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FREE TRADE IN SOUTH CAUCASUS

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Public Association for Assistance to Free Economy

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1. Introduction and Background

Azerbaijan is the only oil and gas-producing countries in the South Caucasus region. After independence, the country achieved the goal of signing production-sharing agreements with well-known Western oil and gas companies to exploit oil and gas fields offshore of the Caspian Sea in the 1990s. Later, in the beginning of the 2000s, Azerbaijan, together with partner companies, constructed the two largest pipelines through Georgia and Türkiye towards Europe. The Baku-Tbilisi-Ceyhan (BTC) is transporting crude oil produced from the Azeri-Chirag-Gunashli field to the Mediterranean Sea further to Europe, which is operated by British Petroleum and other contractor oil-gas companies. The second South Caucasus Pipeline (SCP) pipeline transports Shardeniz gas to Türkiye. Later, this pipeline was expanded with the Trans Anatolian Natural Gas Pipeline (TANAP) and Trans Adriatic Pipeline (TAP) projects to reach Greece and Italy.

Consequently, starting from 2008 the dominant role of fossil fuels in Azerbaijan's GDP and exports significantly increased. The peak of crude oil production in Azerbaijan was in 2010. Over the last 13 years, the share of the oil-gas sector in exports remained over 90%

Oil and gas revenues increased opportunities for the state-owned State Oil Company of Azerbaijan (SOCAR). The company expanded its business worldwide, from Switzerland to Singapore, controlling petrol station networks, oil refineries, chemical industry enterprises, and crude oil trading unions. According to its annual financial report, SOCAR had a \$50 bln turnover in 2023.¹

Apart from the SOCAR, the government established the State Oil Fund (SOFAZ) in 1999 to accumulate oil and gas revenues. SOFAZ accumulates all non-tax revenues and government shares from oil and gas projects. After transfers to the state budget and specific public projects, SOFAZ had \$57.4 bln in net assets by the end of the first quarter of 2023.²

Despite huge oil-gas revenues, Azerbaijan still needs to diversify its economy and exports. According to official figures, the oil-gas share of the country's GDP was 36.86%, 51.53% in state budget revenues, and 90.12% in exports in 2023.³ According to World Bank Open Data, Azerbaijan's manufactured products share in merchandise exports did not exceed 5% after the start of the oil boom. This is the lowest figure in the South Caucasus region.

Despite low economic diversification and exports, Azerbaijan plays a crucial role in the region regarding energy security and transit. Azerbaijan invests in East-West and North-South connectivity, connecting Central Asia to the Black Sea and Russia to Iran. It also supplies oil and gas to Georgia, Ukraine, Türkiye and other Black Sea countries.

However, because of the regional conflict that started at the beginning of the 1990s, Azerbaijan and Armenia did not have any economic cooperation, which had a negative effect on the prosperity of the South Caucasus. Now countries are attempting to reach a peace agreement that can open new economic opportunities in the region.

¹ <https://socar.az/en/page/maliyye-hesabatlari>

² <https://oilfund.az/en/report-and-statistics/recent-figures>

³ State Statistical Committee, State Customs Committee and Supreme Audit Institution

2. Foreign trade framework of Azerbaijan

The foreign trade policy of the government of Azerbaijan relies on protecting domestic industry, improving raw material supplies, expanding non-oil exports, and effectively using the country's export opportunities.

The National Priorities for Socio-economic Development of Azerbaijan 2030⁴ consider further liberalization of trade regimes to increase the access of local products to foreign markets to be the primary factor of economic growth.

Despite 20-years of negotiation from 1997 to 2007, Azerbaijan has not joined the World Trade Organization (WTO). After several years of stasis, we are currently observing a new wave of interaction between Azerbaijan and the WTO.

One of the main advantages of accession to the WTO is the wide opportunities in global markets, particularly for those sectors where Azerbaijan is exploring expanding and

diversifying its exports. When investing in developing export markets, Azerbaijani companies can potentially gain significant protections under WTO rules, a benefit that is currently not accessible without WTO accession. Also, the rights granted by WTO provisions can enhance Azerbaijani exporters' access to other WTO members' markets.

Azerbaijan signed only ten free trade agreements (FTA), all with former Soviet countries.⁵ Besides, the Bilateral preferential trade agreement (PTA) between Azerbaijan and Türkiye was signed in 2020.⁶

In addition, Azerbaijan signed two regional trade agreements (RTAs)—the first between Georgia-Ukraine-Azerbaijan-Moldova (GUAM) countries in 2002⁷ and the second between Economic Cooperation Organization (ECO) members in 2003.⁸

Table 1. Import tariffs⁹ of Azerbaijan by top countries, 2021

Partners	Share of imports in %	AHS Weighted Average (%) tariff	MFN Weighted Average in %
Russia	17.73	0.00	8.23
Türkiye	15.76	9.91	9.91
China	14.02	9.19	9.19
Germany	5.41	4.77	4.77
Ukraine	4.00	0.00	11.75
USA	3.78	4.83	4.83
Italy	3.59	7.71	7.71
Iran	3.40	9.85	9.85
UK	2.32	4.61	4.61
Japan	2.21	4.63	4.63
World	100.00	6.01	8.26

In 2018, Azerbaijan made a significant shift from the 7-step ad valorem customs duties to the 3-step (0%, 5%, 15%) tariffs. This change brought about a reduction in import tariffs on most commodity codes, a move that is expected to provide relief to businesses involved in imports and exports. In contrast, customs duties on specific commodities were raised to protect domestic industry. Under the new regime, most raw materials and machinery are exempt from customs duties. However, it is important to note that final products and agricultural produce are typically charged at 15% tariff under the new system.

Table 1 provides an overall picture of Azerbaijan's tariff policy. In 2021, Azerbaijan applied a 6.01% Effectively Applied (AHS) Weighted Average tariff and an 8.26% Most Favored Nation (MFN) tariff to its imports.

If we compare those indicators with other South Caucasus countries, we can see that, Armenia applied a 3.61% AHS tariff and 6.32% MFN tariffs to its total imports in the same year. Georgia's tariffs are lower: 0.34% AHS tariff and 3% MFN tariff.¹⁰ It is that Azerbaijan's tariffs are high

⁴ <https://president.az/az/articles/view/50474>

⁵ <https://customs.gov.az/az/sahibkarlar-ucun/serbesticaret>

⁶ <https://wto.org/en/article/a-preferential-trade-agreement-between-azerbaijan-and-turkey-has-entered-into-force/80>

⁷ <https://guam-organization.org/en/agreement-on-establishment-of-free-trade-area-between-the-guam-participating-states>

⁸ <https://eco.int/wp-content/uploads/2023/08/4.-ECO-Trade-Agreement-ECOTA.pdf>

⁹ Source: WITS - UNCTAD TRAINS

¹⁰ <https://wits.worldbank.org/CountryProfile/en/Country/GEO/Year/2021/TradeFlow/Import>

compared to other countries in the South Caucasus. This underscores the need for a balanced tariff policy that considers the unique economic conditions of each country.

Azerbaijan's trade policy aims to balance the protection of domestic industries with the need to liberalize trade and expand export markets. Although tariffs are relatively high compared to regional neighbours, the country is gradually moving towards more liberal trade practices, supported by

strategic agreements and reforms.

The shift to a more straightforward tariff structure in 2018 was meant to ease business operations and enhance trade efficiency. However, protecting final products and agricultural produce remains a priority in supporting local industries. The new tariffs simplified custom clearance procedures but did not result in fundamental changes in foreign trade.

3. Foreign trade indicators of Azerbaijan

Azerbaijan's foreign trade is based on an economy that produces a large amount of mineral fuels. Chart 1 demonstrates the range of the volatility in the country's merchandise exports. The prices of mineral fuels in the world market directly impact not only exports but also imports. In other words, increasing the monetary volume of exports has a positive effect on economic activity, which stimulates imports.

In recent years, especially during the COVID-19 pandemic, when commodity prices were low due to reduced demand, exports and imports saw a significant decrease in monetary volume. In 2020, the cost of Brent crude oil declined to \$41.96 per barrel, reducing foreign trade.

In the following two years, there was a sharp increase in foreign trade turnover due to the high price of crude oil in the world market. For example, the cost of crude oil rose to \$100.93 per barrel in 2022 and dropped to \$84.14 in 2023. The substantial increase in imports in 2023 can be attributed to the expansion of re-export operations.

On the one hand, Azerbaijan's significant reserves of mineral resources, particularly crude oil and natural gas, coupled with high global prices for these commodities, present an excellent opportunity for the country's foreign trade surplus. These natural resources form the backbone of Azerbaijan's export economy, enabling it to generate substantial revenue from international markets. High oil

and gas prices increase the value of these exports, enhancing the country's trade balance and creating opportunities for economic growth and financial stability.

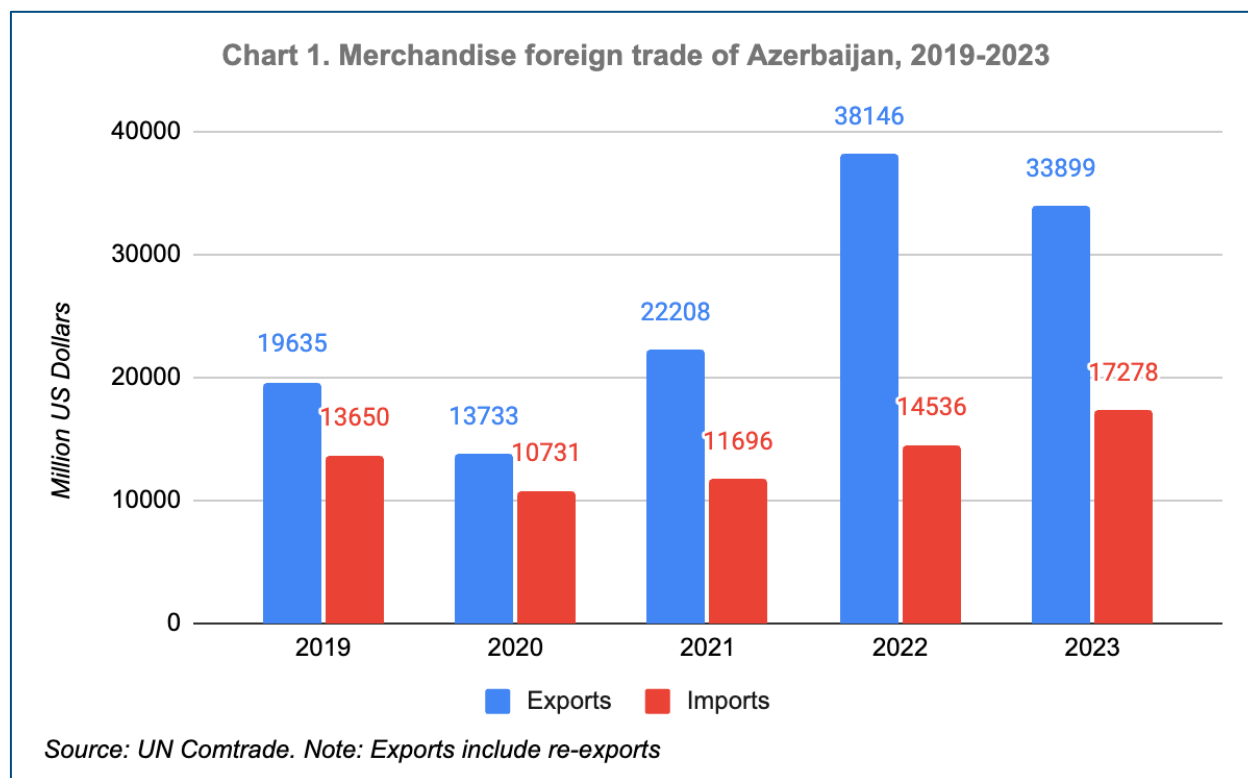
However, after the collapse of oil prices in 2014, external surpluses were diminished, foreign capital inflows turned to outflows, and the Central Bank of Azerbaijan (CBA) spent two-thirds of its reserves to maintain the de facto fixed exchange rate against the US dollar. Nevertheless, in 2015, the national currency was devalued twice and lost half of its value.

