

# The South Caucasus and Iran in the Post-Sanctions Era

## Pursuing Greater Interconnectedness amidst Continuing Constraints and Scaled-down Expectations

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The lifting of international nuclear-related sanctions on Iran in January 2016 was enthusiastically welcomed by the Islamic Republic's neighbours in the South Caucasus. Armenia, Azerbaijan, and Georgia have hoped that Iran's rapprochement with the West and the unfreezing of some hundred billion dollars worth of assets abroad would lead Iran to step up its trade and investment activities in the Caucasus, especially in the energy and transport sectors. However, the anticipated benefits have been slow in coming, as Iran has shown reluctance to fund infrastructural projects in the Caucasus. On the other hand, there have been positive developments in trade and tourism flows and the power transmission sector. On the whole, although Iran is interested in closer economic cooperation with the South Caucasus, it relies on the region's countries to provide the momentum and secure the resources necessary to achieve this goal.

The lifting of the sanctions on Iran on 16 January 2016 gave rise to varied expectations in the South Caucasus. As congratulatory messages flowed to Tehran from the region's capitals, pundits and observers debated what Iran's emergence from international isolation and its comeback to the global economy implied for the South Caucasus. According to one widespread view, with Iran and Europe growing closer together, the South Caucasus could use its geographic position to transform itself into a transit corridor for flows of goods and energy resources between the two. In the past 1.5 years, the region has witnessed a

proliferation of meetings at the ministerial and presidential levels, accompanied by the signing of numerous memorandums of understanding in key sectors. In a symbolic gesture, in 2016 Georgia and Armenia lifted the visa requirement for Iranian citizens.

In official statements, Iran and the South Caucasus countries often emphasise their historical and cultural ties and friendly relations. The territories of Armenia, eastern Georgia, and most of Azerbaijan were under Persian rule until the 19th century. Iran is home to the world's largest population of ethnic Azeris, numbering up to 25 million, as well as smaller populations of

ethnic Georgians (up to 100,000) and Armenians (ca. 65,000). It was quick to recognise the three newly independent republics in 1991 and has been able to maintain a working relationship with each of them. Iran's policy in the South Caucasus has been pragmatic and stability-oriented, in sharp contrast to its ideology-driven policy in the Middle East.

Despite the media attention generated by ambitious cooperation plans, it is important to keep in mind that Iran does not have significant economic clout in the South Caucasus. If the lifting of the sanctions is meant to be a game changer, it will have to start from a very low base. Iran's trade turnover with the entire region was only \$634 million in 2015, placing it far behind top trading partners such as Russia, the EU, China, or Turkey. Its official foreign direct investment (FDI) in Georgia and Armenia is minuscule, although it has been more substantial in Azerbaijan (mainly in the oil sector). The Caucasus countries' aspirations to become a transit corridor between Iran and Europe would require enormous investments and a major shift in trading patterns. Presently, Iran's overland trade with Europe takes place through Turkey, there is no direct rail link between Iran and either Armenia or Azerbaijan, and road connections are poor. Due to US policies, Iran has been excluded from major Western-supported pipeline projects in the region, which means that there is currently no infrastructure in the Caucasus to bring Iranian energy resources to European markets. Moreover, Iran is concerned about the uncertain future of the nuclear agreement under the Trump Administration and, under the pressure of expectations at home, has chosen to prioritise domestic infrastructural development. As a result, incremental changes in Iran's economic cooperation with the South Caucasus constitute a more likely scenario.

## **Armenia:**

### **Iran's complementary neighbour**

Iran's relations with Armenia – its closest partner and ally in the South Caucasus – remained largely unaffected by the increasingly stringent international sanctions, which were progressively introduced from 2006 onward. Armenia refrained from criticising Iran's nuclear programme, using regular mutual high-level visits as occasions to push for the expansion of bilateral ties. Landlocked Armenia is under blockade from two of its four neighbours, Azerbaijan and Turkey, and relies on Georgia and Iran, with which it shares a 219 km and 44 km border respectively, for the transit of goods and energy. The road link to Iran became a lifeline for Armenia in the early 1990s during the conflict with Azerbaijan, as well as briefly in 2008 during the armed hostilities between Georgia and Russia. A close relationship with Iran is meant not only to counterbalance the strong Turkish-Azerbaijani cooperation in the region (which often involves Georgia as a partner) but also sends a message to the domestic audience that Armenia is not solely dependent on Russia.

