

# Economic Cooperation Between Azerbaijan and Iran

## A Basis for New Geopolitical Shifts

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Azerbaijan and Iran are actively building up economic cooperation, both bilaterally and within the framework of international projects. Having common religious, historical, cultural ties, to say nothing of a common border spanning 765 kilometers, the two neighboring states have a chance to transmute an economic relationship—especially in the sphere of natural gas—into a more stable and predictable political one. An additional impetus to heightened interaction between Baku and Tehran can be given by participation in international projects with Russia, China, Türkiye and within the framework of trilateral platforms (e.g., Tehran-Baku-Moscow, Tehran-Baku-Ankara), which may lead to new geopolitical shifts in the Silk Road region and perhaps beyond. This is not to say, of course, that all has suddenly become smooth sailing; but it does mean that Azerbaijan and Iran have an opportunity to reset some of the most important pillars of a relationship that has had its ups and downs from onset of Azerbaijan’s re-emergence on the international scene when it regained its independence in 1991.

### *Through Contradictions to a Mutual Understanding*

The very fact of the restoration of Azerbaijan’s statehood was considered by some Iranian politicians as a potential threat to Iran’s national security, as some 30 million ethnic Azerbaijanis live in the Islamic Republic, mostly in the northern regions adjacent to the Republic of Azerbaijan. It should come as no surprise, therefore, that the first serious test for bilateral relations was the period of the First Karabakh War when Tehran, a Shia Muslim country, failed to provide Baku with much in the way of practical support. On the contrary, Iran openly supported Armenian irredentism. As Thomas de Waal put it in 2003: Iran “became Armenia’s friendliest neighbor, but it

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was remote and could be reached only by winding mountainous roads. Nonetheless, without Iranian trade, Armenia might not have survived the two miserable winters of 1991-1992 and 1992-1993.”

An additional challenge has been Iran’s ongoing negative reaction to the development of close ties between Azerbaijan and Israel, which began in earnest in 1995-1996 at least in partial reaction to Iranian hostility towards the former (i.e., Iran’s support for Armenian irredentism). Iran interprets this alliance as a direct threat to its national security while Azerbaijan views its relationship with the Jewish State as an integral part of its multi-vectoral foreign policy strategy, which seeks to strengthen Baku’s standing in one of the world’s most geopolitically complex neighborhoods. Azerbaijan’s longstanding tradition of multiculturalism (Jews have made a home on the territory of Azerbaijan for two millennia or more) has also played a role in strengthening its strategic posture towards Israel, with Azerbaijani Jews now living in Israel serving as an additional bridge between the two friendly states.

The 1990s also witnessed a serious deterioration of relations between Azerbaijan and Iran caused by a territorial dispute over the ownership of an offshore oilfield in the Caspian Sea. The collapse of the Soviet Union raised the question of the legal status of the world’s largest inland body of water. Initially, two general approaches had been elaborated. The first was the definition of the Caspian as a sea (supported by Russia and Iran) based on the UN Convention on the Law of the Sea (1982), according to which the Caspian states should receive 12 miles of water resources and the seabed, as well as 200 miles of a special economic zone. The second approach was the definition of the Caspian as a lake (supported by Azerbaijan, Kazakhstan, and Turkmenistan), which is based on the sectoral principle: each littoral state should receive its ownership on a corresponding part of the water resources and the bottom, so the most attractive deposits of the Caspian would come under the control of the new Caspian countries. As discussed below, this issue was finally resolved in 2018.

There were also occasional flareups. For instance, in July 2001, Azerbaijan-Iran relations witnessed an incident in the Caspian Sea: an Iranian warship approached very close to an Azerbaijani research vessel named the Geophysicist-3, which was conducting research work with BP in the Azerbaijani sector, causing the crew to retreat. This easily could have escalated into military conflict, but both Baku and Tehran took steps to stabilize their relations in its aftermath, which culminated in President Heydar Aliyev’s visit to Iran in May 2002. The two sides reached a fundamental written agreement—signing a document titled “On the Principles of Friendship and Cooperation.” This document stipulates mutual respect for each other’s sovereignty and territorial integrity as well as the non-interference in each other’s internal affairs and other generally accepted principles and norms of international law. It remains a cornerstone document in the bilateral relationship.

