Trade relations of Georgia

A report for the Business Association of Georgia

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Table of Contents

1. Introduction

The goal of this report is to provide the *Business Association of Georgia* (BAG) with economic analyses that (1) will enable the BAG to formulate a stance on trade issues, and (2) equip the BAG with economic expertise for backing its requests when talking to policy makers.

Trade policy measures have different effects on different sectors of an economy, and so it may be difficult for the BAG to find a position on which all of its members can agree. A company in the BAG that is highly competitive on international markets will welcome a removal of trade barriers, as this gives access to foreign markets and makes the purchase of preliminary products cheaper. Contrarily, a company in the BAG which is less competitive will prefer less openness, as the free influx of foreign goods causes additional competitive pressure. Such a divergence of interests is typical for trade policy.

We will circumvent this problem by focusing on the mere facts and pointing out how the BAG could make use of these facts for pushing different policy goals it might pursue.

The remainder of the report is set up as follows. In Chapter 2, the reader will be familiarized with the long-standing debate in the economics profession on trade liberalization. We review the most prominent arguments for and against free trade and connect this debate to the particular situation of Georgia. In Chapter 3, the current state of Georgia's trade relations are presented. We show how these facts could be used for the lobbying efforts of BAG. The appendix describes the cornerstone trade agreements Georgia has established in recent years. Knowledge about these agreements is essential for any serious lobbying effort on trade issues.

2. Free trade vs. protectionism – aspects of the debate relevant to BAG

Every trade policy can be located on a scale with two poles: Complete lack of trade barriers on the one side, to which we will refer as "free trade", and complete foreclosure of the domestic market on the other side, which for simplicity we will call "protectionism". Though most economists tend to emphasize the advantages of free trade, there is no unanimity in the economics profession about *how much* freedom would be optimal for a small economy like Georgia. In this Chapter, the main arguments in favor of and against free trade will be briefly discussed.

2.1. The case for free trade

The classical argument for free trade is derived from the so-called *Ricardo Model*, named after the British economist David Ricardo (1772-1823). Ricardo shows that under certain assumptions, free trade between two countries is beneficial for *both* countries, even if one of them has higher production costs for *all* goods. This counterintuitive result derives from the fact that also the economy that produces at higher costs will have a *comparative advantage* for producing *some* goods. The concept of comparative advantage, which is central to the debate, can be illustrated by an allegory about the famous American football player Tom Brady:[1]

> "Tom Brady spends a lot of time running around on grass. One of the most talented football players of all time, he can throw a pass with a speed and accuracy that most casual athletes can only dream of. Most likely, he is talented at other physical activities as well. For example, let's imagine that Brady can mow his lawn faster than anyone else. But just because he *can* mow his lawn fast, does this mean he *should?* […] Let's say that Brady can mow his lawn in 2 hours. In that same 2 hours, he could film a television commercial and earn $20,000. By contrast, Forrest Gump, the boy next door, can mow Brady's lawn in 4 hours. In that same 4 hours, Gump could work at McDonald's and earn $40. […] The gains from trade in this example are tremendous. Rather than mowing his own lawn, Brady should make the commercial and hire Gump to mow the lawn. As long as Brady pays Gump more than $40 and less than $20,000, both of them are better off."

In the above example, although Tom Brady is more productive both in mowing the lawn *and* in playing football, he should play only football and leave the lawn-mowing to Forrest Gump. Tom Brady has a comparative advantage in football playing, while Forrest Gump has the comparative advantage in lawn-mowing. The message of the Ricardo Model is that everybody is better off specializing on those activities where he has a comparative advantage, and this holds not only for individuals, but also for countries. So even if Georgia would be more expensive in producing virtually all goods than, say, China, it may still be beneficial for Georgia to open borders for Chinese imports and concentrate on producing those goods for which it has a comparative advantage.

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[1] Cited after Gregory Mankiw, *Principles of Microeconomics*, 6th electronic edition, North-Western 2012, pp. 57-58.

Obviously, not all comparative advantages are equally profitable. If a country has a comparative advantage in software production, this generates more wealth than having a comparative advantage in, say, producing plastic toys. As Samuelson (2004)[2] points out, comparative advantages are not unchangeable. International trade gives an opportunity to less developed countries to acquire industries which are more profitable and in this way to develop *new* comparative advantages. He showed how China took advantage of the outsourcing of Western industry, which only took place because borders were open and the goods produced in China could be imported to the Western countries. Through the outsourcing, China obtained know-how and technological capacities in highly profitable sectors like car production and computers. Today, China can make use of these *new* comparative advantages that it did not have 20 years ago.