In 2023, Azerbaijan's merchandise exports totalled \$33.9 billion, while its imports amounted to \$17.28 billion. An analysis of the commodity structure of imports reveals that Azerbaijan imported crude oil and natural gas from Russia for \$872 million and Turkmenistan for \$525 million. It is essential to make it clear that in recent years, importing crude oil and natural gas from Russia began to show itself in 2022 after starting the Ukraine war and significantly increased in 2023. The official explanation is that Azerbaijan uses imported mineral fuels from Russia for domestic needs and exports more own crude oil and natural gas to Europe. However, Russia is trying to supply more crude oil and natural gas to Azerbaijan.¹¹

Also, SOCAR has a deal with Lukoil to import 200,000 barrels of Russian oil daily to the STAR refinery in Türkiye.¹²

¹¹ <https://www.reuters.com/business/energy/russia-proposed-oil-supplies-azerbaijan-via-baku-tikhoretsk-pipeline-2023-10-13>

¹² <https://www.reuters.com/markets/commodities/azeri-oil-firm-which-took-russian-funds-redeems-us-bank-loans-early-sources-say-2024-03-13>



Azerbaijan heavily relies on the export of mineral fuels, particularly petroleum oils and gas, which make up 90% of its total exports. The remaining 10% consists of electrical energy, fruits, and vegetables, as well as products from the chemical industry.

The majority of exports are composed of crude oil (51.9%), followed by natural gas (36.3%). Smaller shares are held by petroleum outputs (1.86%) and electrical energy (0.63%). The main exported vegetables are tomatoes, while fruits such as persimmons and hazelnuts are also prominent. Among the top ten exported products with HS-6 digit

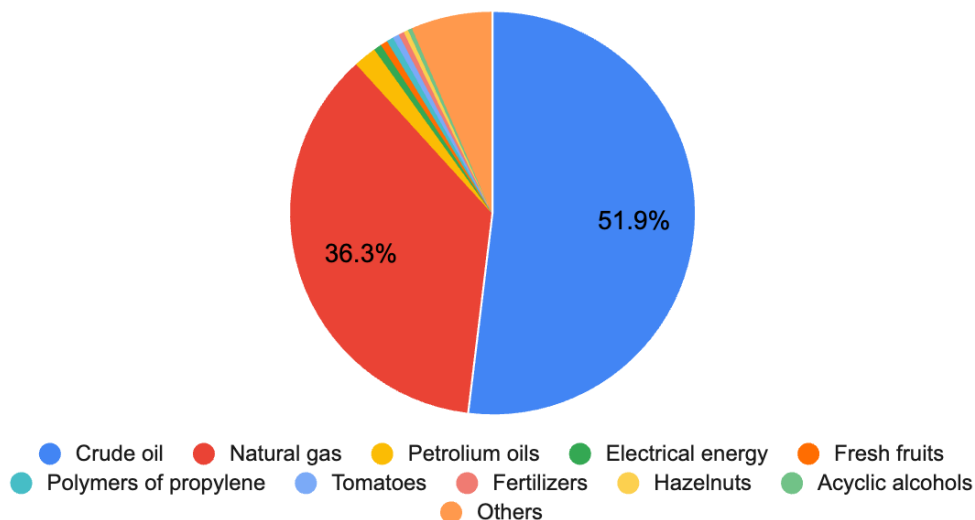
codes¹³ are plastic articles like polypropylene, propylene copolymers, and ethylene polymers.

Azerbaijan's economy is based on the export of mineral fuels, specifically crude oil and natural gas. However, there's a lack of diversification into other sectors like agriculture, chemical products, and plastics. Diversifying exports is important to reduce economic reliance on the energy sector, as it could help buffer against fluctuations in global energy prices and support more sustainable economic growth.

¹³ The World Customs Organization's Harmonized System (HS) uses code numbers to define products. A code with a low number of digits defines broad categories of products; additional digits indicate sub-divisions into more detailed definitions. Six-digit

codes are the most detailed definitions that are used as standard. https://www.wto.org/english/thewto_e/glossary_e/hs6_e.htm

Chart 2. Top 10 exported products of Azerbaijan in HS-4 digit, 2021-2023 annual average

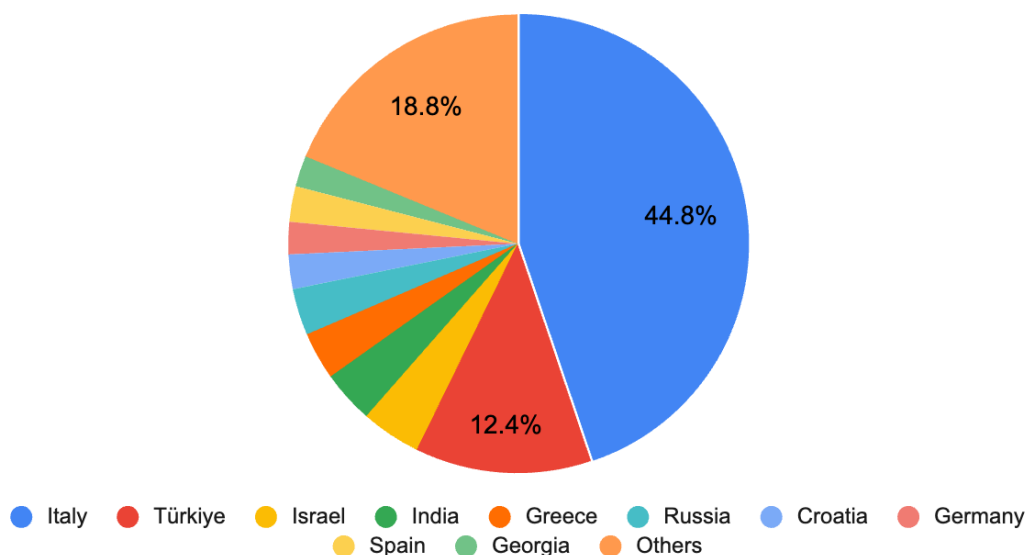


Source: UN Comtrade. Note: Exports include re-exports

The majority of the country's exports, 64.37%, were destined for European Union countries in 2023. Chart 3 shows Italy is the largest importer at 44.8%. Azerbaijan primarily exports oil and gas to European Union countries, with Türkiye following at 12.44%, then Israel at 4.23%, India

at 3.7%, and Russia at 3.28%. Azerbaijan exports both mineral fuel and non-oil products to Türkiye. Russia is the primary destination for exporting non-oil products from Azerbaijan.

Chart 3. Top 10 countries of exports of Azerbaijan, 2021-2023 annual average



Source: UN Comtrade. Note: Exports include re-exports

Azerbaijan's main imports are machinery (12.5%), electrical machinery and equipment (10.6%), vehicles (10.57%), food products (12.5%), and iron and steel and their articles (6.9%). Additionally, pharmaceutical products (4%), plastics and articles thereof (3.03%), clothes and accessories (2.40%), and wood and articles (2.52%) are

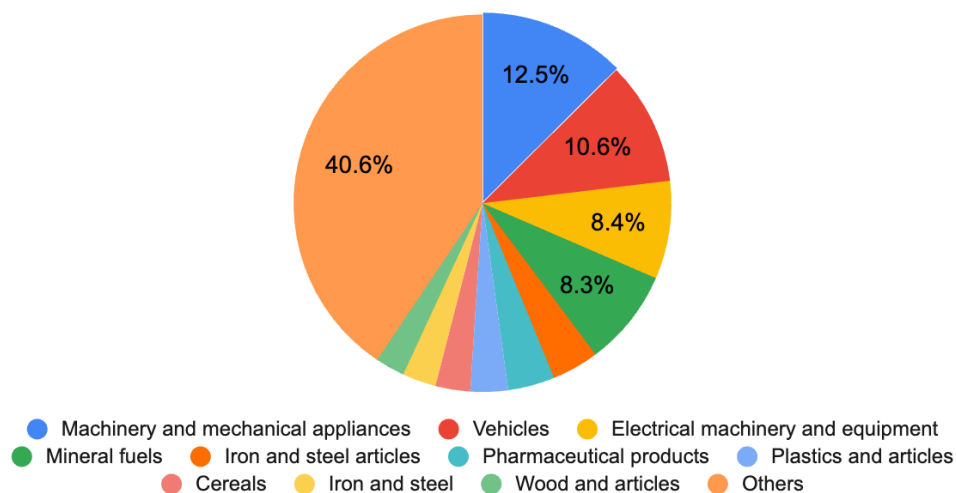
significant imports.

In coordination with this configuration, Azerbaijan's imports in 2023 were mainly composed of manufactured goods, making up 68% of the total imports. This indicates the country's dependence on industrial and technological

products to drive its economic activities. Additionally, agricultural products accounted for approximately 11% of the imports, emphasizing the significance of food and

agricultural inputs to fulfill domestic needs. This varied import profile is essential for maintaining economic growth and meeting the demands of different sectors.

Chart 4. Top 10 imported product groups of Azerbaijan in HS-2 digit, 2021-2023 annual average



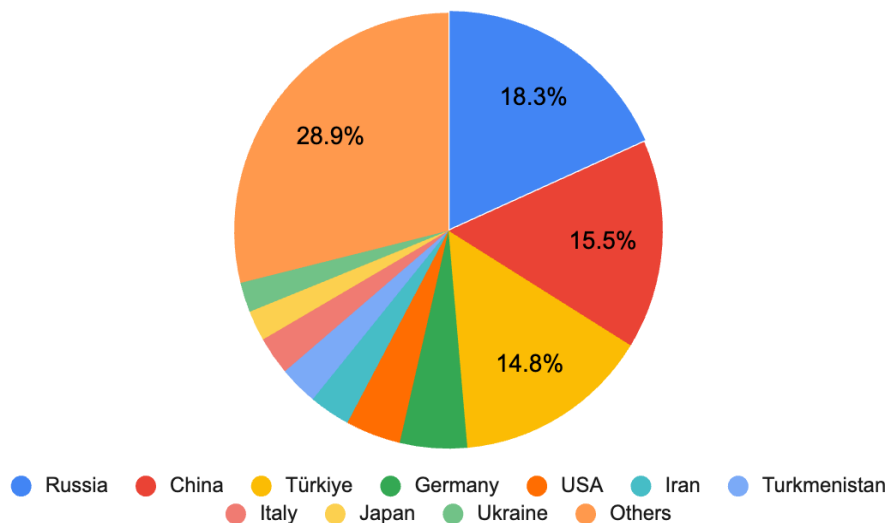
Source: UN Comtrade. Note: Exports include re-exports

The geography of imports is quite diverse. Azerbaijan imports over 1,800 goods from 120 different countries.

