



Free trade with Europe: boosting competitiveness and growth

February 2012

Summary

On February 20 2012, the EU announced the launch of DCFTA (Deep and Comprehensive Free Trade Area) talks with Armenia within the framework of the currently negotiated EU-Armenia AA (Association Agreement). It is in line with the EaP's declared goal of fostering political association and economic integration between the Union and its Eastern partners and is guided by the principle of "more for more". This means that the EU seeks a long-term economic partnership to promote trade, investments, market liberalisation and growth, intellectual property rights and European market standards, while reaffirming that such a long-term development can only be successful if it is embedded in a stable system based on democracy and the rule of law. This document provides a concise description of both the political and institutional processes, which preceded the start of the negotiations. Furthermore it outlines the peculiarities of the Armenian economy, its achievements and shortcomings. Finally, it argues that apart from integrating Armenia into the European Single Market, both the very process of negotiations, during which Armenia is expected to implement measurable reforms, legal approximation and institutional capacity building and the anchoring of Armenia inside a DCFTA with the EU have the potential to boost Armenia's competitiveness and its market growth.

Introduction

Armenia is starting negotiations on a DCFTA (Deep and Comprehensive Free Trade Area) with the European Union. In fact, on 20 February 2012 the Commission announced its readiness to start negotiations of a DCFTA with Armenia.¹ Judging from the path of the EU-Armenia Association Agreement talks and the recent legislative delivery by Armenia on key criteria put forward by the EU in 2009² for the start of the DCFTA talks, a constructive process is underway in the EU-Armenia relations. According to stakeholders on both sides engaged in relevant preparatory steps, both in terms of legislative harmonisation and institutional capacity building, the first round of talks is expected to start in March 2012.

The Armenian government was neither early nor fast to start and advance this process. However, EU officials in Brussels and Yerevan confirm that Armenia is now living up to the commitments made, both by successfully completing the negotiations about 22 out of 28 chapters of the Association Agreement³ and providing for the necessary capacity building and legal approximation for the launch of the DCFTA negotiations, especially during recent months. Moreover, the latest high level EU-Armenia meetings have conferred the necessary political backing to the process. Besides, the EU has been forthcoming institutionally, especially when it comes to its intergovernmental dimension. For instance, on 17 February 2012, upon the Commission's assessment of Armenia's progress, the Council's Trade Policy Committee smoothly secured a mandate for the Commission to negotiate with Armenia on behalf of the EU.⁴

The DCFTA between the EU and some countries covered by the Eastern Partnership (EaP) aims at the integration of these countries within the European Single Market and is framed by the Association Agreements currently negotiated on a bilateral level.⁵ It is in line with the EaP's declared goal of fostering political association and economic integration between the EU and its Eastern partners and is guided by the principle of "more for more". This means that the EU seeks a long-term economic partnership to promote trade, investments, market liberalisation and growth, intellectual property rights and European market standards, while reaffirming that such a long-term development can only be successful if it is

¹ European Commission – DG Trade, *EU launches free trade negotiations with Armenia*, Press Release, Brussels, 20 Feb. 2012, <http://trade.ec.europa.eu/doclib/press/index.cfm?id=777>

² European Commission, *Implementation of the European Neighbourhood Policy in 2010, Country report: Armenia*, Brussels, 25 May 2011, http://ec.europa.eu/world/enp/pdf/progress2011/sec_11_639_en.pdf

³ Moreover, On 19 Dec. 2011, the Council of the European Union authorised the start of talks on visa facilitation and readmission agreements with Armenia in the framework of the currently negotiated Association Agreement. See, Delegation of the EU in Armenia http://eeas.europa.eu/delegations/armenia/press_corner/all_news/news/2011/20111220_01_en.htm