Georgia could aim to follow the Chinese example. Only if Georgian markets are integrated with other countries, Georgia is an attractive production location for foreign companies. There are several examples that such a development already set in, like the German baby food producer Hipp producing organic apple juice in Georgia and transporting it back to its production facilities in Western Europe.

In the beginning, foreign companies outsourcing their production to Georgia may be mainly interested in cheap labor, while technology transfer and know-how sharing is limited. After some time, however, when the production of increasingly sophisticated commodities is outsourced to Georgia, this might change. As a result, the Georgian industrial portfolio may undergo a transformation, shifting its comparative advantage towards the production of sophisticated and more profitable goods and services. Arguably, this upgrade would happen much faster than without foreign engagement.

The benefit of free trade can also be explained without drawing on the Ricardo Model. With open borders, and abstracting from transportation costs, every good will be produced in the country in which production of that good is most profitable. In an ideal market economy this coincides with economic optimality: total output of all countries will be maximized with given resources when production takes place where it is most profitable.

2.2. The case for protectionism

In this section, we will review an argument that questions the validity of the Ricardo Model and the concept of comparative advantage. Furthermore, we will explain the so-called *Infant Industry Argument,* which has potential relevance for Georgia. There exist various other arguments

[2] Paul Samuelson: "Where Ricardo and Mill Rebut and Confirm Arguments of Mainstream Economists Supporting Globalization", *Journal of Economic Perspectives 18,* 135-146, 2004

that support tariffs and trade barriers under certain circumstances; a comprehensive overview can be found in Krugman, Obstfeld, and Melitz, *International Economics*, Addison-Wesley, 2011.

2.2.1. Shortcomings of the Ricardo Model

According to the Ricardo Model, in the equilibrium of a world with free trade, every country would only produce some goods, namely those for which it has comparative advantage. Yet what happens if the population of a country is not well suited to work in those sectors where that country has comparative advantage?

It is not difficult to imagine that the United States have their comparative advantage in producing high-tech and highly sophisticated goods. But obviously, not all Americans are capable of working in the high-tech industry. Many people lack intellectual skills or were trained in fields that cannot be applied in high-tech. In such a situation, the advantages of free trade may be realized only at the cost of increased unemployment.

For Georgia and the BAG this means that when speaking with policy makers, one can indeed make the point that increased international competition may be harmful for the Georgian economy. For tailoring a convincing argument, one should look out for unemployment of people who cannot easily find work in other sectors. If the increased competition hits a sector with such a workforce, the overall effects through free trade may relatively easy be shown to be negative.

2.2.2. The Infant Industry Argument

Georgia may have sectors which are *not yet* ready to cope with international competition. Georgian agriculture, for example, lacks far behind in productivity in comparison with many other countries. Figure 1 on the next page compares Georgian and French agricultural productivity. While in 2009, the value added per agricultural worker in Georgia was below $2000, in France this value was almost $60,000 (constant year 2000 US$). Clearly, also the input costs in Georgia are lower (wages etc.), but not by a factor of 30. What is the outcome if Georgian agriculture is exposed to direct competition with France?

The question is by no means hypothetical, as indeed French agricultural products are imported to Georgia in considerable amounts. The super market chain *Carrefour* offers a huge variety of French-made foodstuff, successfully taking market shares from local sellers offering local agricultural products. In the short run, it is clear that Georgian producers come under pressure when they have to compete with a country like France. What about the long run? Does Georgian agriculture benefit or suffer from the increased competition?

The Infant Industry Argument applied to this question claims that on the long run, Georgian agriculture could compete successfully with foreign competitors, but for that to happen, it needs to be protected until it has caught up in productivity. Many examples show how mechanization and the application of advanced agricultural techniques can boost the output of a country's agricultural sector. Also Georgian agriculture has its particular strengths, like the highly diligent and reliable workforce, but these factors have to be fostered and developed, for which, according to this point of view, competition is detrimental.

