



## Free Trade Agreement Between The European Union and Armenia: How Feasible Is It?

Maryla Maliszewska (ed.), David Dyker, Michael Emerson, Michael Gasiorek, Peter Holmes, Malgorzata Jakubiak, Andre Jungmittag, Vicki Korchagin, Alina Kudina, Evgeny Polyakov, Andrei Roudoi, Svetlana Taran, Gevorg Torosyan

A report was commissioned by the EU to determine whether an FTA between the EU and Armenia would be both economically viable and feasible. For the full report on the Economic Feasibility, General Economic Impact and Implications of a Free Trade Agreement Between The European Union and Armenia, see CASE Network Report series No. 80.

Armenia is a country where the GDP per head is comparable to that of Bulgaria. Although considered low by European standards, Armenia's economy has made significant progress and experienced rapid growth since the early years of transition from command to market economy. Armenia has been a WTO member since 2003 and present EU-Armenian bilateral trade relations provide for most-favoured nation (MFN) status giving Armenian products better access to EU markets. The EU is Armenia's largest trade partner, comprising almost 70% of the country's exports and almost 50% of its imports. Currently, Armenia's trade regime benefits from low levels of EU tariffs under the EU's Generalized System of Preferences (GSP) Agreement as well as non-tariff protection measures.

A report was commissioned by the EU to determine whether an FTA between the EU and Armenia would be both economically viable and feasible. The CASE/GI team identified and analyzed various degrees of trade integration between Armenia and the EU to determine, which if any, would benefit the country. The first two scenarios, Simple FTA and Simple FTA BIS, are variants of a simple free trade agreement (FTA), which assume the elimination of tariffs and quantitative restrictions in bilateral trade. The next two are Deep FTA scenarios (Deep FTA and Deep FTA+), which combine the principles of a Simple FTA with varying degrees of change in the domestic policy and business environment affecting trade and investment. The Deep FTA involves a more complete elimination of barriers to trade and investment throughout various sectors of the economy including a more extensive commitment to domestic policy reforms in the direction of EU standards. The Deep FTA+ includes a comprehensive set of reforms along with flanking measures e.g. on competition and corruption that could lead to re-branding Armenia as a favourable investment location.

The report finds that initiating a Deep FTA+ could materialize in real trade and investment gains in the medium to long-term for Armenia, however, the agreement would need to be backed by a strong political commitment to tackle import monopolies, truly liberalize markets, implement EU regulations, strengthen the rule of law and open markets to foreign companies in all sectors.

### Why A Simple FTA Is Not Enough To Create Significant Economic Benefits?

Armenia is a small, land-locked country with a relatively small GDP. Despite this, the economy is currently enjoying rapid growth after the economic collapse it experienced in the early years of transition. Interestingly Armenia's double-digit GDP growth (above 13% per year over the last three years) has not been driven by an industrial recovery, but rather by an extraordinary boom in the construction sector, much of it financed by remittances.

#### Key macro indicators

	2005	2006	2007
<i>GDP (US\$bn)</i>	4.9	6.4	9.2
<i>Real GDP growth (%)</i>	13.9	13.3	13.7
<i>Inflation (ave.; %)</i>	0.6	2.9	4.4
<i>Population (m)</i>	3.0	3.0	3.0
<i>GDP per head (US\$)</i>	1,634	2,134	3,067
<i>Consolidated fiscal deficit (% of GDP)</i>	-1.9	-1.5	-2.3*

Source: Ministry for the Economy and Finance of Armenia  
\*Planned

#### Annual growth rates of GDP and main production sectors, actual and forecast

	2000	2001	2002	2003	2004	2005	2006	2007	2008*	2009*	2010*
<i>GDP(%)</i>	5.9	9.6	13.2	14.0	10.5	13.9	13.3	13.7	10.0	6.0	6.0
<i>Industrial output (%)</i>	-	-	-	-	2.2	7.4	-1.1	2.7	2.0	3.0	3.0
<i>Construction (%)</i>	-	-	-	-	15.3	35.1	37.2	20.7	19.5	8.6	7.1

Source: Ministry for the Economy and Finance of Armenia

\*Forecast

Additionally, Armenia is an import-oriented economy and these issues dominate the political and economic landscape. Organized powerful cartels keep domestic prices of key imported commodities like wheat and fuel high despite the appreciation of the country's currency. Russia is the largest investor in the Armenian economy (32.6%), particularly in key sectors such as energy and telecom. A Simple FTA or Simple FTA BIS would not come with the flanking measures surrounding a Deep FTA+ that are necessary to move the country away from cartels and towards a more open and diverse economy. It is against this backdrop that the priority within the EU/Armenia Action Plan on strengthening the rule of law and respect for human rights, combating fraud and corruption and reinforcing the executive powers of the competition agency should be enforced.