Additionally, the collective share of EU countries importing from Azerbaijan is noteworthy—17.36%. In general, EU countries not only play a significant role in the export country distribution but also rank second in terms of imports.

From a different perspective, 49% of total merchandise exports is divided among Russia (18.3%), China (15.5%), and Türkiye (14.8%). Following that, Germany (5.1%), the USA (4.6%), Iran (3.1%), and Turkmenistan (2.9%).

Chart 5. Top 10 countries of imports of Azerbaijan, 2021-2023 annual average



Source: UN Comtrade. Note: Exports include re-exports

4. Foreign trade in Georgia

In 2000, Georgia became a member of the World Trade Organization (WTO) and in 2014, it signed the Deep and Comprehensive Free Trade Agreement (DCFTA) with the EU. Import tariffs are categorized into three rates: 0%, 5%, and 12%.

Approximately 90% of goods are not subject to any duty. However, certain items like agricultural products, food, clothing, construction materials, wood products, plastics, wire and cable, iron, steel, and other goods manufactured in Georgia may be taxed at higher rates. For example, beef

from other countries is subject to a 12% customs duty, while beef from the EU faces no tariff under the DCFTA.

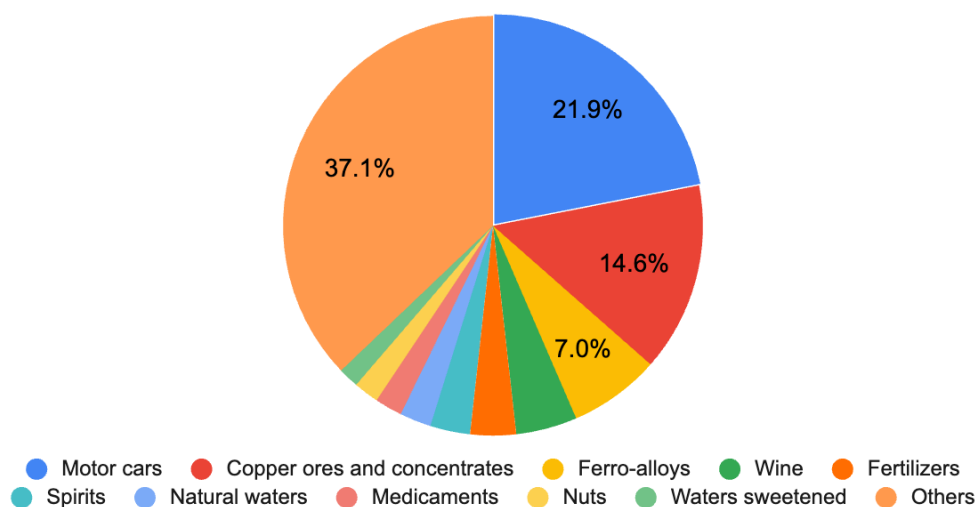
In 2021-2023, Georgia's merchandise foreign trade turnover increased by approximately 50%. In 2021, the country imported goods worth \$10.1 billion and exported goods worth \$4.2 billion. These numbers rose to imports of \$13.5 billion and exports of \$5.6 billion in 2022. By the following year, imports had reached \$15.6 billion, and exports had risen to \$6.1 billion (Chart 6).



In 2021, the primary exported products were copper ores and concentrates, ferro-silico-manganese, wines, automobiles, and mineral waters. However, in 2023, the export landscape changed, with vehicles taking the lead in

exports. The export of mineral waters, wines, and other spirits obtained from distilling grape wine also increased. (Chart 7).

Chart 7. Top 10 exported products of Georgia in HS-4 digit, 2021-2023 annual average



Source: UN Comtrade. Note: Exports include re-exports

The geographical pattern of foreign trade also shifted, with China, Russia, Azerbaijan, Türkiye, and Ukraine being the top five export destinations in 2021. In 2023, Azerbaijan, Armenia, Kazakhstan, Kyrgyzstan, and Russia became the primary export partners. This transformation can be attributed to changes in the regional foreign trade landscape, the Russian invasion of Ukraine, alterations in transit routes, and expanding of reexport operations. Different media reports demonstrate that a large number of cars imported from the USA and other Western countries are passing from Georgia to Russia in spite of sanctions. Apparently, the car dealers in Georgia

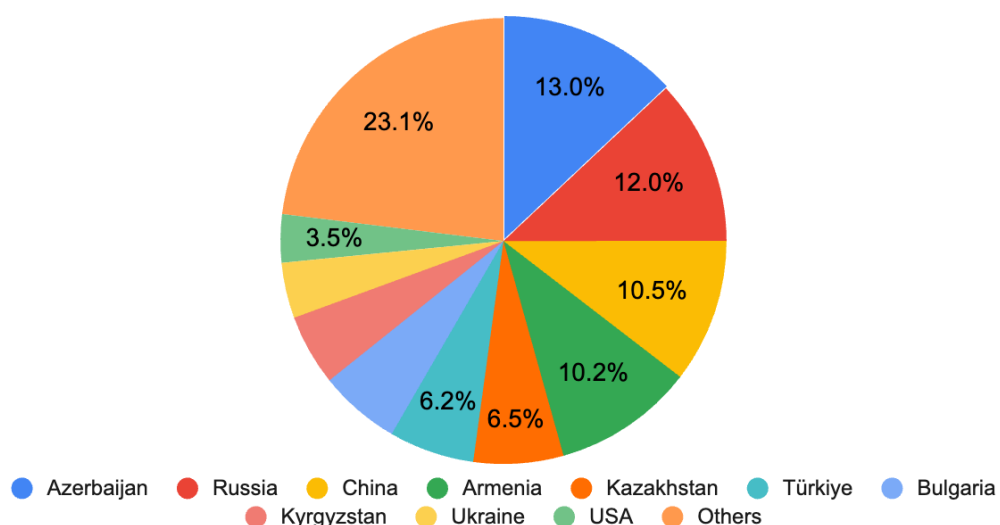
document those cars as being reexported to Armenia, Kazakhstan, and Kyrgyzstan, which are part of the EAEU, and later, cars reaching Russia.¹⁴

Chart 8 shows Georgia's exports by country are pretty diversified. If we look at the annual average export share in 2021-2023 by countries, we can see that the central export partner countries are Azerbaijan (13%), Russia (12%), China (10.5%), Armenia (10.2%), Kazakhstan (6.5%), and Türkiye (6.2%). Bulgaria, Ukraine and the USA also keep a significant share in this line.

¹⁴ [https://news.sky.com/story/brand-new-luxury-british-and-european-cars-are-entering-russia-despite-being-](https://news.sky.com/story/brand-new-luxury-british-and-european-cars-are-entering-russia-despite-being-banned-heres-how-13218444)

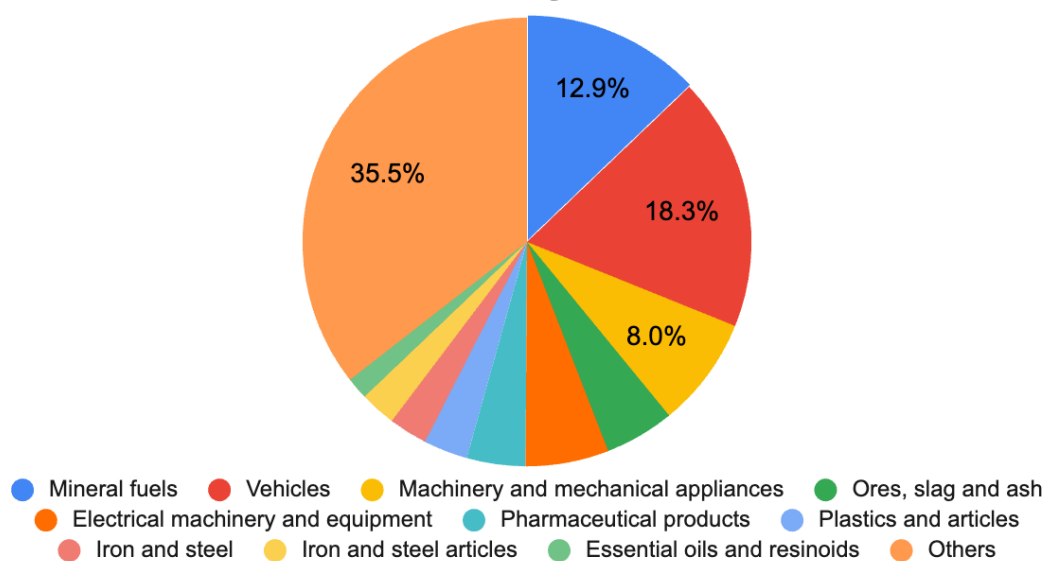
[banned-heres-how-13218444](https://ifact.ge/en/sanctioned-cars)
<https://ifact.ge/en/sanctioned-cars>

Chart 8. Top 10 countries of exports of Georgia, 2021-2023 annual average



Source: UN Comtrade. Note: Exports include re-exports

Chart 9. Top 10 imported product groups of Georgia in HS-2 digit, 2021-2023 annual average



Source: UN Comtrade. Note: Exports include re-exports

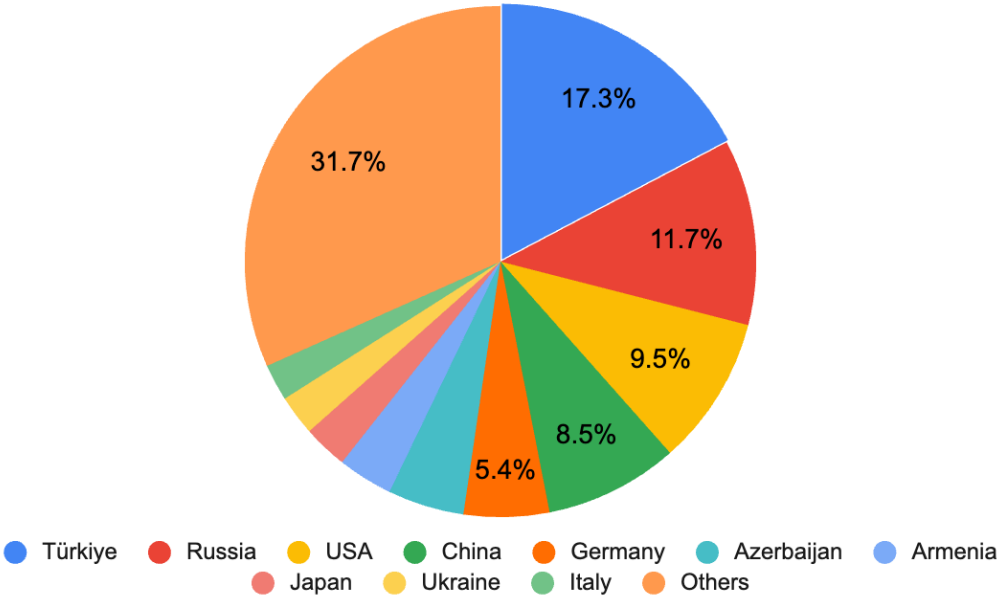
On the other hand, Georgia imports mineral fuels (12.85%), vehicles (18.26%), machinery and mechanical appliances

As in exports, Georgia's geographical pattern of imports changed slightly after 2021. However, Türkiye, Russia, the USA, and China remain significant contributors to the country's imports.