⁴ European Commission – DG Trade, op.cit.,

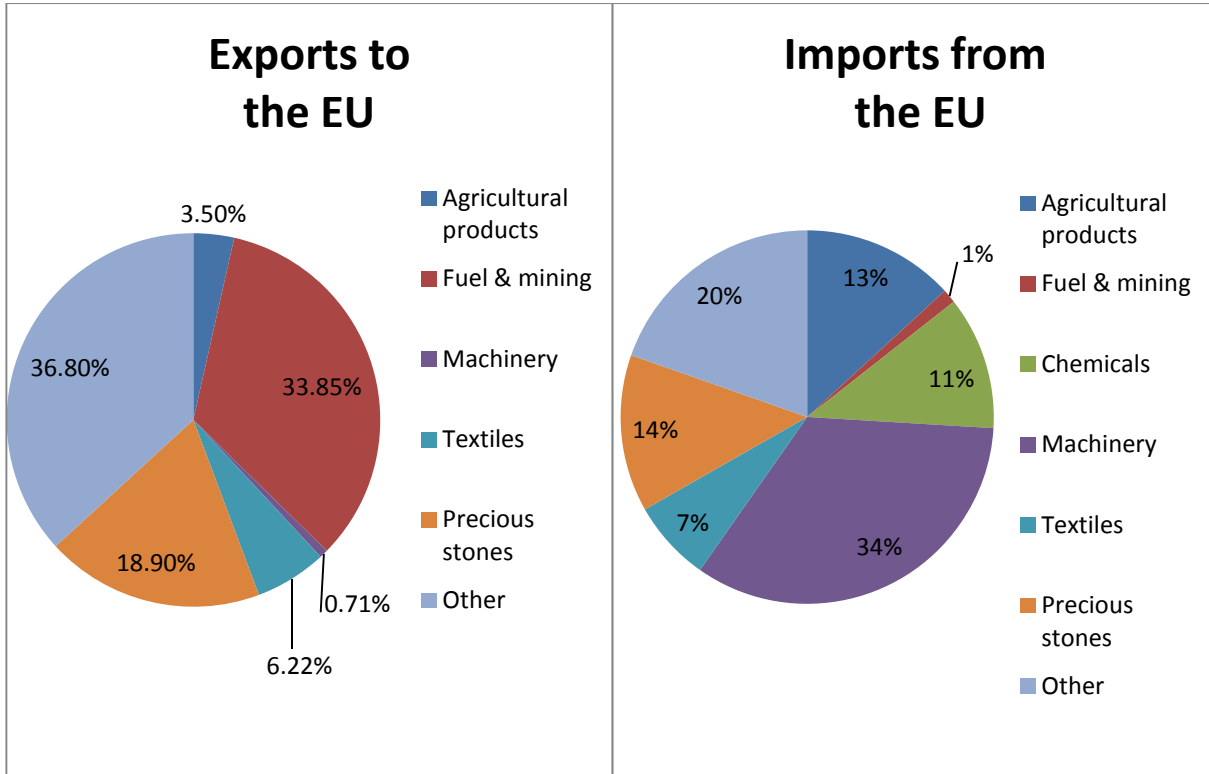
⁵ On this topic, see EEAS, http://eeas.europa.eu/delegations/armenia/eu_armenia/trade_relation/free_trade_agreement/index_en.htm

embedded in a stable system based on democracy and the rule of law. Moreover, the launch of negotiations around these specific free trade agreements is conditioned by a number of extensive economic and legal criteria, which need to be satisfied by the partner country. While Ukraine is about to complete the DCFTA negotiations with the EU, Georgia and Moldova started their bilateral talks in 2011 and Armenia is starting them in early March 2012. Judging from the on-going bilateral negotiations between Georgia, Moldova, Ukraine and the EU, it is safe to say that the DCFTA with Armenia will contain comprehensive chapters on market liberalisation, especially in the services sectors. Moreover, they will focus on harmonisation of standards with the EU, as well as enhanced trade facilitation and lower border costs and will go well beyond tariff liberalisation on goods. The EU draws on experience from decades of market liberalisation, both internally and externally, i.e. in pre-accession cases.