As for Iran, strong ties with Armenia are important both for promoting stability in its Caucasus neighbourhood and to showcase Iran's ability to act as a responsible regional player. Directly bordering the unrecognized Nagorno-Karabakh Republic, Iran has sought peaceful settlement of the conflict, negotiating a short-lived ceasefire in 1992 and repeatedly offering mediation services. Finally, Armenia could become Iran's gateway to Georgia's Black Sea ports, and from there to southern Europe. This would provide Iran with an alternative to its main transport route through Turkey, which has been fraught with many problems, including a major dispute over transit fees, long queues at the border, and attacks on Iranian truck drivers.

### **Ambitions on hold**

Both Armenia and Iran acknowledge the mismatch between their close political partnership and the limited scope of economic cooperation. Indeed, bilateral trade turnover has hovered around a modest \$300 million level, as Armenian producers find it difficult to access Iranian markets, which are protected by some of the world's highest import duties, whereas Iranian consumer goods in Armenia face stiff competition from the more affordable Turkish or Chinese alternatives. Tourism is a promising sector though, with Armenia being the region's most popular destination for Iranian visitors. The US Embassy in Yerevan is also one of the most accessible locations for Iranians to apply for a US visa.

Both Armenia and Iran stress the importance of energy cooperation, although so far it has mostly been limited to the "gas for electricity" arrangement. The 140 km pipeline, which was officially inaugurated in 2007, delivers gas from Tabriz, Iran to Armenia, where most of it is then converted to electricity and transmitted to Iranian northern provinces. Contrary to Iran's initial plans, the pipeline cannot be used for major exports beyond Armenia, as its diameter was reduced under Russia's pressure. Today, the entire gas distribution network in Armenia is controlled by Gazprom Armenia, a full subsidiary of the Russian state-owned gas monopoly.

Armenia has long wanted to vastly expand the scope of its cooperation with Iran. While still under the sanctions, the latter faced a challenging situation: given its forced isolation, Armenian initiatives were attractive, yet the burden of the sanctions made financial commitments difficult. As a result, there has been a glaring disparity between the number of agreements and memorandums of understanding signed in the last decade – often to great media fanfare – and the little to no progress made on the ground. This applies to such big-ticket infrastructural projects as hydropower plants near Meghri on both sides of the Araxes River (2007), the \$3.2 bil-

lion Southern Armenian Railway connecting to the border with Iran (2009), an Iran-Armenia oil pipeline (2011), and an oil refinery near Meghri to process Iranian crude.

### **Post-sanctions prospects**

When the sanctions on Iran were lifted in January 2016, Armenia's expectations focused largely on the fate of the joint projects awaiting implementation. According to one optimistic take, with its unfrozen assets and an ability to export oil to Europe, Iran would be finally able to follow up on its investment promises in Armenia. A more sceptical view has cautioned that a de-isolated Iran could opt for economically more attractive partners.

The sceptics seem to have a point. The most prominent project announced already in 2008 – the 305 km Southern Armenian Railway – has failed to secure external funding. Russia, which controls the Armenian rail network, has limited interest in the project, as it would not connect Iran to Russia (this could only happen if Georgia agreed to allow rail transport through Abkhazia). The railway has thus essentially lost competition to a rival Azerbaijani-Iranian initiative that has gained speed since 2016. However, Armenia is also implementing a major highway construction programme called the North-South Road Corridor, which is financed by international donors and is expected to nearly halve transit times and significantly improve road connections, both to Iran and Georgia. Although Iran stands to benefit from the project, it is not involved in its funding.