(7.97%), ores, slag and ash (5.02%), and electrical machinery and equipment (6%) (Chart 9).

Over the last two years, Germany's role in Georgian imports also enlarged. The next places were occupied by neighbors Azerbaijan and Armenia (Chart 10).

Chart 10. Top 10 countries of imports of Georgia, 2021-2023 annual average



5. Foreign trade of Armenia

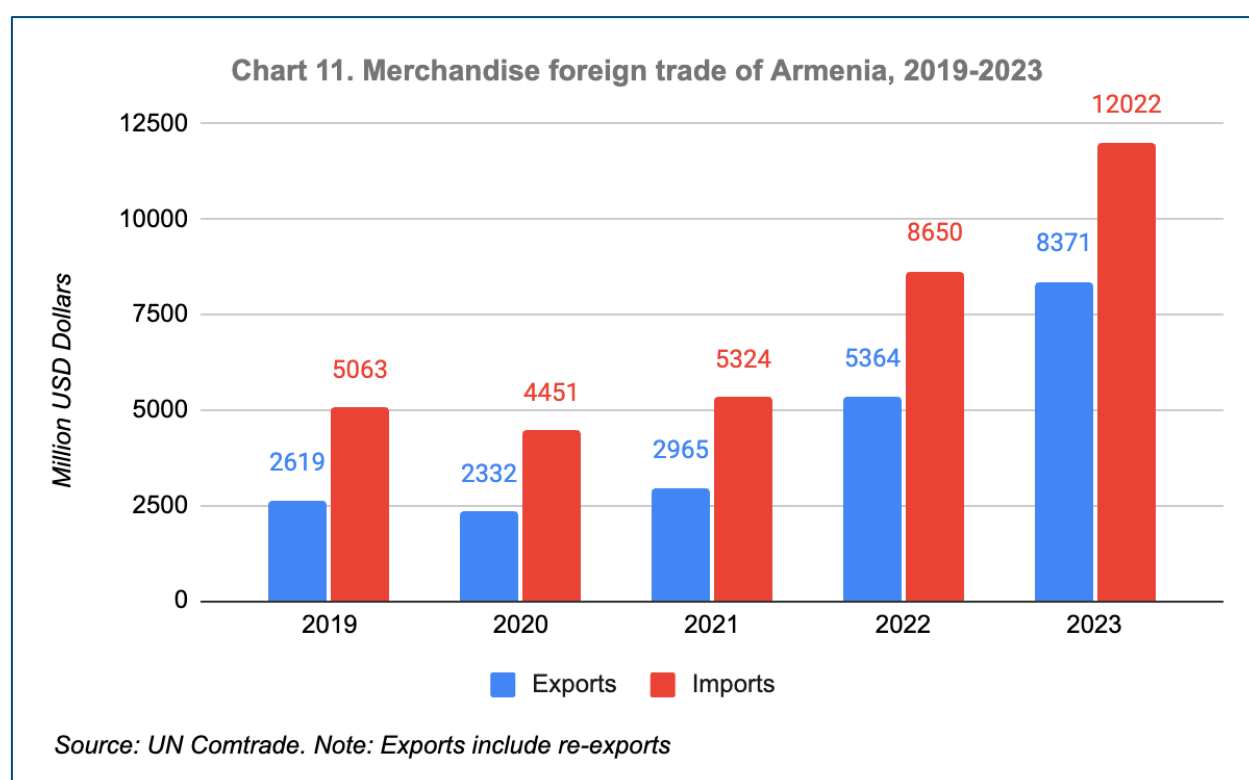
Armenia became a part of the World Trade Organization (WTO) in 2003, and it became a member of the Eurasian Economic Union (EAEU) in 2015.

Armenia's entry into the EAEU led to higher customs tariffs for a wide range of imports. Armenia had to align its customs tariffs with the EAEU's, with some temporary exceptions gradually phased out. The EAEU's standard external tariff is based on Russia's tariff rates and WTO commitments.

Before its EAEU membership, Armenia applied tariffs on

imports at rates of 0% or 10%. By 2009, the average applied tariff was around 3%, which has since surpassed 10%. Tariffs on agricultural products have seen a substantial rise compared to non-agricultural products, and there has been a significant increase in the use of non-ad valorem tariffs.

Several studies consider Armenia's membership in the EAEU an obstacle to expanding its economic relations with EU countries.¹⁵ In fact, it is enough to remember that Armenia joined the EAEU in 2013 after refusing to sign the association agreement with the EU at the last minute due to pressure from Russia.



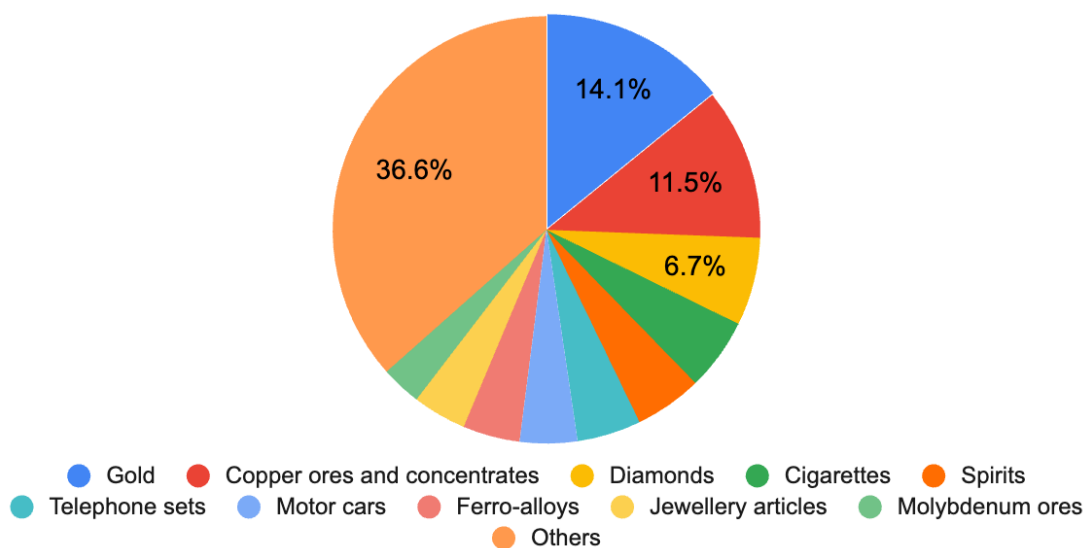
In the past three years, foreign trade in Armenia has followed a similar pattern to that of Georgia. Based on data from the UN Comtrade, Armenia's imports increased to \$12.02 billion in 2023, up by 2.3 times, while exports reached \$8.37 billion in 2023, a 2.8-fold increase. Moreover, during this period, imports from the EU grew from \$892.4 million to \$2.33 billion (a 2.6-fold increase), and exports to Russia rose from \$793.87 million to \$3.38 billion. These trends, which essentially involve re-export operations, elucidate the primary reasons behind the

expansion of Armenia's imports and exports from 2021 to 2023.

Armenia's foreign trade has seen significant growth in recent years, with natural and cultured pearls, semi-precious stones, and imitation jewellery emerging as dominant goods in both imports and exports. The increasing shares of machinery, electric machinery, and vehicles in foreign trade further highlight this growth, providing evidence of expanding re-export operations.

¹⁵ <https://www.chathamhouse.org/2019/03/armenias-foreign-policy-balancing-age-uncertainty-0/3-eaeu-and-csto-armenias->

Chart 12. Top 10 exported products of Armenia in HS-4 digit, 2021-2023 annual average



Source: UN Comtrade. Note: Exports include re-exports

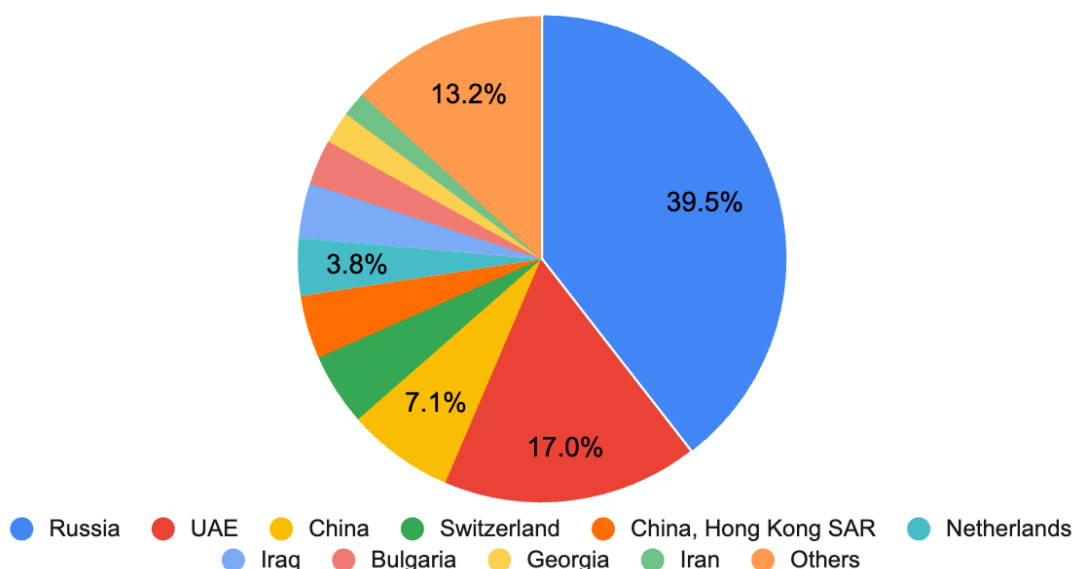
According to UN Comtrade, on average in 2021-2023 Armenia's primary exports included semi-manufactured gold, diamonds, cigarettes and tobacco, spirits, mobile phones and motor cars, and copper and ferro-molybdenum ores.

For example, UN Comtrade data demonstrate that in 2023, Armenia imported gold from Russia for \$1.34 bln (19 times more than in 2021) and exported gold to the United Arab

Emirates for \$1.26 bln (72 times more than in 2021).