Since then, we have seen an overall convergence tendency in relevant fields between the two sides, despite sporadic contradictions and misunderstandings (some of which have not been insignificant). As a result, in the early 2000s, visits of officials from both countries became more frequent and the volume of Azerbaijani-Iranian trade almost tripled, reaching its peak in 2007 with the total amount of \$672 million.

In 2004, Baku and Tehran agreed to create a gas swap deal which provides a supply of the Iranian natural gas to Nakhchivan, Azerbaijan's western exclave. According to the 25-year swap contract, Azerbaijan has in turn been delivering its gas to Iran's north-eastern provinces.

Different international formats also contributed to the strengthening of bilateral ties. Thus, in August 2016, the leaders of Azerbaijan, Iran, and Russia signed a tripartite declaration on strengthening cooperation. In particular, they confirmed the construction of the Rasht-Astara railway line with a length of 170 kilometers as part of the International North-South Transport Corridor (INSTC). According to preliminary estimates, the total investment in the construction of the Qazvin-Resht-Astara section is about \$400 million. The commodity market of the INSTC is estimated at the level of 25-26 million tons per year. The construction of this rail line was protracted due to the COVID-19 pandemic; it now appears that it will be fully completed in 2023.

In August 2018, the five littoral states of the Caspian Sea—Kazakhstan, Russia, Iran, Azerbaijan, and Turkmenistan—signed a landmark declaration determining the legal status of the sea during the fifth Caspian Summit in the Kazakh city of Aktau. The five heads of states who signed the convention agreed to 15 miles of sovereign territorial waters, in addition to a further 10 nautical miles of fishing area, beyond which there will be common waters.

## *A Complete U-turn in Relations*

A new turning point in Azerbaijani-Iranian relations was the Second Karabakh War, which took place over a 44-day period in the fall of 2020. One consequence of Baku's victory was the regaining of full control over the entirety of Azerbaijan's border with Iran, freeing the relevant regions from Armenian occupation.

Initially, Iran appeared frustrated by the very fact that Azerbaijan had restored a historical injustice using its high-qualified military supported by Turkish and Israeli military wherewithal. This produced moments of high-tension, both during and after the war: Tehran had to adjust its posture towards both Baku and Yerevan, and some of this was done in a quite public manner that temporarily raised tensions between Azerbaijan and Iran.

This period of Iranian indecisiveness and even confusion, which corresponded roughly to a period of domestic political transition as a result of elections, resulted in a deterioration of relations with Azerbaijan in autumn 2021, when Tehran held full-fledged military drills on the joint border and accused Baku of harboring Israeli military personnel. The Azerbaijani side, in its turn, rejected all such accusations as “totally baseless,” imposed a road tax on Iranian truck drivers traversing the newly liberated areas of Karabakh, and set up checkpoints for all goods being shipped to Armenia.

Following an almost standard pattern that goes back decades, the two sides found a way to de-escalate through dialogue and some rather deft diplomacy, especially on the Azerbaijani side.

This has already paid significant dividends. Tehran has shifted both the tone and intensity of its negative rhetoric towards Baku. For instance, on 4 July 2022, Iranian Foreign Minister Hossein Amir Abdollahian unequivocally stated that “Iran supports the territorial integrity of the Republic of Azerbaijan” at a joint press conference with his Azerbaijani counterpart Jeyhun Bayramov in Tehran. It also appears that a number of Iranian companies have been given the green light by the Azerbaijani authorities to participate in reconstruction projects in Karabakh.

Deepening economic ties with Tehran (as detailed below) helps Baku keep at bay the Islamic Republic’s discontent with Azerbaijan’s burgeoning strategic ties with Israel. Evidently, Azerbaijan reached some sort of understanding with Iran such that Tehran did not react publicly to the spring 2022 visits to Azerbaijan of high-ranking Israeli officials, including Minister of Agriculture and Rural Development Oded Forer and Minister of Finance Avigdor Lieberman. This could well be a historical first.

All in all, relations between Azerbaijan and Iran in the wake of the Second Karabakh War have acquired a new impetus, especially in the economic sphere. The quintessence of the recent thaw was a meeting between Azerbaijan’s President Ilham Aliyev with his Iranian counterpart, Seyyed Ebrahim Raisi, in Ashgabat on 29 June 2022. The leaders of the two neighboring states disclosed plans for reciprocal presidential visits to both Tehran and Baku. And only a few days ago, Ali Shamkhani, the Secretary of Iran’s Supreme National Security Council, came to Baku, further increasing the likelihood of such visits and the dividends that could result.

