerevan).
- possible use of the Tacis Interstate Programme for eventual north-south links (Russia-Georgia) via Abkhazia. These could include transport, energy and telecommunications.

3.9. By way of illustration of the current trend in EC assistance away from aid and towards PCA-guided development, it will be noted that in 1996, earmarked humanitarian and food-related support accounted for 84 % of total grant aid. Tacis accounted for 16 %. Rehabilitation accounted for only 2 %.⁹

In FY (financial year) 1998, Tacis will account for 28 %:¹⁰, rehabilitation for 12%¹¹ and humanitarian and food-related support for 47 %:

⁹ Included in the 1996-97 Tacis Action Programme for Azerbaijan : rehabilitation in the Fizuli district

¹⁰ Including 10 M€ exceptional Tacis programme for Azerbaijan

¹¹ Including 2 M€ within the 10 M€ exceptional Tacis programme for Azerbaijan

	Georgia	Armenia	Azerbaijan	Total
Tacis	8.00	5.00	8.00	21.00
Except. Tacis			10.00	10.00
Food Security	14.00	12.00	14.00	40.00
ECHO	6.41	1.60	4.40	12.41
Except. Financial assistance (grant component accompanying 15 year loan)	9.00	8.00		17.00
Rehabilitation	6.50		4.50	11.00
Total grant aid	43.91	26.60	40.90	111.41

In addition, the South Caucasian states have been important beneficiaries of the Tacis Interstate programmes. Some 10 mn Euros were allocated to Traceca and 12 mn for Inogate in 1998, but it is difficult to distinguish how much of this went to the region.

3.10. Thus the Commission considers that for the moment, EC assistance should continue to take the form of a mix of short and medium term measures, combining humanitarian and food related support with Tacis projects targeting financial management, administrative changes and improvement in the business climate. The latter includes the enforcement of individual and treaty rights under domestic law.

In the medium term, assistance should however become increasingly related to, in the first instance, conflict resolution and subsequent "normalisation", as well as to those obligations laid down in Articles 2 and 3 of the PCAs. Due note should be taken of the political obligations taken on by the three countries under the terms of their eventual accession to the Council of Europe, and also to the economic obligations taken on under agreements with international financing institutions.

3.11. By the year 2000, the Tacis regulation will need to be renewed. 1999 will also be the final year of the current triannual food security programmes in Georgia and Azerbaijan. ECHO is pursuing its policy of gradual withdrawal, and has already closed its office in Yerevan. Nevertheless, the Community decided to provide 20 mn Euros of exceptional assistance in 1999 to the NIS, including Armenia, Azerbaijan and Georgia, to address additional humanitarian needs related to the effects of the "Russian" crisis. The Commission will keep the situation under review. The future needs of the Caucasus should be an integral part of the Community's planning for the first decade of the 21st century. A number of aspects related to the EC's experience in the Caucasus have, for example, been

reflected in the Commission's proposal for the new "Tacis" regulation – not least the added emphasis on the use of this instrument to promote regional cooperation.

Moreover, as noted in the Commission's communication on the Black Sea¹², it is important that this assistance, particularly in the field of regional cooperation, does not take place in a vacuum. It needs to be co-ordinated with other policies, and cooperation initiatives extended as appropriate westwards, if the EU and its neighbours are to benefit fully from the resulting synergies.

ASSESSMENT

- 4.1. Much of the EC's assistance in the years since the cease-fires in Abkhazia and Nagorno-Karabakh has been short term in nature. In the longer term, however, and in the context of the PCAs the Commission takes the view that financial and technical assistance should aim to assist the beneficiaries to create the conditions needed for the mutual and reciprocal obligations of PCAs to be met.
- 4.2. The texts of the PCAs imply that the South Caucasian republics should become modern, self-reliant, democratic market economies, in the sense that their legislation should be based upon political (OSCE and Council of Europe) and economic (EC and WTO) norms.