The Infant Industry Argument claims that through international competition, profit margins will decrease, and the Georgian agricultural sector will become even less profitable as it already is. This will cause further capital and human resources to be withdrawn from agriculture and deployed elsewhere in the economy. According to this point of view, Georgian agriculture is an *Infant Industry* which in principle *could* deal with strong competition, but only if it has time to develop its productivity potential and foster its particular strengths.

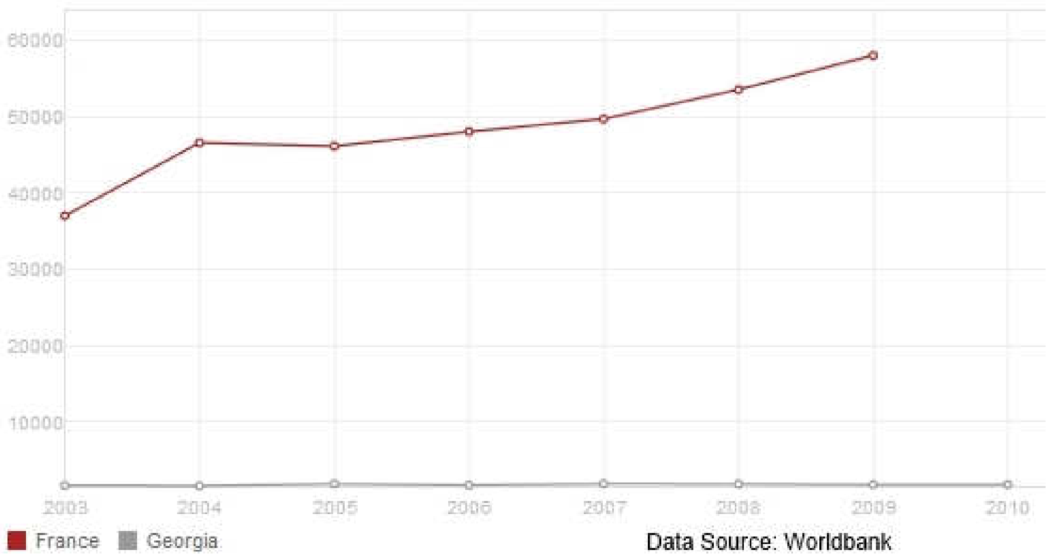

Figure 1: French and Georgian agricultural productivity

3. Facts about Georgia's trade and their relevance to BAG

3.1. The importance of international trade for Georgia

Since the year 2000, the trade volume of Georgia increased steadily (see Figure 2). In 2012, exports reached an amount of USD 2,377 mln and imports amounted to USD 7,842 mln, the largest values ever recorded. The gap between total imports and exports also reached its historical maximum, causing a negative trade balance of USD 5,464 mln in the year 2012.

Relevance to BAG: These numbers suggest that trade and international economic relations are an increasingly important issue for companies organized in the BAG, and that the BAG should formulate a standpoint on these matters.

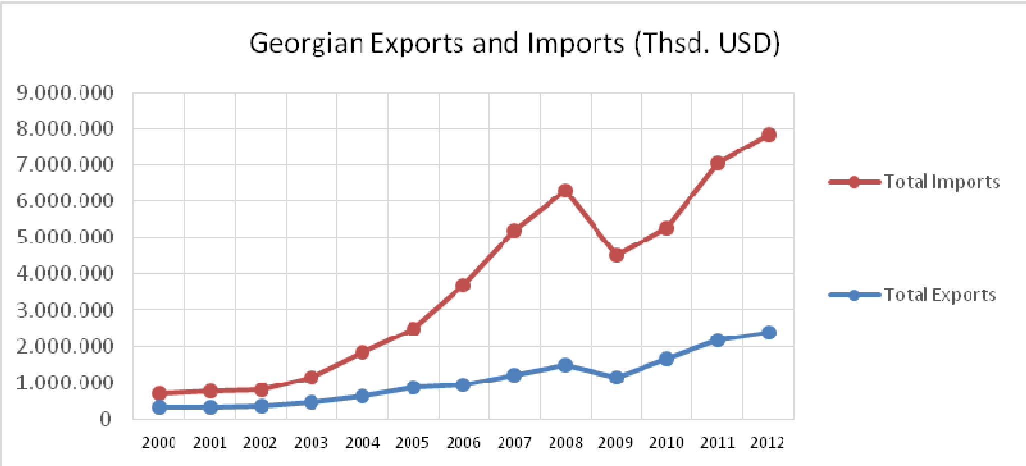

Figure 2: The development of Georgian trade volume 2000-2012

The large gap between the volumes of imports and exports is rather unusual for a country on Georgia's stage of development. One would assume that a country with low factor costs, in particular low wages, would build up manufacturing capacities that serve foreign markets, resulting in a trade balance surplus. Many countries in Asia, notably South Korea and China, achieved their impressive growth rates in the last decades with a pronounced export strategy.