### *New Economic Projects*

In 2021, the trade turnover between Azerbaijan and Iran increased by 30 percent, reaching \$400 million. This puts it within striking distance of the record peak year of 2007, as noted above. Officials in both Baku and Tehran have stated that, in the next two years, this figure may reach \$1 billion.

Various economic and trade agreements were reached between the authorities of the two countries in March and May 2022, including a memorandum of understanding on establishing new communication links between mainland Azerbaijan and Nakhchivan through the territory of Iran as well as three protocols on cooperation in the field of customs. In this regard, it is worth mentioning that despite the COVID-19 pandemic, the volume of road transport economic traffic between the two neighboring countries increased significantly during this period—it went up by 70% in 2021.

The construction of the Khudafarin and the Maiden Tower Hydro-junction and Hydroelectric Power Plants (HPP) on the Aras River are also likely to improve bilateral ties in the energy area. According to officials from both sides, the construction of Khudafarin and Maiden Tower HPPs, with a total installed capacity of 200 MW and 80 MW, is to be completed by 2024. These projects will allow Azerbaijan to produce 358 million kWh of electricity per year, improve irrigation on 252,000 hectares of agricultural lands, and even result in the capacity to irrigate an additional 12,000 hectares of such lands. Further coordination in the energy area was discussed during the latest visit to Baku by Iran's Energy Minister, Ali Akbar Mehrabian, which took place on 5 July 2022.

One of the most attractive fields for joint projects at the moment is the gas sector. The trilateral agreement between Azerbaijan, Iran, and Turkmenistan signed in Ashgabat on 28 November 2021 lays the foundation for gas swaps involving a movement from Turkmenistan to Azerbaijan through Iran: this began to be actualized in January 2022. Furthermore, on 4 June 2022, Azerbaijani Economy Minister Mikayil Jabbarov and Iranian Oil Minister Javad Owji signed a memorandum of understanding doubling the quantity of these swaps, from 1.5 bcm to 3 bcm. Only two weeks later, on 18 June 2022, Owji announced an agreement between Tehran and Baku on the establishment of a joint commission for the field development in the Caspian Sea.

## *International Context of Azerbaijan-Iran Relations*

Nowadays, cooperation between Baku and Tehran is gaining additional importance given developments in neighboring geopolitical theaters, including most notably the conflict over Ukraine. The implications of this war have been examined in other IDD analytic policy briefs and thus will be discussed here only insofar as they impact directly on the subject at hand.

Even before the current phase of the conflict over Ukraine, Russia sought to diversify its economic relations—a trend that has markedly accelerated since 24 February 2022, when the importance of securing reliable non-Western partnerships for long-term cooperation has become an imperative. Thus, on 13 May 2022, the head of

Iranian customs, Ali-Reza Moqaddasi, announced that Iran, Azerbaijan, and Russia would soon sign an agreement on trilateral transit. This was followed up by a 25 May 2022 statement from Russian deputy prime minister Alexander Novak in which he indicated that the INSTC is likely to become a key point in the further development of Russian-Iranian economic cooperation. Although some of this increase in trade will be conducted directly via the Caspian Sea, much of it will necessitate inland transportation, which necessarily means traversing Azerbaijan. Thus, Azerbaijan is likely to play a role as an economic bridge between Moscow and Tehran, which might produce significant economic benefits for Baku in the near future.

Simultaneously, Azerbaijan's important role in the development of Iran-Türkiye economic relations is now beyond doubt. Its basis is the 10 November 2020 tripartite statement that ended the Second Karabakh War. This agreement foresees the establishment of what Azerbaijan calls the Zangezur Corridor—a multimodal transport link that will reconnect Anatolia to the Caspian Sea through the most direct land route (both road and rail) and, in so doing, reconnect Nakhchivan to mainland Azerbaijan through a sliver of sovereign Armenian territory. This route, which forms an integral part of the tripartite statement that ended the Second Karabakh War but has not yet been operationalized due to Armenian reticence, will make it easier for Türkiye to supply its goods to the markets of Central Asia via Azerbaijan and then via Iran (and vice-versa). Here we can note that Iran and Türkiye enabled trade to take place directly with their two national currencies in 2018.