The PCAs institute a process of "rapprochement" between the EU and the Caucasus. The EU requires the partner countries to complete the transition process, both in the political and economic spheres. The conditions need to be created which would allow the EU to develop its role as a trade and investment partner. In parallel, partners should fully contribute towards reinforcing European security, in the region and beyond. In short, not only economic reform but "normalisation" is an effective precondition for the successful implementation of the PCAs .

- 4.3. Any assessment of progress so far must recognise that important successes have been achieved. Thus, Georgia has pulled back from the abyss it faced in 1993-94; it has created a democratic system of government and has been able to stabilise the Lari both in 1995 and in 1998-99. Armenia has been able to build upon its early reforms to ensure continuity in economic policy and to create an efficient central administration, despite its lack of resources and its geographical isolation. Azerbaijan has, for the present, overcome the political instability of 1992-96 and has set in the hand the development of potentially huge energy resources in the Caspian.
- 4.4. Yet a huge amount of work still needs to be done :
 - a) **The introduction of the market economy** is still slow, as throughout the former USSR. In the Caucasus macro-economic stability had been largely achieved by 1995-96. Yet large-scale privatisation programmes only began to be systematically implemented in 1998. Reforms have in each

¹² "Regional cooperation in the Black Sea area": COM(97)597 of 14.11.1997

case not been implemented evenly throughout the country, and there is a growing disparity between the regions and the more affluent capital cities. The process of introducing international norms is more advanced in Georgia and Armenia, thanks in part to the WTO process. Yet so far only Georgia has stated explicitly that its policy is to incorporate EC norms into the legislative process, and has taken measures to implement this policy. Azerbaijan is still at the first stage of the WTO accession process. In all three countries, but especially Azerbaijan, further work is needed to introduce modern accounting systems.

- b) The "**Russian crisis**" has highlighted the need to remedy the defects of existing administrative mechanisms for collecting and spending revenue. Reform of the customs and taxation services is now necessary in Georgia, and Armenia too has recognised this. In Azerbaijan such reforms are equally needed.
- c) These financial problems are inseparable from the overall **business climate**. Corruption, red tape, unreformed standards, and lack of judicial recourse lead the lists of complaints put forward by European businesses. But they also stifle initiative on the part of domestic producers and service-providers, and nowhere more than in the key agricultural sector. For these reasons the Commission has identified the administration of tax and customs and the judiciary as the targets of current and future technical assistance.
- d) In none of the Caucasian republics is the **rule of law** assured. As yet, no strong, independent judiciaries and audit institutions exist.
- e) There is a general recognition in the Caucasus that for the future development **open borders** and increased market access are indispensable. Yet Georgia still cannot access its principal trading partner, Russia, via Abkhazia; Armenia's borders with Turkey and Azerbaijan remain closed, leaving Yerevan dependent on poor-quality land routes to Georgia and Iran. Azerbaijan is in ongoing dispute with Turkmenistan and Iran and its relations with Russia are worse than at any time since the May 1994 cease-fire. Politically, according to analysts, the countries of the region are, if anything, even more isolated now than they were five years ago. Hence the strong support demonstrated by all three governments for non-political economic cooperation initiatives, of which the EC's Traceca and Inogate programmes are the pre-eminent examples.
- f) The **threat to European security** posed by instability in the Caucasus in the larger sense has increased, given the links between the conflicts and the politics of energy in the region. Russia's alliance with, and its military assistance to, Armenia have served to reinforce Azerbaijan's resentment against Russia and to strengthen its informal alliance with Georgia, Ukraine, Uzbekistan and Moldova ("GUUAM"). Russia has not been able to reach agreement with Baku on the jurisdictional issues relating to the control of the Caspian and its resources. Despite Lukoil's membership of the AIOC, Russia has hitherto opposed the construction of pipelines which do not pass through her territory, and in particular the US and Turkish-backed proposal to build a pipeline from Baku to Ceyhan on Turkey's

Mediterranean coast.