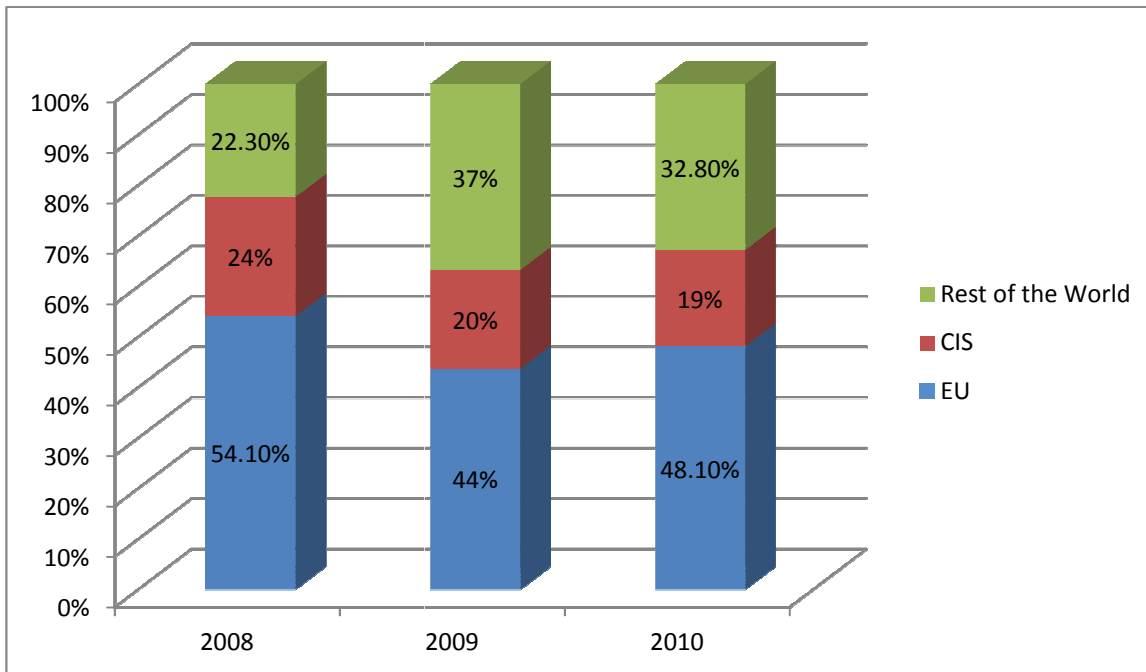
It needs to be emphasised, however, that DCFTA talks are usually long and tortuous processes. Still, most importantly, they generate reformatory outputs even during their preparatory phase. In fact, starting from the stage leading to the launch of negotiations and throughout the whole process of the talks, the applicant country commits itself to set up efficient institutional structures and administrative capacities and undertake substantial and measurable reforms. They will cover key areas of trade liberalisation such as customs, taxation, competition, intellectual property rights as well as harmonisation in sanitary and phytosanitary (SPS) standards etc. These reforms, while intended to pave the way for free trade with the EU, will re-shape the internal markets of applicant countries and market behaviours of economic actors. In the mid and long term, they increase standards, enhance the long term growth dynamics of the internal market, they increase the market's attraction for Foreign Direct Investment and they increase external trade. Yet in the short term, they also require up-front investments and changes in business practices, which represent a one-off burden especially for small and micro-businesses.