Having heavily invested in its domestic power-generation capacity in recent years, Iran seems to have lost interest in the Meghri Hydro Power Plant project, which already had to be scaled down in 2014 for technical reasons. Also, now that Iran has access to European know-how, projects such as having an oil refinery built in Armenia appear to be losing their rationale.

The only project that has truly gained momentum since the nuclear agreement is

the third high-voltage power transmission line between Armenia and Iran. In August 2015, Armenia and Iran signed the contract for its construction, with Iran's Export Development Bank covering 77 percent of the investment costs. The line is expected to more than triple the electricity exchange capacity between Armenia and Iran, which have different seasonal peaks, creating preconditions for increasing Iran's gas exports to Armenia as part of the "gas for electricity" deal. It will also connect to the grids of Armenia, Georgia, Russia, and Turkey, reflecting Iran's ambitions to increase electricity exports to this region.

According to some Armenian economists, the emphasis in Armenian-Iranian relations should move away from a preoccupation with infrastructure towards a more skills-oriented approach. One popular proposal is for the country to capitalise on its liberal business climate and a developed IT industry and to position itself as a business hub for European companies wishing to do business with Iran. For now, however, European companies' interest in Iran remains thwarted by Western banks' reluctance to fund such efforts for fear of US sanctions.

Banking is an area of cooperation that received a special mention during President Hassan Rouhani's official visit to Yerevan in December 2016. In the past, Iran was suspected of using Armenian banks to evade sanctions, although allegations were never substantiated. The Armenian branch of Iran's Mellat Bank, which mainly serves Iranian customers, has received an investment boost following the lifting of the sanctions.

The tourism sector is also continuing to develop. Armenia hosted 189,000 Iranian tourists in 2016, a record number. The bilateral visa-free agreement that entered into force in August 2016 is helpful, although Iranians had already been able to obtain Armenian visas on arrival for a small fee. Although Armenia might face stronger competition from Georgia now that the latter has dropped the visa requirement for Iranians, both might gain from Turkey's diminishing appeal.

Finally, as the only member of the Eurasian Economic Union (EEU) that directly borders Iran, Armenia has been actively pushing for a free trade agreement between the EEU and the Islamic Republic. Better terms of trade between the two would increase Armenia's importance as a transit country and give it better access to Iranian markets – something that Armenia had unsuccessfully been trying to negotiate for years. Iran is interested in stronger links with the EEU but is treading cautiously, as it has no experience with free trade agreements. In the meantime, Armenia and Iran are planning to set up a free trade zone near Meghri and signed a customs cooperation agreement in April 2017.

### **Azerbaijan: Iran's ambivalent neighbour**

Iran's relations with Azerbaijan have been the most tension-ridden of all countries in the South Caucasus, leading many observers to expect Baku to be negatively impacted by Iran's de-isolation. Azerbaijan has criticised Iran's close ties with Armenia and accused Iran of trying to influence Azerbaijan's Shia religious activists and the Talysh, an Iranian ethnic group in the south. In turn, Iran has been apprehensive about Azerbaijan's thriving military and security cooperation with Israel and its perceived attempts to stir discontent among Iran's large ethnic Azeri population. The two countries have also disagreed about the way to delimit the Caspian Sea with its valuable energy resources. Unlike Armenia or Georgia, Azerbaijan has kept its unilateral visa requirement for Iranians.

On the other hand, Azerbaijan, whose oil production has been in decline since 2009, is also seeking to develop its non-oil sector and become a regional transport hub. Cooperation with Iran is important to these plans, and it has the added benefit of undermining similar initiatives by Armenia. Iranian-Azerbaijani relations began to improve in 2013, after Rouhani became president in Iran. Since then, President

Ilham Aliyev and President Rouhani have met eight times.

