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Free Trade and Connectivity Opportunities in the South Caucasus – A Review of Policy Papers

The Friedrich Naumann Foundation for Freedom (FNF) has commissioned a series of papers examining the potential opportunities for enhancing trade and connectivity in the South Caucasus. The goal is to explore the potential for increased free trade and assess the economic benefits of deeper regional integration, while also analysing existing trade patterns, identifying potential areas for cooperation, examining challenges and proposing solutions to overcome them. From a broader perspective, increased regional cooperation through enhanced trade relations is a highly desirable outcome. This would not only create an important pillar of stability based on economic cooperation in the South Caucasus but would also raise the region's profile in the eyes of international partners – an important step towards securing additional investment, diversifying trade and putting the whole region on a higher growth path. However, different starting points in terms of natural resources, ongoing conflicts, and diverse geopolitical considerations make this a rather difficult task in practice.

Although the debate has been ongoing for several decades, no real breakthrough has been achieved. To further contribute to the discussion, three papers—one for each country — have been prepared by economists from Armenia, Azerbaijan and Georgia. The authors of the respective papers analyse existing and historical trade patterns, regimes, and agreements, as well as the overall relationship between the countries. This allows data-driven conclusions about the trade potential to be drawn and provides recommendations for practical steps to enhance regional cooperation.

Georgia. The paper covers a wide range of topics, from Georgia's historical trade relations to modern agreements such as the Deep and Comprehensive Free Trade Area (DCFTA) and includes a case study of the Baltic Free Trade Agreement (BAFTA). Considering these experiences, as well as the current trade relations with its neighbours Azerbaijan and Armenia, the authors propose the idea of a so-called South Caucasus Free Trade Area (SCaFTA). Leaving out a narrow discussion on the legal plausibility and political will for such a trade regime, the authors highlight historical obstacles such as armed conflicts in the region, the lack of economic reforms, limited access to technology and modern infrastructure, as well as the close economic dependence on the Russian market, which has reduced incentives for innovation and diversification of existing trade relations. The proposed steps focus mainly on Georgia's experience with the DCFTA and the principles behind the EU's common markets. While there are indeed some lessons to be learnt – particularly for developing a well-coordinated regional cooperation strategy – they need to be tailored more specifically to the concrete needs of the South Caucasus region.

Azerbaijan. The author provides a range of insights into Azerbaijan's trade framework, from its historical background to detailed information on specific trade policies and agreements. To a lesser extent, a similar exercise has also been undertaken for Georgia and Armenia. In contrast to the Georgia paper, the Azerbaijan paper focuses much more on the economic opportunities and export potential in the South Caucasus. For example, the author employs the International Trade Centre's (ITC) widely used Export Potential Map to identify the overall potential for increasing trade in the region. While some products with export potential are identified, the overall conclusion is that the structure of current trade

between Azerbaijan, Georgia and Armenia does not demonstrate a level of complementarity that would allow for a broad expansion of trade. This is partly due to existing barriers such as regional political tensions, infrastructure bottlenecks and lack of investment in cross-border trade initiatives. Consequently, the practical recommendations focus on steps towards developing a regional free trade area, accompanied by proposals for establishing a free trade zone near the Red Bridge area.

Armenia. Similar in structure to the Azerbaijan paper, the authors provide a comprehensive overview of the three countries' trade profiles and existing trade agreements before discussing the potential for enhancing trade in the South Caucasus. The Trade Complementarity Index (TCI) calculated by the authors is a widely used approach to assess this potential. It overcomes the limitation of the ITC Export Potential Map used by the author of the Azerbaijan paper by allowing direct conclusions on the trade potential between Armenia and Azerbaijan. Moreover, combining the TCI results with expert assessments allows for a more refined analysis. However, the overall finding of a rather low intra-regional trade complementarity with limited potential for some goods, still holds. Once again, the major political constraint of the absence of a peace agreement between Azerbaijan and Armenia is highlighted, leading the authors to propose more business-to-business oriented solutions, while also bringing up the idea of additional free trade agreements and a free trade zone.

The papers outlined above should be read as a joint work rather than three separate contributions. Together, they provide a good introduction to a much deeper discussion that seeks to answer the question of how to improve trade and connectivity in the South Caucasus. Overall, the papers reflect the country-specific approaches and views on enhancing regional cooperation quite well. However, it also becomes clear that these approaches are not yet based on a common vision and that many political, economic and legal obstacles must be overcome before progress can be made in any direction. For example, Georgia's Deep and Comprehensive Free Trade Area (DCFTA) with the European Union – the lessons of which may need to be reviewed considering the recent political developments – conflicts with Armenia's membership in the Eurasian Economic Union (EAEU). While these two countries have an existing free trade agreement (FTA), there are bound to be administrative conflicts between the trade regimes. Azerbaijan, meanwhile, currently has closed borders with Armenia due to the Nagorno-Karabakh conflict. Any meaningful development of cooperation between these two countries, and by extension in the South Caucasus, can only be envisaged once a comprehensive peace agreement has been reached.

One of the main findings of the papers is that while there is certainly potential for additional trade, it tends to be small and limited to specific products. This is not surprising from a historical perspective, as the trade profiles of the three countries evolved in different directions and were not focused on regional cooperation after the collapse of the Soviet Union. Therefore, the authors' practical recommendations for increasing trade and connectivity focus on some first small steps, such as improving business-to-business relations. While broader proposals for a free trade zone and new free trade agreements are mentioned, they require a much more focused discussion than the scope of the papers can provide. Such a discussion is also needed to develop a common vision for future regional development in the South Caucasus and must be backed by political will of all three

countries. Nevertheless, the authors' combined work provides a very good analytical contribution to the ongoing discussion on improving cooperation in the region and making it attractive from the perspective of international partners.

From the point of view of a Western and specifically German audience, further research on this topic is certainly interesting. However, it should be noted that the South Caucasus as a region is currently rarely considered as a homogeneous construct. Most discussions tend to focus on specific countries or issues. For example, Azerbaijan is currently seen as an essential partner for the further diversification of European energy imports, making the country an important part of the international climate discussion (e.g. at the United Nations Climate Change Conference "COP29", which took place in Baku). On the other hand, trade cooperation with Georgia is mainly seen in the context of the DCFTA. Logistics and the so-called Middle Corridor – an additional diversification of the Northern Corridor and maritime routes – are also high on the agenda for both countries. By contrast, resource-poor and landlocked Armenia is often overlooked. This is also true when looking at the region from the perspective of larger companies, which simply do not see enough potential to invest or expand their presence, as ongoing conflicts, closed borders and a general lack of regional cooperation reduce their interest. It would, therefore, be of particular interest to broaden the discussion to explore untapped potential not only in trade but also in infrastructure and energy, especially in the context of security issues and potential shifts in the geopolitical orientation of the South Caucasus countries.

Coming back to the initial task of exploring the potential opportunities for enhancing trade and connectivity in the South Caucasus, it can be concluded that while the papers do not offer major solutions, they provide many interesting angles to deepen the discussion further. However, even the first steps proposed by the authors require the political will of all three countries to deepen their relations. One important step is a comprehensive peace agreement between Azerbaijan and Armenia. Only then can many other projects be launched. In the meantime, building trust through small steps at the business-to-business level – as suggested in the papers – seems to be the only way forward. The Western audience may also need to re-evaluate its perception of the region and decide whether it is more interested in cooperation on specific aspects and issues or in a broader strengthening of the South Caucasus as a whole. Both approaches are often contradictory in practice.