As for the EU-Armenia trade indicators, the EU is the number one destination for Armenian exports and its share grew from 44% in 2009 to 48.1% in 2010. When it comes to imports, the EU totalled 27,4% in 2009 and 27.5% in 2010 coming second after the CIS countries. Furthermore, starting from 2009 Armenia has been benefitting from the EU Generalised System of Preferences Plus (GSP+), aiming at further diversifying its export structure and improving its export performance. While the EU's exports to Armenia in 2010 were mainly composed of machinery (34%), precious stones (14%), agricultural products (13%) and chemicals (11%); Armenia's exports to the EU principally constitute base metals and derivatives (33.8%), processed precious stones (18.9%) and textiles (6.2%).⁶

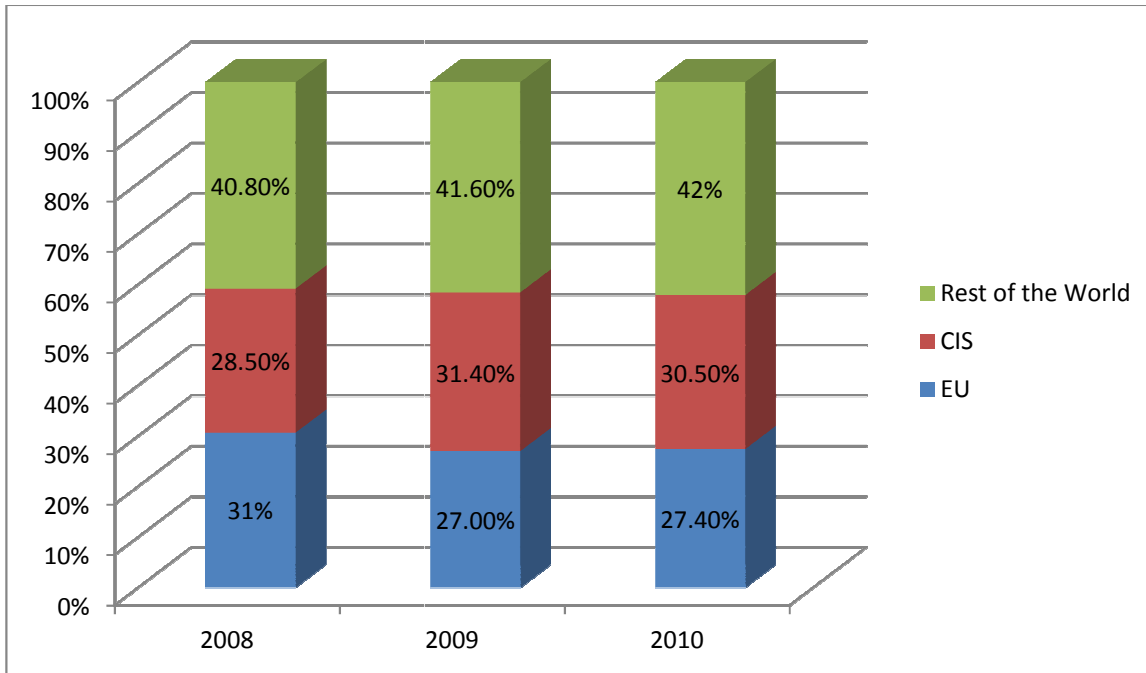
⁶ See European Commission – DG Trade, *EU trade relations with the South Caucasus countries*, <http://ec.europa.eu/trade/creating-opportunities/bilateral-relations/regions/south-caucasus/>



Graph 1. EU-Armenia trade break-down by type of product, source: Eurostat (NewCronos) 10 January 2012



Graph 2. Armenian exports 2008-10, source: combined data by Eurostat, DG Trade and National Statistical Service of the Republic of Armenia



Graph 3. Armenian imports 2008-10, source: combined data by Eurostat, DG Trade and National Statistical Service of the Republic of Armenia

The Armenian economy operates under special circumstances, which are conditioned both by a complicated geopolitical reality and by lack of competition in some market sectors. In fact, the country is landlocked, with Azerbaijan and Turkey blocking their borders. Such a condition impacts the transportation costs and diversification of transport routes. As for the internal market of Armenia, there are obstacles to market freedom and efficiency, such as trusts and cartels, especially in the commodity market.