Also, Armenia imported smartphones from Viet Nam for \$494 million and exported smartphones to Russia for \$500 million in 2023. In other words, Armenia's import of smartphones from Viet Nam increased 30 times, and the export of those products to Russia increased 2658 times compared to 2021

Chart 13. Top 10 countries of exports of Armenia, 2021-2023 annual average

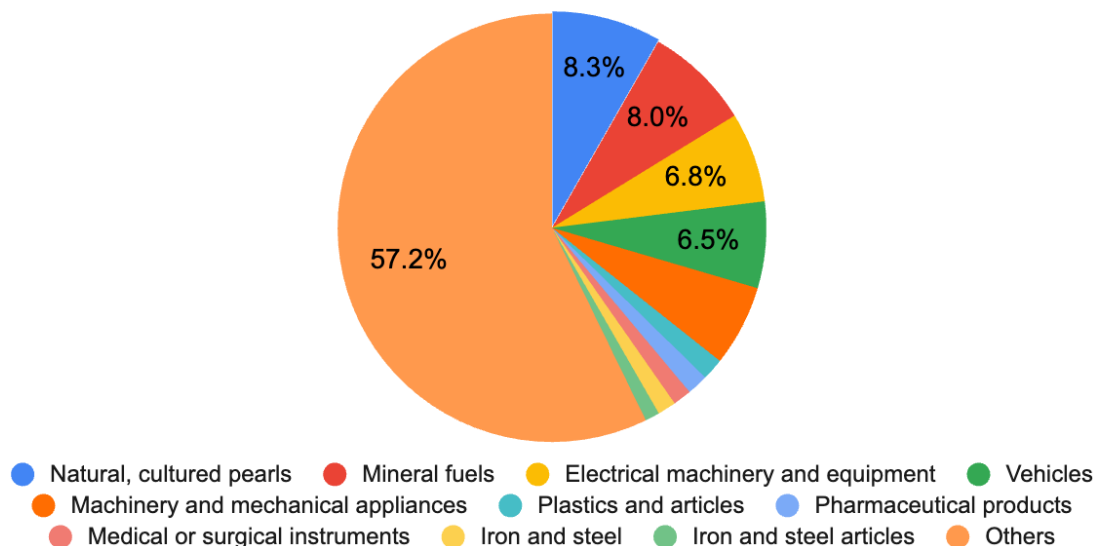


Source: UN Comtrade. Note: Exports include re-exports

Overall, the external trade basket fundamentally changed after starting the Russian invasion of Ukraine. If Armenian main trade partners were Russia, China, Iran, Switzerland, and Germany in 2021, the top five partners' baskets shifted

to Russia, China, and the basket shifted to Russia, United Arab Emirates, China, Vietnam Nam, and Hong Kong SAR of China. 67% of Armenia's total exports went to Russia and the United Arab Emirates in 2023.

Chart 14. Top 10 imported product groups of Armenia in HS-2 digit, 2021-2023 annual average

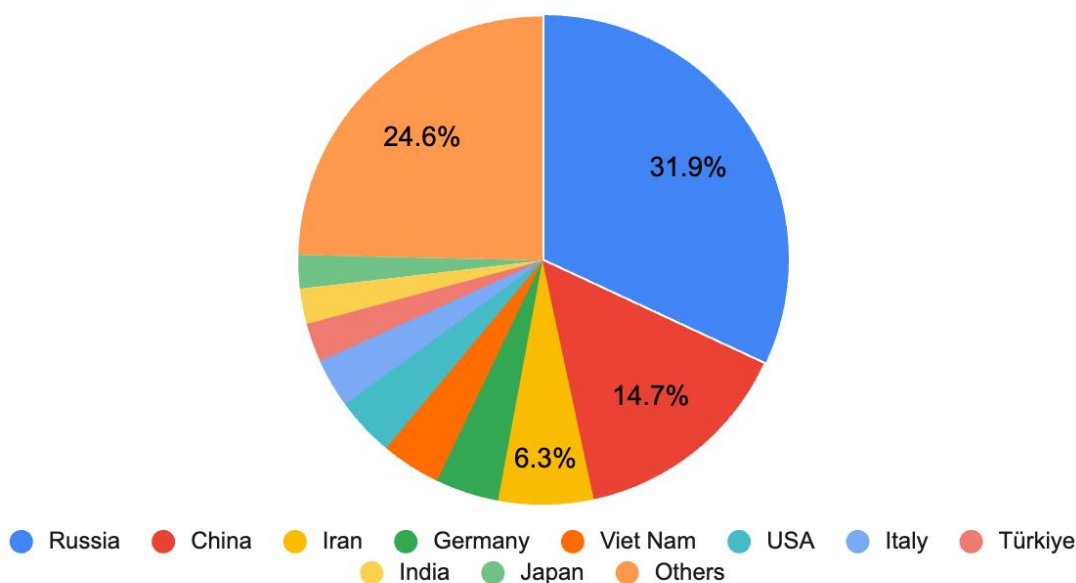


Source: UN Comtrade. Note: Exports include re-exports

On the other hand, the shape of the leading imported products changed in 2021-2023. If the main imported products were natural gas, petroleum oils, other medicaments, unwrought forms of gold, transmission

apparatus, and radiotelephones in 2021, over the last two years, natural, cultured pearls, electrical equipment, machinery, and mechanical appliances, and vehicles have taken a dominant place in the import basket.

Chart 15. Top 10 countries of imports of Armenia, 2021-2023 annual average



Source: UN Comtrade. Note: Exports include re-exports

The main import partners of Armenia are Russia, China, and Iran (overall 53%). Germany, Vietnam, USA, and Italy are next in this line.

As we see from Chart 15, Türkiye, a close ally of Azerbaijan is also one of the top ten import partners of Armenia. Armenia imported goods from Türkiye for \$336 million in 2023. The vital highlight for this study is that the Armenia and Türkiye trade relationship not only recovered after the II Karabagh war in 2020 but also enlarged in 2022-2023.

Although there are no official diplomatic relations between Turkey and Armenia and the borders are closed, trade relations between the two countries have persisted even before the war. For instance, in 2019, Armenia imported \$265 million worth of goods from Turkey while exporting

\$2.2 million. The trade turnover between countries was about \$240 million in 2020.

Right after the war, in December 2020, Armenia's government imposed a six-month temporary embargo on imports of Turkish goods, which was later extended by another six months. Consequently, post-war in 2021, imports dropped to \$73 million, and exports decreased to \$0.44 million. But later, in 2022, Türkiye-Armenia trade turnover increased to \$323 million and in 2023 to \$342 million.

The increase in trade relations between the two countries above the pre-war level shows that economic ties are possible and necessary even without diplomatic relations.

6. Economic opportunities and export potential in the region

When examining the expansion of economic cooperation opportunities in the South Caucasus, it is helpful to consider the trade potential of all three countries first, particularly the mutual trade potentials of Azerbaijan, Georgia, and Armenia.

The trade turnover between Azerbaijan and Georgia was growing dynamically. In 2023, Azerbaijan exported \$759.4 million worth of goods to Georgia and imported \$126.2 million. The main products sold by Azerbaijan to Georgia are natural gas, electrical energy, petroleum oils, cement clinkers, iron, and non-alloy steel, while Georgia exported live cattle, sheep, lemons, ferroalloys, and cyanides and cyanide oxides to Azerbaijan.

The trade turnover between Georgia and Armenia is not just increasing. It is growing dynamically, bringing mutual benefits to both countries. Particularly after the Russian war of aggression on Ukraine, both countries' business communities leverage the situation to increase trade opportunities. This factor provides additional impulse to trade also between Georgia and Armenia.

Thus, Georgia's exports to Armenia reached \$787.1 million, and imports totaled about \$336.5 million in 2023.

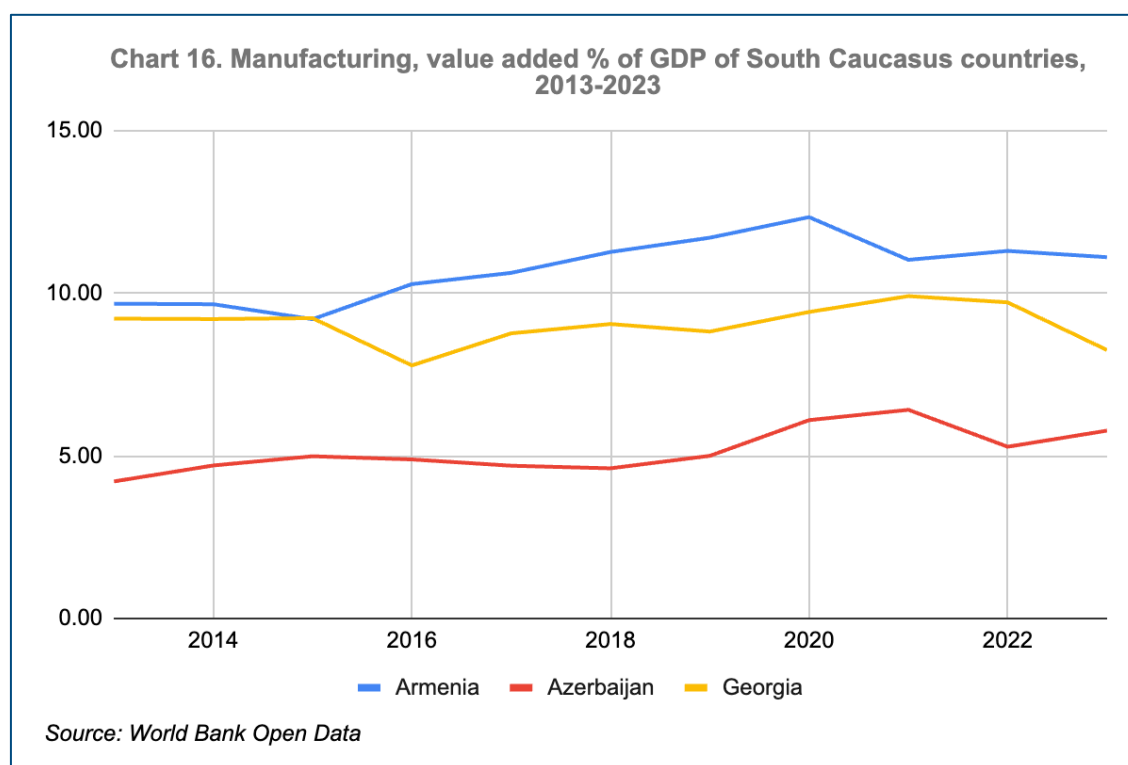
Obviously, 45% of those exports consist of motor cars and other vehicles. Exports of vehicles from Georgia to

Armenia was only \$14.7 million in 2021. In 2021, this amount increased to \$173.2, and in 2023, it reached \$352.5 million. At the same time, Armenia exported to Russia vehicles for \$301.4 million in 2022 and \$431.6 million in 2023. But before the war in 2021, Armenia's vehicle exports to Russia consisted of \$9.6 million

To see an accurate picture of the exchange of goods between the two countries, let's look at the indicators from the pre-war period to 2021. Georgia exported spirits from grape wine, medicaments, electrical energy, fertilizers, and nuts to Armenia and imported copper ores, iron, non-alloy steel, glass, and plastic containers for packaging goods and cigarettes.

If we do not consider re-export operations, the structure of trade between Azerbaijan, Georgia, and Georgia-Armenia demonstrates that the export potential of all three countries mainly relies on extractive, processing, and agricultural industries.