Relevance to BAG: The BAG may want to use the imbalance of imports and exports as an argument for pushing policy steps that either subsidize exports or restrict imports.

It is important to note that trade deficits of a country cannot accrue forever. For fundamental economic reasons that would go beyond the scope of this report, trade deficits and trade surpluses must cancel out over time. The USA are running trade deficits since the early 80's, but this a unique phenomenon, only possible through the exceptional role of the US economy and the US Dollar as the world's primary reserve currency.

Relevance to BAG: The BAG could back a stance to change the current policy by pointing out that the current situation is not sustainable in the long run.

There are several mutually complementary explanations for the fact that Georgia's trade balance is so asymmetrical. An optimistic interpretation is that Georgia attracts high amounts of foreign investment that makes use of technology and machinery imported from abroad. If this would be a dominant reason, the trade imbalance would disappear if the economic activities facilitated by these investments would become operational and exports pick up.

Relevance to BAG: If the BAG wants to lobby against changes of the current liberal Georgian trade regime, it could argue that the trade balance deficit is not worrying because it just shows that Georgia is a target country for foreign investments.

An alternative explanation is that the trade liberalizations introduced in the last 10 years may have been more beneficial for Georgia's trading partners than for Georgia itself. For example, the free trade agreement with Turkey, signed in 2008, seems to be not equally beneficial for Georgia and Turkey. While Turkey could increase its exports to Georgia by almost 50%, the Georgian exports to Turkey have actually *declined* (the FTA with Turkey will be discussed in more detail in the appendix).

Relevance to BAG: If BAG wants to push for the protection of domestic industries, the trade imbalance with Turkey could be useful to show that open borders benefit Georgia's trading partners but have negative impacts on Georgian manufacturers.

3.2. The structure of Georgian trade

As can be seen in Figure 3 on the next page, two areas of the world have particular importance for the Georgian economy, namely the *Commonwealth of Independent States* (CIS), an outgrowth of the former Soviet Union, and the European Union (EU). As can be seen in Figure 3, the share of Georgian exports to CIS countries was increasing since 2009, fostered by a free trade agreement that came into effect in 2008 (see the appendix). In 2012, 52% of total Georgian exports go to CIS countries and 15% to the EU. Regarding imports, the EU and the rest of the world have greater shares. In 2012, 44% of total imports came from the rest of the world, primarily Turkey and China, 31% of total imports were from EU countries, and only 25% from CIS countries.