Below we provide a concise description of the Armenian economy, its achievements and the persisting challenges. Moreover, the initial conditions from which Armenia started its path towards the launch of these talks will be highlighted.

Background

The current economic landscape of Armenia has been shaped by both internal and external circumstances. The country emerged from the Soviet Union being affected by severe conditions. In fact, its economy was not only subjected to the corrosion of the Soviet industrial network-centric system, while facing the challenges of transition from a planned to a free market economy. In addition, in 1988 a devastating earthquake destroyed vital infrastructure and the industrial agglomerates in the north of the country. Moreover, by 1991 the conflict in Nagorno-Karabakh had already spiralled out into a large-scale war with neighbouring Azerbaijan causing a blockade by both Azerbaijan and Turkey. In that period, the country was subjected to a severe shortage of basic commodities and virtually cut off FDI.

Against the backdrop of the above-mentioned hardships, some economic progress was registered as well. For instance, Armenia implemented a campaign of privatisation in the early '90s. The overall macroeconomic policies implemented by successive governments have been quite successful in securing relatively low levels of inflation, a stable currency and a sustained GDP growth starting from the mid '90s. As for the industrial policies of Armenia, taking into account the reality inherited from the Soviet Union, as well as its two closed borders, the output was oriented towards goods having low transportation costs (e.g. processing of precious stones and high-tech engineering) and being labour or knowledge-intensive. Besides, an increased output was registered in the last decade in the mining industry, especially in the extraction of nonferrous metals. However, so far the bulk of these raw materials is being exported and

not processed locally. Consequently, while its environmental impact is growing, the added value generated by the mining sector has not reached its full potential yet.

As for the overall economic freedom and business environment in Armenia, some encouraging results have been achieved so far. In fact, the country ranks 39th in the Heritage Foundation and Wall Street Journal's World Economic Freedom Index, and is the 19th among 43 European countries.⁷

One of the most criticised aspects of the Armenian economy is the presence of commodity-based cartels. They started emerging in the early '90s under conditions of shortage of basic goods and quickly acquired dominant market positions. Their capital served as a power basis for establishing influential networks with political decision makers and regulators, generating market concentrations and having easy access to state procurement contracts. In other words, these oligopolic businesses grew in parallel with the gradual economic growth of the country. At the beginning of this process in the mid '90s, fragile institutional capacities of the state, combined with weak judiciary and corruption allowed for the birth of these cartels in Armenia.

Another peculiarity of the Armenian economy is the role of the Armenian Diaspora and its investments in the country. They are relevant both in terms of quantity and, most importantly, quality when it comes to socio-economic, educational and cultural processes. Taking into account that about two-thirds of Armenians - approximately 6 million - live abroad and have strong bonds with the country, Diaspora-based businessmen practice what is commonly known as "patriotic investments". Their economic activities in Armenia are multifaceted: on the one hand they focus on the local capital and the production of traditional goods (carpets and rugs, agro-alimentary industry, winemaking, jewellery and precious stones, tourist industry). On the other hand, they embark on very challenging knowledge-intensive business endeavours in the fields of high-tech, nanotechnology and scientific R&D. Moreover, in the current crucial phase of transition of the Armenian economy, such activities generate very positive spin-offs locally as they project towards the country a more innovative business culture from Western Europe, the Americas and South-East Asia. Last but not least, the Diaspora represents a gigantic world-wide network facilitating trade, mostly based on personal links.