So far, trade between Iran and Azerbaijan has been limited in scope, with the turnover standing at \$229 million in 2015, although it reportedly grew by 70 percent in 2016. Iran's National Oil Company holds a 10 percent stake in the development of Azerbaijan's Shah Deniz 2 gas field, and the two countries have had a small-scale gas-swap deal in place since 2005: Azerbaijan pumps gas to Iran's northern provinces through Astara, and Iran in exchange supplies Azerbaijan's exclave, Nakhchivan. For Azerbaijanis, especially those living in border regions, Iran is an affordable visa-free destination for shopping and medical tourism.

### **Transport sector**

Since the conclusion of the nuclear agreement in 2015, Azerbaijan has greatly intensified its efforts in pursuing a direct rail link with Iran, which the two countries agreed to construct in 2010. It is currently the main missing element in a grand vision for a 7,200 km North-South Transport Corridor connecting Iran's Persian Gulf port of Bandar Abbas with northern Europe through Azerbaijan and Russia, and providing an alternative to the lengthy maritime route through the Suez Canal and the Mediterranean. The projected 375 km Iran-Azerbaijan railway, which is less expensive and technically challenging than Armenia's rival project, would run from Qazvin – a regional capital in northern Iran – to Rasht and then to Iranian Astara at the border with Azerbaijan. From there, it would connect to Azerbaijani Astara through a bridge and an 8 km section. Most construction would take place on Iranian territory, which fits in with Iran's strategy to develop its domestic rail network. The railway has been at the top of the agenda of all recent official meetings between Iran and Azerbaijan, most prominently during the August 2016 trilateral presidential summit of Azerbaijan, Iran, and Russia in Baku.

With the Qazvin-Rasht section to become operational in 2017 and the Astara-Astara link completed, the crucial element is the 175 km Rasht-Astara section, which would cost ca. \$1 billion and take some five years to construct. Azerbaijan has offered Iran a \$500 million loan to help finance the project, but Iran has been slow in securing the remaining funding (which may also include Russian investment). Nevertheless, according to Iranian officials, construction is supposed to begin in 2017.

While cooperating with Azerbaijan on the North-South Corridor, Iran is increasingly competing against it in the Caspian, where it is trying to gain control over a greater share of shipping traffic currently dominated by Azerbaijan. Reflecting Iran's growing cooperation with Russia and its interest in developing trade with Central Asia, Iran launched a new Caspian shipping line in June 2015, and Iranian companies purchased majority stakes in Russia's ports of Makhachkala and Astrakhan in January 2017.

### **Iran and the Trans-Anatolian Pipeline**

Since the lifting of the sanctions, much discussion has focused on the prospects of Iran's potential gas exports to Europe. Iran has the world's second-largest gas reserves but consumes almost 90 percent of its gas domestically. However, with its newly regained access to funding and Western technologies, Iran is intent on increasing its production volumes and becoming a major exporter. Azerbaijan has been interested in Iran's participation in its flagship project, the Trans-Anatolian Gas Pipeline (TANAP), which is supposed to connect to the planned Trans-Adriatic Pipeline to deliver gas to southern Europe. TANAP will initially carry only Azerbaijani gas, but its capacity will be significantly expanded in the future, allowing for the transit of gas from other suppliers such as Iran. The EU, which is seeking to diversify its supplies away from Russia, has welcomed this option.

Iran first expressed its interest in TANAP in 2014, but its participation in the project

is far from certain, especially amidst persistently low gas prices. One obstacle is the lack of suitable infrastructure for transporting large amounts of gas from Iran's rich fields in the south to the north. It would be feasible to connect the Tabriz-Ankara pipeline used by Iran for its exports to Turkey to TANAP, but this pipeline has faced serious security challenges, and its limited capacity would prevent Iran from exporting much. For now, Iran's strategy seems to be to concentrate on developing its liquefied natural gas facilities for exports to Asian markets, with plans to expand to Europe later on.