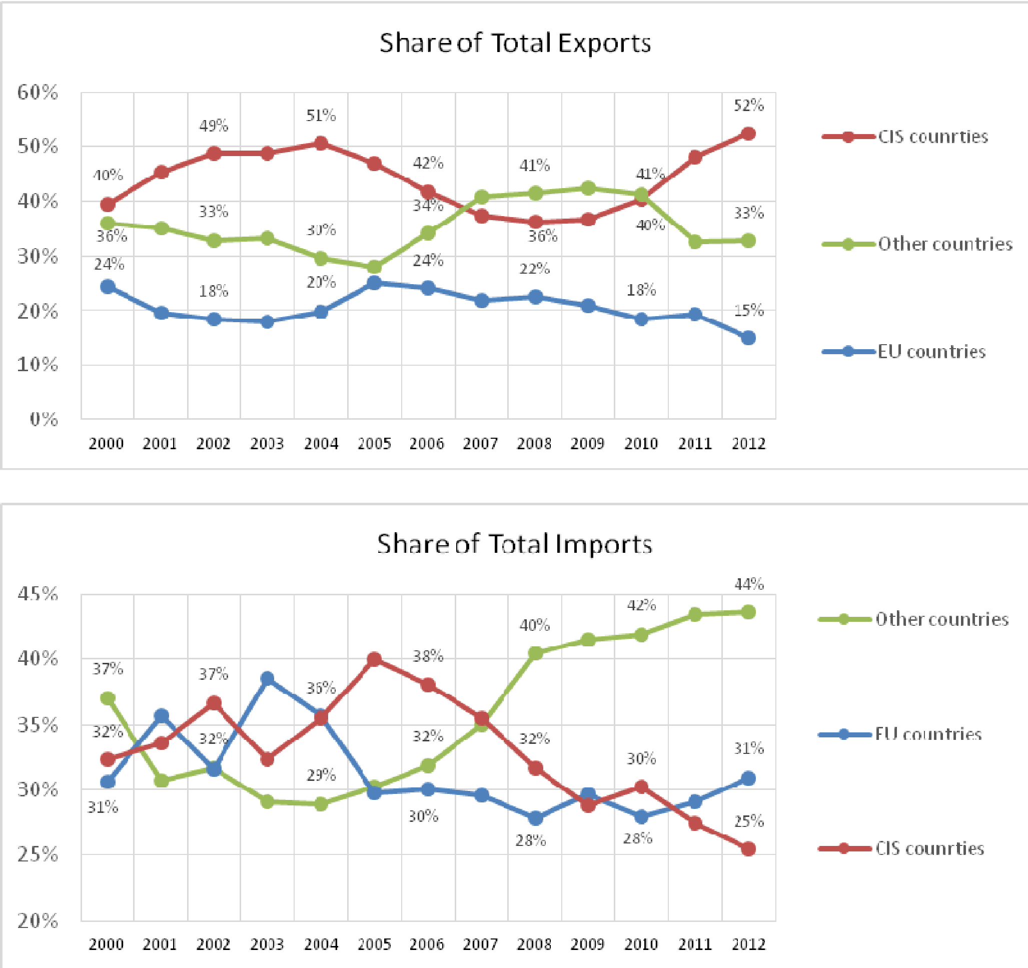

Figure 3: Georgian import and export partners 2000-2012

Relevance to BAG: To what extent trade takes place with Russia is mainly determined by political parameters. Companies in the BAG that want to export to Russia and ask for political support may point at the high importance of the CIS region as a target for Georgia's exports and argue that the political problems with Russia cause major losses to the Georgian export potential.

Based on 2012 data, Table 1 on the next page identifies countries with significant (more than 1%) share in total Georgian exports and imports, respectively. Azerbaijan, Armenia and USA are the three most important export destinations, with Azerbaijan having an exceptional position with a share of 26% of the total exports. Note that the top five destination countries of Georgia's exports do not include EU members.

Turkey is the main source of Georgia's imports with about 18% share in total imports, followed by Azerbaijan and Ukraine with 8.1% and 7.6% shares, respectively.

Table 1 : Trade Partners

Ranking	Country	Share in Exports (%)
1	Azerbaijan	26.3
2	Armenia	11.0
3	USA	9.0
4	Ukraine	7.0
5	Turkey	6.0
6	Canada	4.4
7	Bulgaria	2.9
8	Kazakhstan	2.6
9	Belgium	2.5
10	Italy	2.2
11	Russia	1.9
12	UAE	1.6
13	Germany	1.6
14	Israel	1.5
15	Belarus	1.4
16	China	1.0
	-	-
	-	-
	-	-
	-	-
	Total Share	82.9

Ranking	Country	Share in Imports (%)
1	Turkey	17.8
2	Azerbaijan	8.1
3	Ukraine	7.6
4	China	7.2
5	Germany	7.0
6	Russia	6.0
7	Japan	4.0
8	Italy	3.5
9	Bulgaria	3.5
10	Romania	3.3
11	USA	2.7
12	UAE	2.1
13	Netherlands	1.8
14	Kazakhstan	1.7
15	UK	1.5
16	Brazil	1.5
17	France	1.4
18	Iran	1.3
19	Poland	1.1
20	Spain	1.1
	Total Share	84.2

3.3. *The development of Georgia's trade relations*

As can be seen in Figure 4 on the next page, until the year 2005 Russia was Georgia's main trade partner, both regarding exports and imports. Exports to Russia fell between 2006 and 2009 by about USD 133 mln. Ever since, a modest improvement can be observed. Imports from Russia decreased by USD 283 mln between 2007 and 2010.

After the Russian embargo of 2006, the Azeri share in Georgian exports has been steadily increasing. Apparently, Georgian exporting firms managed to shift their focus from the Russian market to other markets.