These specific qualities of the Armenian economy provide the opportunities and challenges in implementing a DCFTA. Regarding the EU-Armenia DCFTA related developments on the side of the EU, the 2008 findings of an independent feasibility study by the Centre for Social and Economic Research (CASE, Warsaw) on a possible EU-Armenia FTA, concluded that it could be economically beneficial to Armenia.⁸ In particular, the study argued that "a free trade agreement between Armenia and the EU is feasible, but a Simple FTA (abolition of tariffs) would not bring significant economic benefits to Armenia. The real gains could materialize over the medium to long term with a completion of a Deep FTA (abolition of tariffs, significant institutional harmonization and improvement in the business environment)."⁹ Capitalising on the above-mentioned document, in February 2009 the European Commission sent a fact-finding mission to Armenia in order to assess the steps needed to meet the criteria for the start of future DCFTA talks. The recommendations set forth by the Commission reportedly called for specific institutional capacity building in Armenia and extensive regulatory approximation with the EU trade-related laws and standards.¹⁰ At the same time the EU started providing Armenia with the necessary technical assistance and know-how, amongst others through an EU Advisory Group,¹¹ based in all ministries and key administrative bodies.

⁷ The Heritage Foundation – Wall Street Journal 2012 Index of Economic Freedom, Armenia Profile, <http://www.heritage.org/index/country/armenia>

⁸ M. Maliszewska (Ed.), *Economic Feasibility, General Economic Impact and Implications of a Free Trade Agreement Between the European Union and Armenia*, CASE Network Report, No. 80, 2008, Warsaw

⁹ Op. cit., p. 22

¹⁰ On this topic see EEAS http://eeas.europa.eu/delegations/armenia/eu_armenia/trade_relation/free_trade_agreement/index_en.htm

¹¹ EU Advisory Group to the Republic of Armenia, <http://www.euadvisorygroup.eu/> This Advisory Group was set up upon the invitation of the Armenian government and seems to serve as a model for other EaP countries.

Implications: DCFTA getting underway

On 18 December 2009¹², the EU Commission concluded that when it comes to trade related issues, market and regulatory reform, after noting some progress on the Armenian side, especially in the customs area, the Commission's document reads "As concerns other key recommendations limited progress was noted." For instance, when assessing the reforms in the field of competition the document states that "The legislative and institutional framework regarding competition policy is relatively well developed in Armenia." However, it concludes that "While there has been a lot of progress by Armenia in putting in place a legislative framework in support of IPR, other property ownership and competition laws, there remain clear shortcomings regarding the practical and effective enforcement of these laws. Whether this is to do with institutional capacity or lack of implementing rules and guidelines, until the practical application on the ground ensures that a clear regulatory framework is de facto in place this criterion cannot be considered as met.", states the report of 2009.¹³

The EU has experienced similar problems in all countries which emerged from communism and transformed their economies and governance to European standards. Legal approximation precedes the practice of good governance. The practical implementation of the new laws lags behind as much as there is a genuine will or force to transform the country. Armenia finds strong motivation in its difficult geo-political situation and its need to keep up the socio-economic development at least in comparison with its war threatening neighbour Azerbaijan.¹⁴ The population also compares the socio-economic situation with other neighbours and the countries hosting its Diaspora, especially France, Russia and the USA. This creates a permanent pressure on the Armenian government to increase the efficiency of the administration and to implement reforms, such as those connected to the DCFTA. As for the conclusions of the above-mentioned Commission's report dated 2009, the situation has changed, both in terms of capacity building and legal approximation in Armenia.

The findings of a recent World Bank-funded research forecast substantial gains for Armenia from the "deep" aspects of the DCFTA.¹⁵ According to the authors, these gains will be generated, "in order of importance, by

- trade facilitation and reduction in border costs;
- services liberalisation;
- and standards harmonisation.

Additional gains can be expected in the long run from an improvement in the investment climate.", the document concludes.¹⁶

Moreover, an EU-Armenia DCFTA will serve as a facilitator in minimising the effects of the border-blockade imposed on Armenia by Turkey and Azerbaijan – shifting the country's geo-economy and making its market more performing. Experience shows that such liberalisations lead to a more competitive market with more opportunities for all economic actors and consumers, but above all with more investments and a growing overall market size. Paradoxically, those who currently dominate certain segments of the Armenian market will in the mid-term have the best chances to increase their gains with the overall growing market size, while their individual market shares decrease from being *dominant* to being merely *strong*.