### **Georgia: Iran's potential "gateway" to the West**

Georgia is the most removed from Iran among the South Caucasus countries, not only due to the absence of a common border, but also due to its pronounced Western orientation. On the other hand, Georgia's proximity to the West – and, in particular, the EU – has also served as a factor of attraction for Iran and Iranians. Generally, unlike Armenia or Azerbaijan, Georgia has lacked a consistent strategy on how to engage with Iran, at times introducing abrupt policy changes.

Georgian-Iranian economic ties began developing after the 2003 Rose Revolution, with the Mikheil Saakashvili government viewing Iran as a useful (although not top priority) regional partner, especially as relations with Russia soured. When the latter stopped gas deliveries to Georgia in the winter of 2006, it was Iran that filled the gap. Trade turnover between Georgia and Iran rose from \$10.4 million in 2003 to \$176.8 million in 2013; in 2016, it stood at \$131 million. Currently, the main Georgian export good with relative potential for growth is live sheep, whereas Georgia imports construction materials such as bitumen from Iran. Given its structure and low volumes, trade with Iran is unlikely to become a major driver of economic growth in the near future.

With its liberal business climate, lax residency requirements, and geographic closeness, Georgia attracted many Iranian companies during the sanctions period, especially in the agriculture, food, and construction industries. In official data, Iranian FDI has never exceeded \$1.8 million, although these figures do not account for investments coming from expatriate Iranians. When Georgia lifted visa requirements in January 2011, many Iranians relocated to Tbilisi, registering companies in the Poti Free Zone on the Black Sea. Some were fleeing Iran's economic woes, whereas others flocked in from Dubai – a popular destination for evading sanctions that was now tightening its regulations. In 2011–2012, three Iranian businessmen from Dubai (later placed on the US sanctions list) established a private airline and gained control of JSC InvestBank. Soon, Iran's business activities attracted media attention, with a 2013 *Wall Street Journal* article reporting that more than 150 front groups linked to Iran's Revolutionary Guards were active in the country.

Under mounting US pressure, in July 2013 Georgia froze Iranian citizens' and businesses' bank accounts with no prior notice, suspended the visa-free regime, and unilaterally cancelled some earlier agreements and contracts. The restrictions were applied rather indiscriminately and affected many legitimate businesses, dealing a serious blow to Iranian investors' confidence in Georgia. Small and medium-sized enterprises were hit especially hard, whereas some larger businesses adapted by setting up front companies under Georgians' names through proxies. With Georgian banks fearful of US sanctions, some of the restrictions remain in place, making it complicated for Iranian citizens to open a bank account in Georgia, and especially to receive bank transfers from Iran. This continues to be a serious limitation on the development of business ties between the two countries.

### **Outlook post-sanctions**

Georgia has promoted its Black Sea ports as part of the transport corridor connecting Iran to Europe, but this ultimately depends on the success of Iran's transport cooperation with Armenia and Azerbaijan. In the energy sector, in early 2016, Georgia – faced with growing domestic demand for gas – expressed interest in purchasing gas from Iran via Armenia. Azerbaijan, which supplies 90 percent of Georgia's gas, reacted by offering a large increase in exports and reducing the price. In July 2016, Iran's National Gas Company signed a memorandum of understanding with a private Georgian company on test deliveries of 40 million m<sup>3</sup> of gas through Armenia over a four-month period. Deliveries are reportedly expected to start soon, but there is still a lack of clarity regarding some technical aspects of such a transaction. Georgia is also a partner in Iran's plans to create a large electricity-exchange market in the region.

Although Georgian-Iranian economic relations have yet to fully recover from the damage inflicted by the restrictions imposed in 2013, the reintroduction of the visa-free regime in February 2016 was an important step forward. Iranian tourism to Georgia has experienced strong growth over the years, strongly reacting to the changes in the visa regime. The number of arrivals increased from 21,000 in 2010 to 60,000 in 2011 and fell sharply in 2013, only to rebound to a record 148,000 in 2016. These data include not only recreational visitors but also those involved in small-scale shuttle trade and those coming on multi-purpose visits.