Since 2003, Georgia successfully diversified its export markets. The shares of Bulgaria, Canada and USA expanded and continue to expand, though they are still low in absolute terms. Likewise, the share of Chinese imports increased since 2003.

Relevance to BAG: If the BAG wants to lobby against a change of the current liberal trade policy, the impressive performance of Georgian exporters to adjust to new conditions may serve as an illustration of the resourcefulness of the Georgian economy. This lets fears that open markets would harm the Georgian economy and lead to unemployment appear ungrounded.

Since the Rose Revolution, Georgian exports to Turkey were volatile with a decreasing trend. Imports from Turkey, on the other hand, are steadily increasing since 2003. Possibly, this development occurred because Georgian goods are not competitive on the Turkish market (while Turkish products sells well in Georgia), but more likely, it is due to the unequal interpretation of the free trade agreement between Turkey and Georgia (see the appendix) for details.

Relevance to BAG: The development of trade with Turkey could support lobbying efforts to revoke the free trade agreement with Turkey or to change the liberal way it is currently interpreted by Georgia.

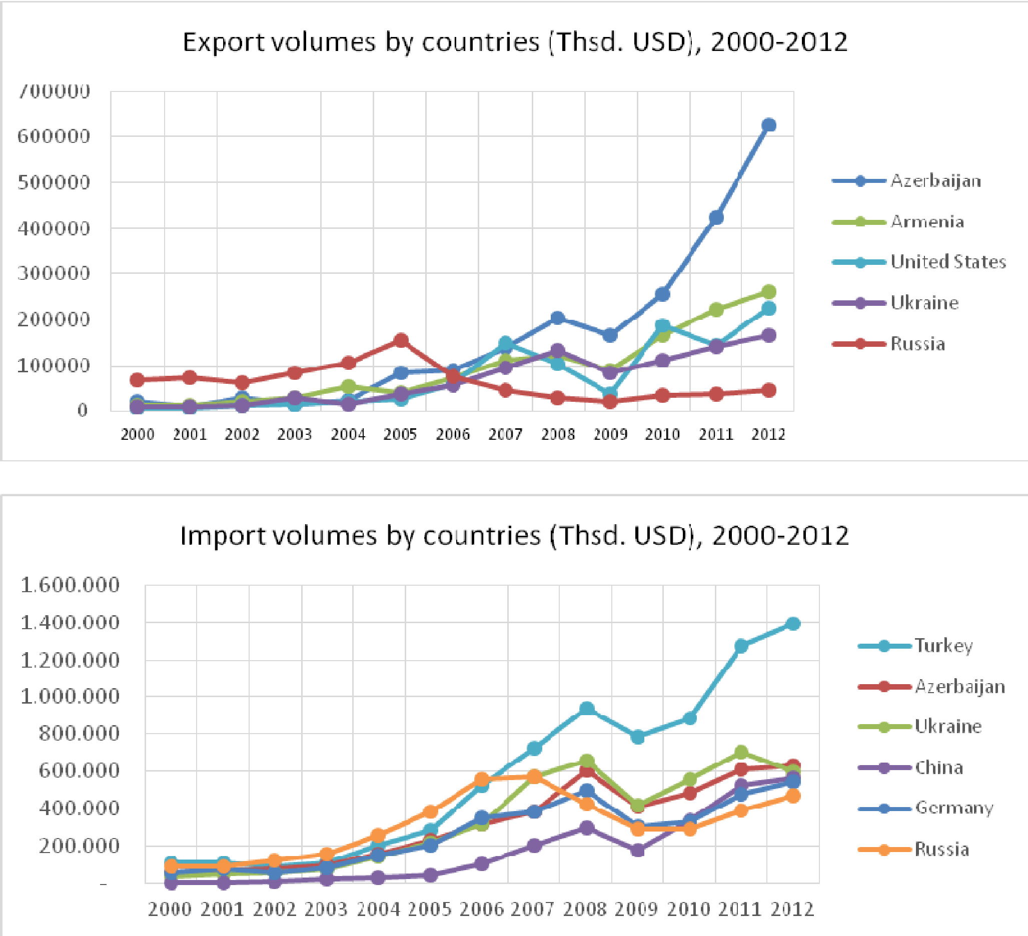

Figure 4: Georgian trade by countries 2000-2012

3.4. Trade diversification

Georgian trade concentrates around rather few products and geographic locations. Georgia exports high quantities of few product categories to a small group of countries rather than a diversified set of goods to many different countries.