Moreover, the opening up of the Zangezur Corridor—which seems to be a key prerequisite in establishing sustainable peace agreements between Armenia and both Azerbaijan and Türkiye—would enable Armenia to end its regional economic isolation and allow it to benefit from the trade opportunities that are coming online throughout the region.

Additionally, it is useful to mention the prospects of heightened interaction between Azerbaijan and China as well as between Iran and China. Baku has never been better placed to leverage its geopolitical position to become a key hub in the Belt and Road Initiative (BRI) thanks to the heightened geopolitical importance of the “middle corridor” route traversing the Silk Road region whilst avoiding Russian territory, as well as its expanding port facilities at Alat. This would enable Azerbaijan to participate more fully in BRI—in the world's largest megaproject with Iran, Türkiye, and many other regional and global powers. The 25-year strategic cooperation agreement between Iran and China, which was reached in March 2021, could also contribute to more effective cooperation between Baku, Tehran, and Beijing.

Parallel to that, Iran's gradual rapprochement with the West in light of Russia's isolation and the possibility of reviving the nuclear deal (and the resulting lifting of sanctions) would open up new opportunities for more fruitful cooperation between

Tehran and the EU (particularly some of its most important member states) as well as, potentially, the United States. In this regard, Azerbaijan could act as a transit country, leveraging its existing relationships with the West and Iran (and, of course, Türkiye).

In addition, participating in joint projects with Iran, Türkiye, and Russia would allow Azerbaijan to demonstrate even more independence in foreign policy decision-making, in furtherance of its longstanding multi-vectoral strategy. Contrary to perception, Baku is neither “pro-Turkish” nor “pro-Russian”—much less pro-EU. It is, to put it simply, “pro-Azerbaijani.” Baku puts the interests of Azerbaijan first, and that means placing an emphasis on partnerships.

Suffice it to say that while closely interacting with Iran within the framework of such platforms as Tehran-Baku-Moscow or Tehran-Baku-Ankara (and, in the future, Baku-Tehran-Beijing), Azerbaijan has ample opportunities to transform itself fully into a regional hub and, in turn, increasing its geopolitical and geostrategic impact even further.

To sum up: despite existing contradictions and reciprocal grievances in the past, today Azerbaijan and Iran, mainly thanks to deft diplomacy and increasing economic opportunities, are actively working together to overcome bilateral challenges. The trajectory of this relationship suggests that both economic and political cooperation will increase in the time to come. This of course does not mean that the forecast is clear skies and smooth sailing; but it does indicate that the effects of any storms that could form are likely to be more easily manageable: a more solid economic base should allow Baku and Tehran to proceed from common presuppositions in the event of disputes.

## Takeaways

The following takeaways may be said to summarize the abovementioned considerations:

- Azerbaijan and Iran have great prospects for increasing economic cooperation and reaching a trade turnover of \$1 billion in the next two years.
- One of the most attractive fields for joint projects between Azerbaijan and Iran is the gas sector. According to the latest agreements between both sides, gas supplies from Turkmenistan to Azerbaijan through Iran will likely increase to at least 3 billion cubic meters.
- The deepening of economic ties with Tehran should help Baku to keep at a bay Iran’s discontent with Azerbaijan’s ongoing strategic cooperation with Israel.

- Azerbaijan and Iran can strengthen bilateral cooperation within the framework of such geopolitical axes as Tehran-Baku-Moscow, Tehran-Baku-Ankara, and Baku-Tehran-Beijing.
- Participation in joint projects with Iran, Türkiye, and Russia allows Azerbaijan to further demonstrate its foreign policy independence and reject any insinuations about Baku’s zero-sum “pro-Turkish” or “pro-Russian” orientation.
- Engaging more fully within the framework of BRI would provide Azerbaijan with ample opportunities to turn itself further into a regional hub and raise its geopolitical and geostrategic profile and impact.
- Joint projects in different areas may lead to an increase in not only economic but also political cooperation between Azerbaijan and Iran.
- An expanded, more solid economic base may allow Baku and Tehran to proceed from common presuppositions in the event of disputes.