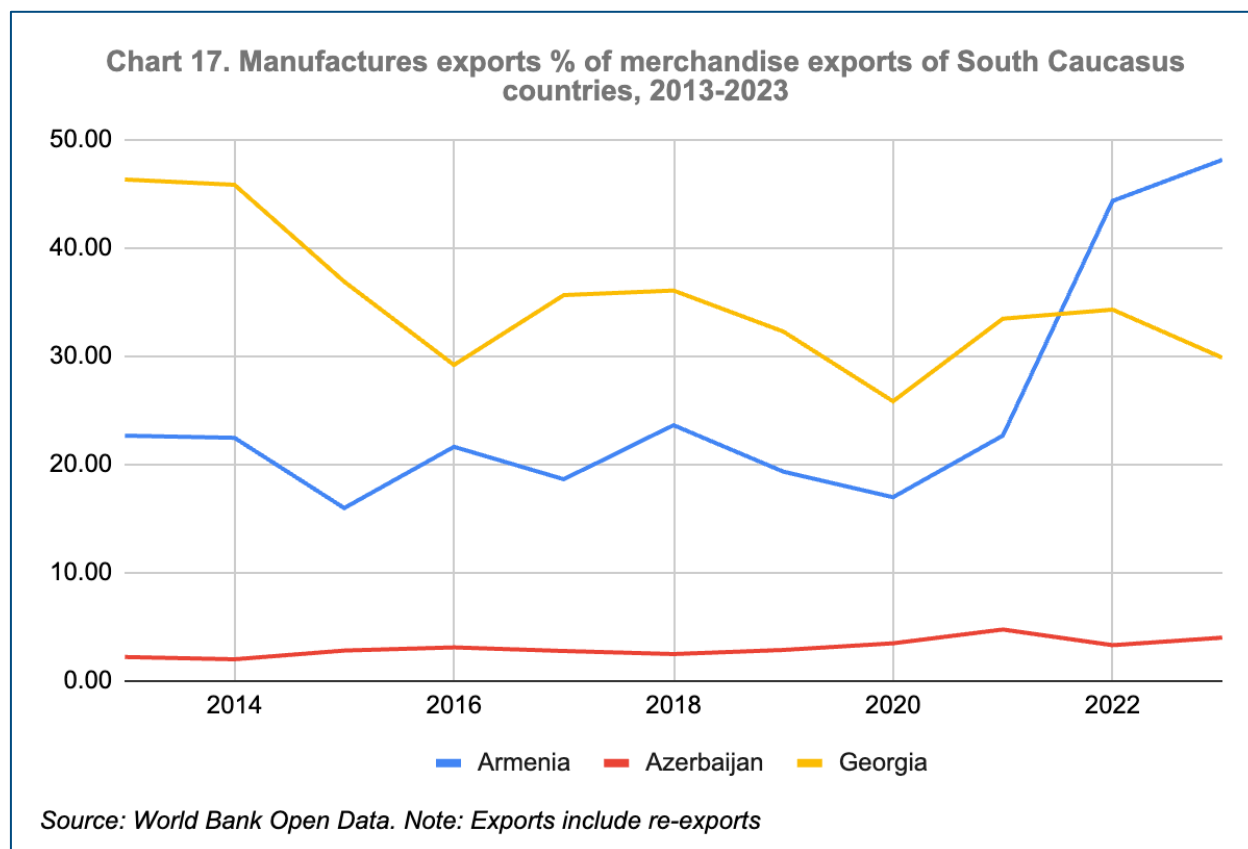
According to the World Bank, the manufacturing share in the GDP of the three countries has remained relatively stable over the last decade (Chart 16). This trend suggests that while other sectors, such as mining and oil-gas industries, may have fluctuated, manufacturing has not seen significant growth as a percentage of GDP.



Similarly, the manufacturing export share has shown limited variation over the same period (Chart 17). However, in the case of Azerbaijan, its manufacturing export share is notably low. This drawback is primarily due to the country's overwhelming focus on oil and gas exports. Like other resource-rich countries, Azerbaijan's economy heavily depends on the energy sector, which dominates GDP and

export revenues.

Azerbaijan's low manufacturing export share highlights the country's need to invest in and develop non-oil sectors to ensure long-term economic stability, reduce its dependency on volatile commodity markets, and create a more diversified export portfolio.



Despite the ongoing trade relations, studies indicate that the full potential of trade between Azerbaijan-Georgia and Georgia-Armenia still needs to be explored. There are significant unrealized opportunities, suggesting that barriers such as political tensions, infrastructure bottlenecks, or lack of investment in cross-border trade initiatives might be limiting the scope of regional commerce.

From this perspective, these untapped opportunities also offer insight into the potential future trade relations between Azerbaijan and Armenia, two countries with historically fraught political relations. If regional stability and trade benefits become priorities, Azerbaijan and Armenia could begin to explore and expand trade relations, mirroring the unrealized potential seen in other South Caucasus countries.

A crucial factor in understanding the underdevelopment of trade relationships within the South Caucasus is the fact that the largest trading partners of these countries are external powers, not from the region itself. For instance, Azerbaijan's significant trade relationships are with countries like the EU and Turkey, primarily driven by oil and gas exports. Russia remains one of the country's main export-import partners. Similarly, despite the reliable trade framework with the EU, Georgia approaches China and Russia. Also, Armenia maintains economic dependence on Russia and Iran. While the reliance on larger, non-regional trade partners can create a dynamic where local economies prioritize external relationships over regional ones, it also underscores the potential for significant economic collaboration within the South Caucasus.

6.1. Export Potential Methodology

The Export Potential Map¹⁶ offers a valuable method for assessing export potential between specific countries.

This method identifies products, markets, and suppliers with untapped export potential and opportunities for

¹⁶ <https://exportpotential.intracen.org/en>

export diversification across 226 countries and over 4500 products. Using the International Trade Centre (ITC) export potential methodology,¹⁷ the Export Potential Map assesses export performance, target market demand, market access conditions, and bilateral connections between exporting and importing countries to rank unrealized opportunities.

The potential export value of product k supplied by country i to market j , in US dollars, is meticulously calculated as supply \times demand (corrected for market access) \times bilateral ease of trade. This calculation is not arbitrary but based on precise projections of supply and demand into the future, considering GDP and population forecasts, demand elasticities, and forward-looking tariffs.

The supply side in the export potential indicator is based on the projected market share. As a result, the share of the country's exports of product k in total exports of product k , multiplied by the exporter's expected GDP growth rate (relative to the expected GDP growth of other exporters of the same product), captures the relative increase in overall supply performance. This indicator is corrected for global tariff advantages of country i in product k . It is meant to capture projected market share, and thus supply performance, in the absence of tariffs. A filter to remove re-exported products is applied in specific manufacturing

sectors.

The demand component is exhaustively based on projected imports, thus the market's imports of product k , are augmented by the expected growth of GDP per capita.

Ease of trade is based on the ratio of actual trade between exporter i and market j for products with potential relative to their hypothetical trade if exporter i had the same share in market j as it has in world markets. The numerator captures the actual trade between the exporter i and market j and the denominator capture trade complementarities between the exporter i and market j . If $\text{Ease} > 1$, country i finds it more accessible to trade with market j than with world markets on average, augmenting the potential to trade any product with market j . By contrast, if $\text{Ease} < 1$, country i finds it relatively more difficult to trade with market j , lowering its potential to trade with that market across all products.¹⁸

Using this methodology we can measure export potential between Azerbaijan-Georgia and Georgia-Armenia. The methodology cannot be applied to Azerbaijan and Armenia, because they are not trading now. However, based on those potentials, we can assume possible trade opportunities between Azerbaijan and Armenia.

6.2. Azerbaijan-Georgia

Azerbaijan and Georgia share a crucial economic and transit partnership, which brings mutual benefits and shared prosperity. Georgia's role as a key transit country for exporting Azerbaijan's most valuable resources—petroleum and natural gas - underscores the interdependence of the two nations. This partnership, primarily underpinned by the energy sector, infrastructure projects, and strategic geographic positioning, enhances trade and regional connectivity for both countries.

One of the most important aspects of the Azerbaijan-Georgia partnership is Georgia's role in transporting Azerbaijani oil and gas to global markets. Major pipelines, the BTC oil pipeline and the SCP, which transports natural gas, pass through Georgia. Moreover, Georgia benefits from transit fees, further strengthening the economic interdependence between the two nations.

Georgia also plays a crucial role in Azerbaijan's broader transportation network, mainly through its railway connections and Black Sea ports. The Baku-Tbilisi-Kars (BTK) railway, a key part of this network, links Azerbaijan with Georgia and Turkey, creating a direct and significant rail connection to Europe. Georgia's Black Sea ports, such

as Poti and Batumi, also provide Azerbaijan with maritime access to Europe.

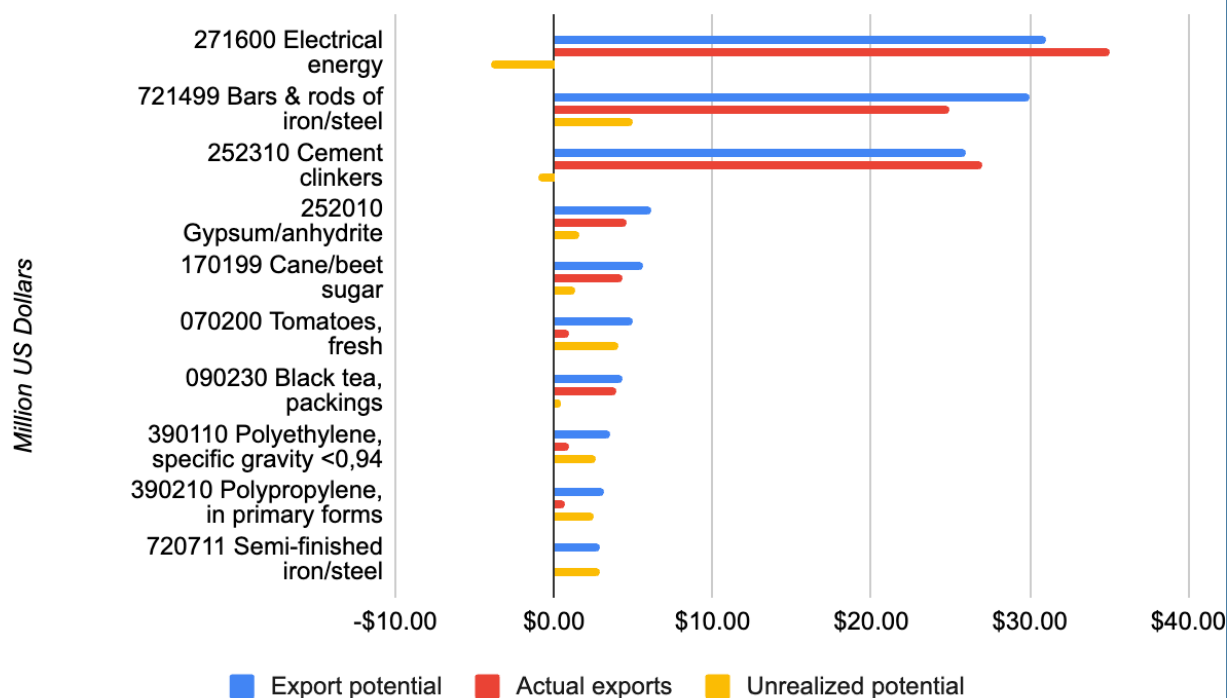
While Georgia is crucial for Azerbaijan's access to the West, Azerbaijan plays an equally important role in the opposite direction, acting as Georgia's gateway to the Caspian Sea, Central Asia, and China. opportunities. The trade between Azerbaijan and Georgia reached \$886 million in 2023, rebounding after a decline during the COVID-19 pandemic. Azerbaijan primarily exports petroleum products and natural gas to Georgia, and Georgia is an important market for Azerbaijan's non-oil products, including construction materials, metal and steel articles, plastics, tractors, and electric machinery products. In return, Georgia mainly exports live animals, mineral water, wine, and alcohol to Azerbaijan.