Before analyzing the economic benefits of any future EU-Armenia FTAs (Simple or Deep), the CASE/GI team decided to study the effects of previous trade liberalization measures in order to provide a comparable baseline scenario. The team used a comparative static computable general equilibrium (CGE) model to consider the implications of trade liberalization in Armenia between 2004 and 2006 as well as deeper EU-Armenia integration. Overall, the CGE simulation results indicate that in the long-run the liberalization of 2006 is likely to add very little to the Armenian GDP, less than 0.4%.

What became apparent from the CGE analysis was that a Simple FTA or Simple FTA BIS, though feasible, would likely not have any noticeable impact on the economy given that Armenia is already a member of the WTO and its tariffs are quite low. A Simple FTA, which involves the elimination of remaining industrial tariffs, halving of the remaining agricultural tariffs, and the elimination of all quantitative restrictions in bilateral trade, would bring additional welfare gains amounting to only 0.18% of GDP over the expected gains from the 2006 liberalization. Results for a Simple FTA BIS are even less positive, with welfare gains that are only 0.08% higher. The elimination of tariffs on trade in agricultural and food products does not have any noticeable impact because non-tariff trade barriers and the lack of diversified agricultural production satisfying the EU safety and quality requirements are major obstacles to export development.

### **Why A Deeper Form Of Integration Is Better?**

Armenia has achieved a certain degree of regulatory harmonization with the EU in many trade-related areas, in particular approximation of legislation. Nevertheless, incongruities still remain high, especially in the areas of IPR (intellectual property rights), SPS (sanitary and phytosanitary measures) and state procurement. The most striking differences with EU regulations lie in enforcement of adopted legislation and practices. Even in those areas where regulatory harmonization is relatively high, the achievements are mostly in the harmonization of laws on the books rather than implementation. The Armenian regulatory system is both bureaucratic and ineffectual. Shady and corrupt practices further undermine the system of enforcement. In the areas of standards and SPS, the impulse towards harmonization depends not only on Government efforts, but also on the private sector, which many times looks to promote its own interests and thus makes cooperation difficult.

A Deep FTA with the EU would lead to closer relations between Armenia and European companies and therefore improve the implementation of sound property rights protection, corporate governance, and accounting standards. Such an improvement could develop over the long-term, as business interests between EU and Armenian firms become more intertwined. Therefore, deeper cooperation between the EU and Armenia needs to focus on the harmonization of implementing regulations and practices as well as the upgrade of institutional structures in Armenia so as to encourage reforms and fight corruption, as is designed by the EU Partnership and Cooperation Agreement (PCA) and European Neighbourhood Policy Action Plan (ENP AP). Once this is achieved, A Deep FTA/Deep FTA+ would be able to bring significant economic benefits.

Armenia has made substantial commitments to liberalize trade in services in acceding to the WTO. This is why the CASE/GI study focused mainly on the Deep FTA/Deep FTA+ scenarios, and on the flanking measures that will be necessary to make liberalization a reality. Services account for around 40% of Armenian GDP, considered a relatively low figure compared to other transition economies. That said several services sectors are expected to emerge as key focal points for future economic growth. The report concludes that any agreement between the EU and Armenia, which seeks to accelerate the process of economic development, must have a strong emphasis on the services sector. Services sectors that are deemed to be critical to the development of the economy include tourism, information and communications technology (ICT), construction and engineering services, financial services and banking, and energy related services.

The services sectors in Armenia would be affected only marginally by the implementation of a Simple FTA. A Deep FTA+ could have more of an impact, but to be effective it would have to be heavily flanked by further regulatory reform, strengthened competition policy, and measures that strengthen democracy, rule of law, respect for human rights, and combat corruption and fraud.

### **What Are the Long-Run Effects of Deep Integration?**

When considering the positive long-run effects of deeper trade integration, the CASE/GI team analyzed the merits of two separate scenarios, a Deep FTA and Deep FTA+.

The Deep FTA scenario includes a more complete elimination of barriers to trade and investment, in particular the removal of such NTBs as border and standards costs as well as barriers to foreign provision of services. This involves a more extensive commitment to the reform of domestic policies in the direction of EU standards in Armenia. The estimates of the magnitude of those barriers in Armenia are not perfect, but they do provide a useful tool to gain insight into the degree and direction of sectoral changes in trade, prices and output. The results indicate that the impact of a Deep FTA, here narrowly defined as only the removal of NTBs, would bring significant benefits to Armenia amounting to welfare gains up to 3.76% of GDP or 3.38 percentage points above the 2006 liberalization scenario.