Table 2 on the next page lists those product categories which had more than 1% share in total Georgian exports and imports, respectively. The most important products in exports are (re-exported) cars, ferroalloy, scrap-copper, scrap-metal, and scrap-aluminum. Since Georgia does not have a car production, cars are re-exported -- Georgia utilizes on its geographic location that connects Europe with some Asian countries. In imports, cars and petroleum related products are the most important categories. The importance of car imports is due to re-exports, while the high ranking of oil in imports follows from the fact that fact oil is indispensible and Georgia is no oil producer.

Table 2: Georgian trade by product categories

Product	Share in Exports (%)
Motor cars	25
Ferro-alloys	11
Mineral or chemical fertilizers, nitrogenous	5.8
Fresh or dried nuts	3.5
Indentured ethyl alcohol, spirits, liqueurs and other spirituous beverages	3.4
Wine of fresh grapes	2.7
Waters, natural or artificial mineral and aerated waters, not containing added sugar	2.5
Copper Ores and Concentrates	2.3
Wheat and meslin	2.2
Medicaments put up in measured doses	2.2
Other bars and rods of iron or non-alloy steel	2.1
Total Share	62.7

Product	Share in Imports (%)
Petroleum and petroleum oils	12
Motor cars	8.5
Petroleum gases and other gaseous hydrocarbons	3.2
Wheat and meslin	3.1
Medicaments put up in measured doses	3
Telephone sets	1.5
Automatic data processing machines and units thereof	1.3
Structures and parts of structures of iron or steel	1.2
Cigars, cheroots, cigarillos and cigarettes	1.2
Electrical transformers, static converters and inductors	1.1
Sugar and chemically pure sucrose	1.1
Total Share	37.2

3.5. *Beverage exports to Russia*

The developments of exports of the Georgian beverage producers to Russia tell an insightful story about the competitiveness of Georgian exports. Whether this story can be generalized to other Georgian export sectors would demand deeper analysis.

The share of Georgian mineral waters among total Russian imports of mineral waters increased by 2% per year from 1996 to 2006. Dividing this period into two parts, namely before 2001 and after 2001, shows an interesting pattern. Before 2001, Georgian mineral waters gained on average additional 9.2% of the Russian market for imported mineral waters each year. After 2001, Georgian mineral waters were losing 7.5% of the Russian market annually.

With wine exports the situation is similar – before 2001 Georgia was gaining 2.8% of the market annually and after 2001 it was gaining only 0.5% (see table below). What are the reasons?

Georgian beverages started to lose their markets shares in Russia after 2001, when Russia opened up to European markets. This might suggest that Georgian beverages, once they faced European competition, did not successfully compete on the Russian market, despite the fact that they had a long tradition and well-known brand names in Russia.

	1996-2000	**2001-2005**	**1996-2005**
Average Annual Change in the Share of Georgian Mineral Waters Exports to Russia in The Total Imports of Mineral Waters to Russia	9.2%	-7.5%	2%
Average Annual Change in the Share of Georgian Wine Exports to Russia in The Total Imports of Wines to Russia	2.8%	0.5%	1%

Relevance to BAG: If Georgian products are lacking competitiveness, this would give support to introducing protective measures. Likewise, it could be an argument for demanding subsidies from the government for raising the productivity of Georgian producers.

Appendix: An Overview of Georgian Trade Agreements

Georgia implemented major trade liberalizations in the years 2005 and 2006. In the course of these reforms, the number of tariff brackets was reduced from 16 to three. Currently, imports are taxed by either 0, 5, or 12 percent. In addition, the country imposes no quantitative restrictions on imports (quotas).

Georgia is part of several trade agreement that grant favorable conditions for trade with certain countries. These agreements are:

1. Free Trade Agreement – with the CIS countries and with Turkey (since November 1, 2008)

2. Most Favored Nation Status (MFN) – applies to World Trade Organization (WTO) member countries

3. Preferential Status (GSP) – with USA, Canada, Japan, Switzerland, and Norway

4. Preferential Status Plus (GSP+) – with EU (7200 products duty free)

In addition, there is the possibility that a *Deep and Comprehensive Free Trade Agreement* (DCFTA) will be established with the EU in the near future, extending on the agreements that already exist.

We will now look at these agreements in more detail.