Overall, the economic partnership between Azerbaijan and Georgia is multifaceted, involving strategic energy transport, significant trade in various goods, and mutual benefits from regional connectivity. Both countries continue to leverage their geographical positions and trade agreements to boost economic growth and regional integration

¹⁷ https://umbraco.exportpotential.intracen.org/media/cklh2pi5/epa-methodology_230627.pdf

¹⁸ <https://exportpotential.intracen.org/en/resources/glossary>

Chart 18. Azerbaijan's 10 products in HS-6 digit with potential to Georgia, 2018-2022 annual average



Source: ITC Export Potential Map exportpotential.intracen.org

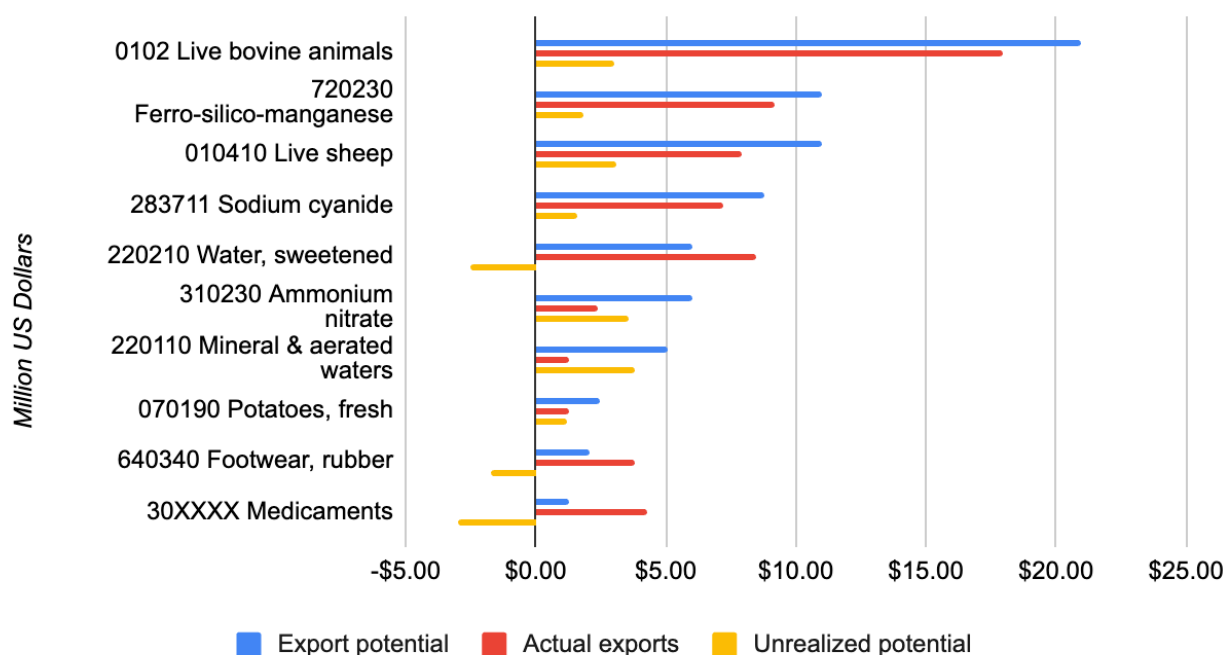
The products with the greatest export potential from Azerbaijan to Georgia are electrical energy, bars & rods of iron/steel, cement clinkers, gypsum, and sugar. Chart 18 shows that Azerbaijan provides exports of electrical energy and cement clinkers in excess. Bars & rods of iron/steel show the largest absolute difference between

potential and actual exports in value terms, leaving room to realize additional exports worth \$5.6 million. Also, fresh tomatoes and plastic materials can potentially be exported to Georgia. The interactive chart illustrates the export potential of 40 products.¹⁹

¹⁹ <https://exportpotential.intracen.org/en/products/gap-chart?toMarker=j&market=268&fromMarker=i&exporter=31&what>

[Marker=k](#)

Chart 19. Georgia's 10 products in HS-6 digit with potential to Azerbaijan, 2018-2022 annual average



Source: ITC Export Potential Map exportpotential.intracen.org

Besides, the products with the most significant export potential from Georgia to Azerbaijan are live bovine animals, ferro-silico-manganese, and live sheep (Chart 19). Mineral and aerated waters show the most considerable absolute difference between potential and actual exports

in value terms, leaving room to realize additional exports worth \$3.8 million. Also, live bovine animals, sheep, and ferro-silico-manganese still have further potential to export.²⁰

6.3. Georgia-Armenia

Georgia is strategically and economically important to Armenia, mainly due to its unique geographical constraints. As a landlocked country, Armenia faces significant challenges in accessing international markets because it has closed borders to its two other neighbours, Türkiye and Azerbaijan. Since the beginning of the 1990s, because of the Nagorno Karabakh conflict and the occupation of surrounding districts by Armenia. Azerbaijan and its ally Türkiye don't have a diplomatic relationship with this country, and borders remain closed.

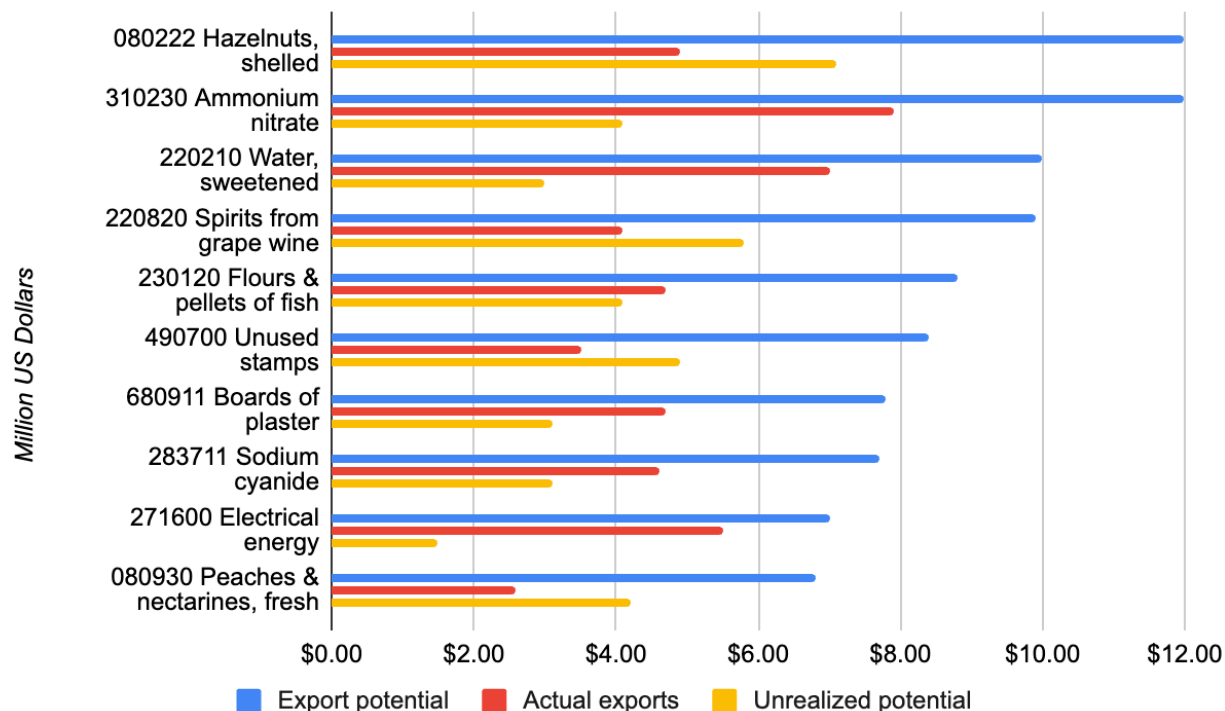
One of the most crucial roles Georgia plays for Armenia is providing access to the Black Sea, which serves as Armenia's primary maritime route to Europe. Armenia can transport goods to and from Europe and other global

destinations through Georgian ports.

Given Russia's importance as a trade partner and a political ally, Georgia serves as Armenia's land bridge to Russia. While Armenia is part of the EAEU, which includes Russia, the ability to trade with Russia heavily depends on the transit routes that run through Georgia.

Despite the closed border between Armenia and Türkiye, Georgia is a crucial link between the two nations, allowing for indirect trade. Goods from Armenia destined for Türkiye or passing through to other markets in the Middle East or Europe often traverse Georgian territory.

Chart 20. Georgia's 10 products in HS-6 digit with potential to Armenia, 2018-2022 annual average