In this, Moscow's interests partly coincide with those of Iran. With at least 13 million Azeris concentrated in its north-western provinces, Iran has apparently no desire to support the Republic of Azerbaijan. Hence the open communications, and cordial relations, Iran maintains with Armenia. It too objects to the Baku-Ceyhan project. It is also in dispute with Azerbaijan over the territorial division of the Caspian. Thus, as the oil comes on stream, the risk of involvement by powers outside the region is increasing.

- g) The recent history of negotiations on both Abkhazia and Nagorno-Karabagh has served to demonstrate the difficulty of "**normalisation**" (return of refugees, resumption of economic activity) without a settlement regarding political status questions and security guarantees for returning refugees and IDPs, as well as for the ethnic Armenian or Abkhazian populations. The refugee burden remains as heavy as it ever was.

Neither Georgia nor Azerbaijan have given priority to the integration of refugees into the population at large, and they continue to seek international aid for their support.

- h) There is a need to address pressing **environmental** problems, especially those affecting the Black and Caspian Seas. This is an important field for future regional cooperation, extending beyond the Caucasus itself.

- 4.5. It is difficult to avoid the conclusion that the root of many, if not most of these problems facing the three republics are to be linked to the continuing failure to resolve the ethnic conflicts. The present stalemate is not, in reality, a status quo. It institutionalises an abnormal situation. Borders and communications remain closed. 1,5 million refugees continue to live in conditions of extreme poverty and squalor. Businesses operate under particularly difficult constraints, and are not able to access regional markets. Organised crime flourishes due to shortages and interruptions of supply.

Apart from these economic questions, the existence of the conflicts preserves an effective state of emergency which in turn hampers an open debate on the democratic institutions of state. There are also concerns about emigration. Some of the best brains in the region have left.

Moreover, the inability of the three countries to break out of this vicious circle means that they will continue to rely upon international assistance; while at the same time, that assistance is less effective than it would be under more favourable circumstances.

- 4.6. In short, any policy which addresses only bilateral assistance issues and does not touch upon the source of the problems will not bring the "dividend" which PCA implementation should imply. It follows that the EU will need to fashion its policy under the PCAs in such a way as to ensure that its actions and its assistance become an incentive for positive change.

CONCLUSIONS

The importance of contractual relations

- 5.1 For the first time, the PCAs offer the EC and its Member States a platform from which to address coherently political, economic and assistance-related issues. This will, inter alia, allow them to capitalise on the Community's instruments, in a way which was not previously possible, in order to improve the prospects for peace and enhanced regional cooperation. Initiatives such as Traceca, Inogate and in the telecommunications sector can be used to help break the log-jam of closed communications, frozen commercial activity and economic deprivation.

Regional Cooperation and implications for conflict resolution

- 5.2. The Community's **regional cooperation and rehabilitation** instruments are strongly supported at the highest level in all three countries and currently offer the best option for progress on economic questions and for confidence-building measures. Their use would imply a broader EU role in support of international efforts on conflict resolution and closer co-ordination between the Union's policy instruments under first and second "pillars".
- 5.3. This is necessary because although such measures cannot serve as alternatives to political solutions - they can only complement and reinforce international mediation through OSCE and UN - technical initiatives in the field of transport, energy or communication/networks still require the **political support** of the Union. This can be expressed through the PCA mechanisms; but it would also be helpful if the profile of such measures could be raised, within the CFSP, possibly through adopting a Common Position under Art. J.2. One option would be for the Union to discuss with the three republics, at political level, a timetable for the implementation of measures such as those referred to in paras 3.7 and 3.8.
- 5.4. In meetings with the Prime Ministers of the three republics in the margins of the Inogate Conference, in February 1999, the Commission reminded them that irrespective of the arguments which the protagonists in the conflicts are well able to deploy, the Union needs to assess whether the will exists to make real progress in ending the current stalemate. The EU will inevitably take this into account when taking decisions on how to allocate increasingly scarce resources. The 22 June Presidential meeting offers a prime opportunity for the three heads of state to confirm this. The EU needs to reinforce the importance it attaches to conflict resolution by sending a clear **political signal on the form the Community's assistance can be expected to take** in the medium term. It could concentrate on support programmes for the return of refugees to their places of origin through rehabilitation projects, and on the preparation of investment plans, as appropriate together with other international donors, to attract investors to former conflict zones. Another objective could be to use such measures to ensure the full integration of those refugees and IDPs who do not seek to return to their original homes.