The biggest economic gains to be reaped however come from a Deep FTA+. With the introduction of flanking measures on competition and corruption, a Deep FTA+ could help Armenia achieve a notable reduction in its investment risk premium, reflecting a re-branding of Armenia as a safe and favourable place to invest. In this scenario total economic gains could reach 7.95% of GDP. Dramatic changes in domestic policies are a pre-condition for this scenario to materialize. The boost to investors' confidence could only be brought about by significant harmonization with the EU *acquis* as well as consistent efforts to break up various monopolies, eliminate corruption, strengthen the rule of law and improve the general business environment.

*Welfare, and factor returns results of the CGE simulations*

	2006	SIMPLE FTA	SIMPLE FTA BIS	DEEP FTA	DEEP FTA+
	(1)	(2)	(3)	(4)	(5)
Welfare (% change)					
Russia	0	0	-0.001	0	0.002
Ukraine	0	-0.002	-0.004	0.005	0.006
<b>Armenia</b>	<b>0.381</b>	<b>0.559</b>	<b>0.456</b>	<b>3.756</b>	<b>8.333</b>
Azerbaijan	-0.009	-0.009	-0.008	0.008	0.018
Georgia	0.031	0.027	0.013	0.171	0.217
Turkey	0	0	0	-0.003	-0.004
EU27	0	0.001	0.001	0.001	0
CIS	-0.001	0	-0.001	0.001	0.001
ROW	0	0	0	-0.001	-0.002

Source: Center for Social and Economic Research and Global Insight (CASE/GI) CGE model calculations.

### POLICY RECOMMENDATIONS

**The report concludes that a free trade agreement between the EU and Armenia is feasible, however significant economic benefits would only materialize in the medium to long-term with the implementation of a Deep FTA+. Given the slow progress with the implementation of the ENP Action Plan, serious questions remain as to the institutional capacity of Armenia to undertake steps towards harmonization with the EU acquis. A Deep FTA+ would almost certainly need to go beyond the implementation of the ENP Action Plan and would require not only domestic regulatory harmonization obligations but also a number of flanking measures such as strengthening the rule of law, improving the general business climate, combating corruption and reinforcing the internal authority of the competition policy regime. Creating a level playing field and market economy conditions are prerequisites to the realization of benefits that might stem from deeper integration with the EU. While Armenia has made some progress towards meeting many of the legislative requirements of a Deep FTA+, it is clear that implementation of statutory laws and obligations remains a problem. Therefore, the impact of a Deep FTA and Deep FTA+ on the economy would to a large extent depend not only on the content, but also the actual implementation of the provisions of the free trade agreement and general business environment.**

The sectors that stand to benefit the most from a Deep FTA+ are the agro-food, mining, and the processing of precious stones. Armenia's agricultural sector has traditionally been the foundation of the economy, and has been experiencing a great deal of reform since its privatization after the fall of the USSR. This sector will undergo considerable changes in the upcoming years in relation to Armenia's WTO commitments, specifically when it starts taxing agricultural products on January 1, 2009. The report finds that only a Deep FTA+ with robust dispute settlement mechanisms and strong investment provision could increase the attractiveness of Armenia as a safe place to invest. The agricultural sector could also gain from the inclusion of provisions on competition policy that would protect and encourage both domestic and foreign investors.

Armenia possesses important reserves of copper, lead, zinc, iron and gold. The mining sector is the second largest producer of the country's industrial output. As of 2005, all mining resources have been privatized, and most Armenian mining companies now have commitments (with mostly foreign investors) to upgrade facilities and expand production capabilities. Assuming additional dispute settlement mechanisms are put in place, a Deep FTA+ would entail better protection of foreign investments, and therefore reduce the risk of investment.

The processing of precious stones has traditionally been a key industry in Armenia due to the availability of skillful diamond cutters with competitive wage rates, modern equipment and tax privileges. However, this sector has been quickly losing traction due primarily to the fall of global demand for precious stones and the inability of Armenia's craftsmen to compete with Western methods of production and certification. Although the structure of this industry on an international level is closely-knit and cartel-like, there are some benefits that a Deep FTA+ could bring to Armenian firms, namely increased investment in the sector and therefore easier access to the European market for final products.

The opinions expressed in this publication are solely the authors'; they do not necessarily reflect the views of CASE - Center for Social and Economic Research, nor any of its partner organizations in the CASE Network. CASE E-BRIEF EDITOR: EWA BŁASZCZYŃSKA