Source: ITC Export Potential Map exportpotential.intracen.org

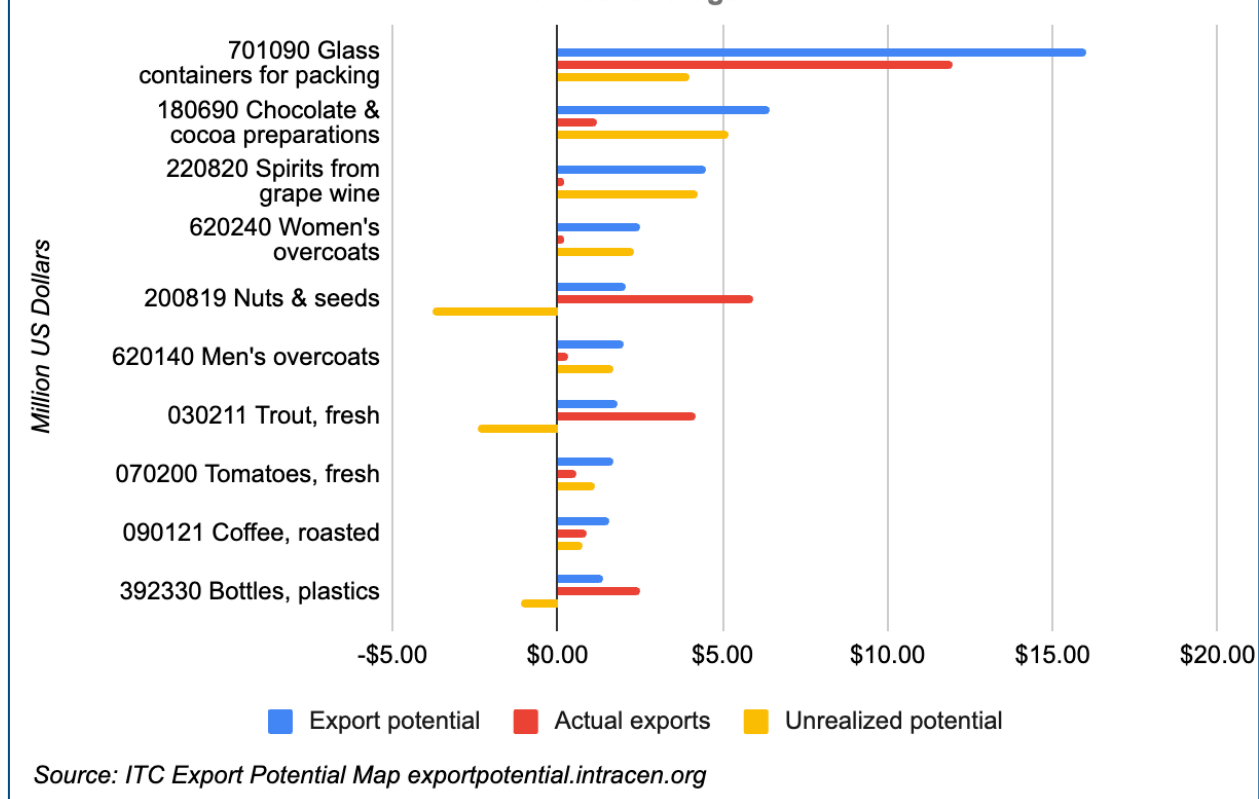
The products with the greatest export potential from Georgia to Armenia are shelled hazelnuts, ammonium nitrate, and lemonade. Hazelnuts show the largest absolute difference between potential and actual exports in value terms, leaving room to realize additional exports worth \$7.2 million.²¹ Furthermore, there is significant untapped potential for all other major products exported from Georgia to Armenia (Chart 20).

The products with the greatest export potential from Armenia to Georgia are glass containers for conveyance/packing of goods, chocolate & cocoa preparations, and spirits obtained by distilling grape wine. Chocolate & cocoa preparations demonstrate the most considerable absolute difference between potential and actual exports in value terms, leaving room to realize additional exports worth \$5.3 million.²²

²¹ <https://exportpotential.intracen.org/en/products/gap-chart?toMarker=j&market=51&fromMarker=i&exporter=268&whatMarker=k>

²² <https://exportpotential.intracen.org/en/products/gap-chart?toMarker=j&market=268&fromMarker=i&exporter=51&whatMarker=k>

Chart 21. Armenia's 10 products in HS-6 digit with potential to Georgia, 2018-2022 annual average



6.4. Azerbaijan-Armenia

Currently, Azerbaijan and Armenia don't have any trade relationship. Therefore, we will apply the ITC export potential methodology to project future trading opportunities between the two countries.

Here, we will identify matches between Azerbaijan and Armenia's trade potentials with other East Europe and Central Asia (EECA) countries. The ICT Export Potential Map allows us to summarize the unrealized trade potentials of Armenia and Azerbaijan in the East Europe and Central Asia regions where both countries belong. The trade potentials based on projections of supply, demand, market access conditions, and bilateral ease of trade are expected for 2028. Also, we study the 20 largest sectors here for analysis.

Azerbaijan's unrealized export potential to EECA²³:

1. Fruits - \$228 million
2. Vegetables - \$81 million
3. Plastics & rubber - \$48 million
4. Ferrous metals - \$19 million
5. Metals (except ferrous & precious) - \$14 million
6. Chemicals - \$11 million
7. Food products (processed or preserved) - \$9 million
8. Machinery, electricity - \$7.3 million
9. Beverages (alcoholic) - \$7.1 million
10. Sugar - \$6.9 million
11. Vegetal textile fibers - \$6.3 million
12. Tea & mate - \$6.1 million
13. Glass articles - \$4.1 million
14. Cotton (fabric) - \$3.9 million
15. Cocoa beans & products - \$2.9 million
16. Beverages (not alcoholic) - \$2.6 million
17. Fertilizers - \$2.5 million
18. Dairy products - \$1.8 million
19. Nuts - \$1.8 million

²³ <https://exportpotential.intracen.org/en/products/gap-chart?fromMarker=i&exporter=31&toMarker=r&market=5&what>

20. Vegetal residues & animal feed – \$1 million

EECA's unrealized export potential to Azerbaijan²⁴:

1. Precious metals - \$104 million
2. Wood - \$67 million
3. Ferrous metals - \$64 million
4. Machinery, electricity - \$60 million
5. Wheat - \$51 million
6. Trains & parts - \$46 million
7. Chemicals - \$38 million
8. Plastics & rubber – \$30 million
9. Metal products - \$27 million
10. Paper products - \$26 million
11. Dairy products -25 million
12. Vegetable oils & fats -24 million
13. Meat (poultry) – \$13 million
14. Motor vehicles & parts – \$12 million
15. Miscellaneous manufactured products - \$11 million
16. Wood products – \$11 million
17. Synthetic textile fabric – \$11 million
18. Live animals (except poultry) – \$10 million
19. Cereals (except wheat & rice) – \$9.5 million
20. Beverages (not alcoholic) – \$9.3 million

Armenia's unrealized export potential to EECA²⁵:

1. Beverages (Alcoholic) - \$150 million
2. Fish & shellfish - \$107 million
3. Mineral resources - \$90 million
4. Apparel - \$66 million
5. Fruits - \$47 million
6. Vegetables - \$26 million
7. Pharmaceutical components - \$19 million
8. Metals (except ferrous & precious) - \$19 million
9. Food products (processed or preserved) - \$13 million
10. Cocoa beans & products - \$9.5 million
11. Glass articles – \$7.4
12. Plastics & rubber - \$7
13. Beverages (not alcoholic) – \$6.4
14. Ferrous metals – \$4.9
15. Live plants, flowers, foliage – \$4.6
16. Dairy products – \$3.2 million
17. Vegetal residues & animal feed – \$3.2 million
18. Chemicals – \$3.1 million
19. Beauty products & perfumes – \$2.1 million
20. Machinery, electricity – \$2 million

EECA's unrealized export potential to Armenia²⁶:

1. Paper products - \$187 million
2. Ferrous metals - \$41 million
3. Meat (poultry) - \$38 million
4. Vegetal residues & animal feed - \$26 million
5. Machinery, electricity - \$21 million
6. Jewellery & precious metal articles
7. Wood - \$20 million
8. Chemicals - \$15 million
9. Plastics & rubber - \$13 million
10. Metal products - \$12 million
11. Pearls & semiprecious stones - \$12 million
12. Fruits – \$12 million
13. Beverages (alcoholic) – \$11 million
14. Metals (except ferrous & precious) – \$9.6 million
15. Food products (processed or preserved) – \$7.8 million
16. Dairy products – \$8.6 million
17. Vegetable oils & fats – \$8.4 million
18. Fertilizers – \$8.3 million
19. Mineral products – \$8.2 million
20. Wheat – \$8.1 million

From the findings, we look at matches between Azerbaijan's export potential to EECA and EECA's export potential to Armenia, and also Armenia's export potential to EECA and EECA's export potential to Azerbaijan.

Azerbaijan's export potential to Armenia:

- Ferrous metals
- Plastics & rubber
- Chemicals
- Machinery, electricity
- Fertilizers
- Food products (processed or preserved)
- Dairy products
- Fruits
- Beverages (alcoholic)

Armenia's export potential to Azerbaijan:

- Beverages (not alcoholic)
- Ferrous metals
- Chemicals
- Machinery, electricity
- Dairy products
- Plastics & rubber

²⁴ <https://exportpotential.intracen.org/en/products/gap-chart?fromMarker=r&exporter=5&toMarker=j&market=31&whatMarker=s>

²⁵ <https://exportpotential.intracen.org/en/products/gap-chart?fromMarker=i&exporter=51&toMarker=r&market=5&whatMarker=s>

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²⁶ <https://exportpotential.intracen.org/en/products/gap-chart?fromMarker=r&exporter=5&toMarker=j&market=51&whatMarker=s>

7. Conclusions and Recommendations

7.1. Conclusions:

- The structure of domestic export and import between Azerbaijan-Georgia, and Georgia-Armenia demonstrates that the export potential of all three countries mainly relies on extractive, processing, and agricultural industries.
- The analysis of trade potentials shows that there is additional trade opportunity between South Caucasus countries. Only in the basket of ten exported products does Azerbaijan have an additional \$20 million to export to Georgia. Besides, Georgia has an additional 16 million potential to export to Azerbaijan. Hence, Georgia has \$41 million additional potential to export to Armenia, and Armenia has an additional \$19 million potential to export to Georgia.
- Azerbaijan can export to Armenia ferrous metals, plastics and rubber, chemicals, fertilizers, electricity processed or preserved food products, dairy products, fruits, alcoholic beverages.
- At the same time, Armenia can export to Azerbaijan not alcoholic beverages, ferrous metals, chemicals, electricity, dairy products, plastics & rubber.
- Türkiye became one of Armenia's top ten import partners. In 2023, Armenia imported goods from Türkiye for \$336 million. Armenia and Türkiye's trade relationship not only recovered after the 2020 II Karabagh war but also enlarged in 2022-2023 comparison to 2019.
- Azerbaijan's non-membership in the WTO and Armenia's membership in the Russian-controlled EAEU are factors hindering the expansion of trade opportunities of those countries. Azerbaijani companies are deprived of the opportunity to expand the export of non-oil products using the WTO's opportunities. Armenia, being a member of the Russia-controlled EAEU, cannot develop trade relations with the EU.

7.2. Recommendations:

- While a peace agreement between Azerbaijan and Armenia is yet to be signed, trade operations can commence. Initially, this can be facilitated from Georgia's territory. However, the crucial element for this to proceed is political support from the leadership of both countries.
- It is important to start negotiations to sign a trilateral FTA between the countries of the South Caucasus. This will take a long time, and therefore, negotiations on FTA can start before the signing of a peace treaty between Azerbaijan and Armenia.
- The establishment of a free trade zone at the junction of the borders of Azerbaijan, Georgia, and Armenia, particularly in the area near the Red Bridge, could be a game-changer in enhancing economic cooperation in the South Caucasus.
- This location holds immense potential and should be seriously considered for the proposed free trade zone.
- If Azerbaijan finalizes WTO membership, it could boost its non-oil and gas exports and facilitate local companies' market access in other WTO member countries.
- Azerbaijan, Georgia, and Armenia can fulfil regional infrastructure projects, attracting investment interest from international financial institutes like the World Bank, the European Bank for Reconstruction and Development (EBRD), and the Asian Development Bank (ADB). Joint infrastructure projects also have potential because of the EU Global Gateway/China Belt and Road projects.

About the organization:

Public Association for Assistance to Free Economy (PAAFE) was registered by the Ministry of Justice of Azerbaijan on May 26, 2006. PAAFE is a non-governmental organization operating fully on a non-profit basis. The main directions of work of the organization are promoting

economic freedoms, good governance and economic diversification, and the protection of economic and social rights, freedom of association and information. For more information please visit: www.freeeconomy.az