A.1. GSP

The idea behind the Generalized System of Preferences (GSP) is that developed countries assist less developed countries in promoting their exports. To this end, developed countries unilaterally grant advantageous conditions for imports from GSP partners, most importantly setting lower tariffs for certain products from GSP countries. Georgia was granted a GSP treatment by the following countries and entities: the EU, the USA, Japan, Canada, Switzerland and Norway.

In July 2005, Georgia was granted a new GSP scheme by the EU named GSP+ discussed in more detail below. While the previous scheme covered only 3300 products which could enter the EU market without tariffs, and 6900 products which were eligible to some preferences, under the new scheme Georgia can export 7200 products to the EU without tariffs.

The GSP scheme granted to Georgia by the USA covers 3448 products according to the eight-digit classification of the *Harmonized Tariff Schedule of the United States* (HTSUS). The US preferential trade regime covers a wide spectrum of Georgia's export products, including walnuts, dried fruit, processed fruit and vegetable products, green tea, cheese, bay leaf, spices, mineral waters, beer, some sorts of wine, essential oils, leather and leather articles, copper and lead ores, ferroalloys, stone, ceramic and glass articles, six categories of handicraft textiles, etc. For an article to be GSP-eligible in the USA, it must be entirely manufactured in a beneficiary country or if manufactured with imported materials, the cost of local materials plus the direct costs of processing must be higher than 35 percent of the total value of the article at the time of entry into the United States.

A.2. GSP+

Georgia is a member of GSP+ trade regime with the European Union. The GSP+ program offers preferential access to the EU market for 7,200 products and a few other products that are excluded from basic GSP preferences (natural honey, asparagus, strawberries, raspberries, blackberries, mulberries, loganberries, black, white and redcurrants, and gooseberries). Contrary to the standard GSP status, all products covered by GSP+ enter at zero tariff rates.

A.3. FTA

At present, Georgia has free trade agreements with the CIS countries (Azerbaijan, Moldova, Ukraine, Uzbekistan, Kazakhstan, Turkmenistan, Russia, and Armenia) and Turkey, which means that goods and services are exempt from import customs duties. While GSP and GSP+ are unilateral programs granted by developed countries to Georgia, the FTAs are bilateral, i.e. also Georgia has to open its borders to foreign imports.

Georgia has a FTA with Turkey since 2008 which applies to manufactured products. According to the agreement, customs duties on imports of industrial products and any charges having equivalent effect are reciprocally abolished if these products originate in the Republic of Turkey or the Republic of Georgia. Concerning agricultural products, Turkey granted duty reduction or exemption from customs duties for certain products up to specified quotas. In return, the Georgian Side eliminated tariffs on imports into Georgia for agricultural products originating in Turkey, except for a limited number of products. As mentioned before, since 2008 the trade deficit with Turkey has increased. The imports from Turkey showed impressive growth rates, while exports remained roughly at the same level. While Georgia is almost completely open to Turkish imports, Turkey has maintained tariff quota schemes for certain Georgian goods, it sets higher standards on food safety and quality, and it has a complex regulatory system preventing entry of certain Georgian products.

<u>Relevance to BAG:</u> The unequal interpretation of the FTA with Turkey is potentially harmful to Georgian producers, and the actual trade deficit with Turkey suggests that Georgian exporters are indeed disadvantaged. Political pressure on Turkey might be required to change their policy or, if this is not successful, Georgia could adopt a similar interpretation of the FTA as Turkey.

A.4. MFN

At present Georgia enjoys *Most Favored Nation* (MFN) treatment from all the WTO member states. This regime sets lower customs tariffs for WTO member states (153 states). The MFN regime is one of the fundamental principles of the World Trade Organization (WTO) and tries to achieve non-discriminative treatment in trade. It means that countries eligible for this regime must receive equal trade advantages when entering the market and may not be treated less advantageously than any other country with MFN status. However, since 2006, the Georgian legislation concerning import customs tariffs does not differentiate WTO member-states from non-member states.

A.5. DCFTA

The negotiations on a *Deep and Comprehensive Free Trade Agreement* (DCFTA) between Georgia and the EU started in 2012. The goal of the agreement is to integrate Georgia into the EU area by further lowering trade barriers and assisting Georgia in increasing goods and services standards according to EU norms. DCFTA agreements target the abolition of quotas and duties in trade, as well as the elimination of non-tariff barriers.