- 5.5. The **political dialogue** foreseen under the PCAs contains a regional dimension (Art. 4, final indent). This should be used as a framework for a concrete dialogue on the main themes of the South Caucasus's relationship with the EU. Providing sufficient progress can be achieved in technical discussions and, in parallel, in the Minsk Group (Nagorno Karabakh) and the Geneva Conference, the EU could announce its readiness to discuss possibilities to open borders and increased market access in the region with the three republics. As appropriate, Russia, Turkey and Iran could be included in this dialogue.
- 5.6. The EU should benefit from the synergies derived from linking its activities in the South Caucasus to those in Central Europe, the Balkans and the Black Sea area generally. The agreements sponsored by Traceca and Inogate, the development of a Pan-European Transport Area (PETrA) in the Black Sea, the Energy Charter Treaty, links between the EU and BSEC and initiatives such as the Black Sea Regional Energy Centre can all play a role in achieving this.

Bilateral cooperation

- 5.7. The institutions established under the PCAs should move quickly to define the principal priorities for longer-term bilateral cooperation. These should include projects aimed at improving financial and fiscal management, administrative efficiency, and the business climate. Relevant to all these, but above all to the "essential elements" underlying each PCA, is the strengthening of the rule of law. This is a sine qua non for the development of the EU's relations with the partner countries to evolve into multi-faceted "two way" relationships as foreseen in the Agreements. The new "Tacis" regulation will be the key vehicle for these longer-term projects.
- 5.8. Given the very difficult economic and social conditions in the South Caucasus, the Community should continue to respond to the needs of the region in a sensitive and adaptable way. It is important that the EC should in the short term continue to use the assistance instruments at its disposal to reinforce economic and political stability in the three republics, since without this it will be very difficult to make progress, either on regional cooperation or on post-conflict reconstruction. However, the objective must remain that of moving steadily towards balanced relationships based primarily on trade and investment, including further administrative reforms and reform of the financial services.
- 5.9. Regarding the further reform of democratic institutions and **strengthening the rule of law**, the objective of technical assistance should be to help each republic to develop, as a priority, a fully independent judiciary and a powerful and independent audit body. The EC should strongly urge partners to roll back government control of commercial operations and to "contract out" administrative activities wherever there is any doubt that they can be carried out in an impartial and effective way. It should play a more consistent and higher profile role in election observation, in cooperation with ODIHR. This should be complemented by the dialogue between the European Parliament and the Parliaments of each of the partners, through the Parliamentary Cooperation Committees.

- 5.10. The EU should use the Cooperation Council and Committees to reinforce the **European Policy and Legal Advice Centres** and their role in promoting EC and international norms.
- 5.11. The PCA institutions should be used to reinforce the message that improvement of the **business climate** has very high political priority, and that more efforts must be made to set the right conditions to attract private investment.
- 5.12. Energy is an important factor for integration, through the development of regional markets and the realisation of the Caspian Basin's export potential. The EU should continue to pay particular attention to the promotion of international cooperation in this domain.

The Community should help to draw up a comprehensive strategy, including financing aspects, which should lead to the closure of the **Medzamor nuclear power station** in Armenia, by the year 2004. It should if possible seek to define a regional plan, with other national or international donors, which would ensure access to alternative energy sources. An EC-Armenia Working Group is mandated with this task.

EU policies, not least in the energy sector, must take into account the fragile environmental balance in the region, especially in coastal zones. Thus, bilateral and regional cooperation initiatives should be developed with due regard to the principles of environmental protection and to the region's specific needs (Art. 55 of the PCAs).

ISSN 0254-1475

COM(1999) 272 final

DOCUMENTS

EN

06 11 01 02

Catalogue number : CB-CO-99-279-EN-C

Office for Official Publications of the European Communities
L-2985 Luxembourg