Georgia's deep and comprehensive free trade agreement (DCFTA) with the EU, which entered into force in 2014, can also potentially increase the country's attractiveness for Iranian investors wishing to use it as a platform for tariff-free exports to the EU. Investors can assemble the entire product in Georgia, taking advantage of competitive labour costs. Alternatively, they can move only the final stage of the production

process, as long as they meet the minimum requirements on rules of origin, as stipulated in the DCFTA.

### **Conclusions**

Contrary to initial expectations in the South Caucasus, the lifting of the sanctions on Iran has not yet produced major benefits for the region. The region's small-sized economies in themselves hold limited attraction for the Islamic Republic unless they can function as a gateway to larger markets such as Russia or the EU. If successfully completed, large infrastructural projects such as the Iran-Azerbaijan railway or the Iran-Caucasus power market could increase the region's economic significance for Iran. Until now, however, with the exception of the power transmission sector, Iran has been cautious about making major financial commitments due to its emphasis on domestic infrastructural development and its interest in emerging opportunities in other regions, such as Central and South Asia. In the case of Armenia, the removal of the sanctions has also eliminated the rationale for some of the earlier cooperation plans with Iran. It would be wrong to say that Iran's de-isolation has had no positive impact on the Caucasus. On the whole, however, many constraints remain in place, as both Iran and the South Caucasus continue to prioritise relations with other partners.

### **Recommendations for a multi-faceted EU engagement**

Although the EU and Iran have no experience of cooperation in the South Caucasus, both are interested in the region's stability and economic development and, unlike in the Middle East, are not stymied by ideological divisions. As the EU and Iran are still in the early stages of institutionalising their relationship – including working towards establishing the EU's first-ever delegation to Iran – they understandably have many higher-priority issues on their

agenda. In the medium term, however, the South Caucasus could become a promising area for EU-Iranian cooperation, with Iran eager to be recognised as a responsible regional actor. The South Caucasus nations, which have stressed their region's role as a bridge between Iran and Europe, are likely to welcome such cooperation as well.

In the revised version (2015) of the European Neighbourhood Policy, the EU emphasises the need for broader formats of cooperation involving both EU partners and third countries where this is required by connections and interdependencies. For the South Caucasus and Iran, relevant issues may include energy, transport, customs, environment, education, and societal ties – all areas where the EU is well-placed to play the role of a mediator, a source of expertise, or a donor. Promoting regional cooperation is one of the main strands of work of the Iran Task Force – a special unit within the EU External Action Service that monitors the implementation of the nuclear agreement. The South Caucasus, Iran, and the EU all stand to benefit from closer economic ties, greater mobility, and enhanced engagement and dialogue on various scales. This type of cooperation would not only be valuable as a confidence-building measure, but it would also reflect the EU's identity as a global actor advancing European values.

There are a number of practical steps the EU could take, starting with building expertise on Iran's relations with the South Caucasus. Whereas Iran has closely followed EU activities in the South Caucasus, the EU has viewed the region primarily through the post-Soviet prism, with the result that both the Task Force and EU delegations to Georgia, Armenia, and Azerbaijan lack a nuanced understanding of Iran's role in the region.

By stepping up its support for Iran's membership bid in the World Trade Organization, the EU would help promote a more transparent business environment in Iran that would benefit Iran's partners, both in the EU and the South Caucasus. The EU could also cooperate with Iran and

Armenia on nuclear safety standards or facilitate Iran's cooperation with Armenia and Azerbaijan on addressing environmental issues in border areas, such as water pollution in the Araxes basin. Another idea is to share the EU's best practices on efficient and citizen-friendly border management that could be applied at Armenia's and Azerbaijan's border crossings with Iran.

In addition, the EU could promote societal contacts by bringing together students, young professionals, and civil society representatives from Iran and the South Caucasus to discuss issues of common interest, including under-researched phenomena such as small-scale cross-border trade. More generally, the EU could act as a facilitator and donor to projects aimed at developing the Iranian-Caucasus border areas and cross-border ties by focusing on the impact of trade and transit on border communities.

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