¹² European Commission, *Commission staff working document on progress by Armenia towards graduation to market economy status in trade defence investigations*, 18 Dec. 2009, http://www.europa-nu.nl/id/vib98omjyzzu/commission_staff_working_document_on

¹³ Op . cit.

¹⁴ On the Azerbaijani war threats see, *Collection of war threat statements by President Ilham Aliyev and other Azerbaijani officials*, EuFoA, Brussels, <http://www.eufoa.org/uploads/AliyevWarThreats.pdf>

¹⁵ J. Jensen and D. G. Tarr, *Deep trade policy options for Armenia : the importance of services, trade facilitation and standards liberalization*, Policy Research Working Paper 5662, the World Bank, May 2011, p. 3, http://www-wds.worldbank.org/external/default/WDSCContentServer/IW3P/IB/2011/05/18/000158349_20110518082525/Rendered/PDF/WPS5662.pdf

¹⁶ Op. cit, p. 3

Meanwhile, the DCFTA can facilitate another long necessary transition in Armenia, namely towards a stronger financial services industry linked up with its Western counterparts. Financial services are an industry sector which bypasses any border blockage and which does not depend on a geographically close location. Financial services in Armenia are well developed but still fail to meet European standards, and thus cannot play the most unique role which they could play, namely offering an attractive financial hub between Europe, Russia and the Middle East.

The DCFTA is a long-term project which needs to have the widest possible consensus among political actors in Armenia. Moreover, this can only succeed if the people and the business elites in Armenia largely support and do not torpedo this process. The Armenian government has so far taken a quiet approach and failed to communicate the benefits of the DCFTA more broadly. Above all, it has so far failed to organise a consensus with most of the business elites, be they close to politics or far, about the goal of a DCFTA with the EU. The DCFTA is a helper for anyway necessary reforms. Without a broad support, many will blame "Europe" for current and upcoming problems, which are actually of Armenian origin.

In parallel, the EU will closely follow the delivery of the Armenian government on democracy, human rights and the rule of law.¹⁷ In this perspective political processes around the parliamentary elections in May 2012 and the presidential elections in February 2013 need to be fair, pluralistic and transparent. Otherwise, the public pressure for reforms and socio-economic progress is bound to lead to a disconnection of the current political elites with the electorate and possibly strong socio-political tensions. Furthermore, the Armenian leadership should be aware that in case significant democratic shortcomings are registered in the country, the DCFTA talks can be easily suspended by the EU. In other words, the EU's *more for more* principle also implies *less for less*. This project will only be beneficial for both sides, if Armenia is a strong and stable democracy, neither fickle nor unpredictable in this course. The EU has little interest in building up a long-term economic partnership based on short-term political deals. In return, the EU offers to be a stable partner with a long term vision and assistance. The EU is no homogenous strategic power with changing goals; it is a block of 27 member states who simply offer to their neighbours what they achieved for themselves, with the goal of increasing peace and prosperity for all sides.

The combination of the communist and post-communist legacies, the progress and growth during 20 years of independence and the aforementioned public expectations mark the conditions in which Armenia embarks upon the track to the DCFTA. Numerous examples of other countries and their transformations show the enormous potential, but also the challenges of such a project. The DCFTA negotiations are getting underway and both sides finally found the motivation necessary to make this a big success. The conduct and outcome of the coming parliamentary and presidential elections in Armenia, the continued implementation of the reforms begun now and the increasing support from the EU will determine how long we will have to wait to reap the fruits of the DCFTA.

¹⁷ Council of the European Union, *Council Conclusions on the South Caucasus*, Brussels 27 Feb. 2012, http://consilium.europa.eu/uedocs/cms_data/docs/pressdata/EN/foraff/128197.pdf