



**Feasibility study on the Deep and Comprehensive Free
Trade Area (DCFTA) between Azerbaijan and the European
Union**

Center for Economic & Social Development

September 2016

**ISBN 978-9952-81-313-5
CESD Press
Baku, Azerbaijan**

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1. Introduction

The trade relations between Azerbaijan and the European Union are a substantial part of enhancing economic and political relations among both parties. Recent years have been characterized by an expansion of the trade volume between two parties; the EU turned out to be Azerbaijan's biggest trade partner, in terms of both imports and exports. Moreover, trade in services and foreign direct investment relations were also on rise. On the other hand, Azerbaijan is one of the main energy suppliers of the European Union among European Neighborhood countries and is a key partner to guarantee energy security.

The political ties of Azerbaijan with other commercial partners are diminishing the full expansion of its trade with the EU, for instance the Euro-Asian Union.

Besides of political ties, also there are several barriers for the development of trade between Azerbaijan and the EU, for example, the tariff and non-tariff barriers. The latest ones refer to sanitary measures, production process, packaging, labor regulations, quotas, etc.

Additionally, this research paper analyzes the potential benefits of joining the *Deep and Comprehensive Free Trade Area (DCFTA) of the EU*, showing specific data with the support of the Computable General Equilibrium (CGE) model.

Methodology

In order to complete this research paper, the two researchers used both quantitative and qualitative data. For the quantitative research, they gathered information from official websites like the State Statistical Committee of the Republic of Azerbaijan, the European Commission Directorate-General for Trade, World Trade Organisation, United Nations Conference on Trade and Development, and European Bank for Reconstruction and Development. Additionally, the Computable General Equilibrium (CGE) model was selected as a scientific method using mathematical equations in order to estimate the impact of a certain policy shock on general macroeconomic variables (total income, aggregate savings, investments and tax revenues) as well as trade variables. The qualitative research has been complemented by the reading of annual reports, news and statements from officials from various countries.

2. DCFTA

2.1. The definition and standard structure of DCFTA

According to Cecilia Malmström, EU's Trade Commissioner¹, The European Union Trade Policy's priorities are to:

- 1) Create a global system for fair and open trade
- 2) Open up markets with key partner countries
- 3) Make sure others play by the rules
- 4) Ensure trade is a force for sustainable development

The Deep and Comprehensive Free Trade Area (DCFTA) is part of the Association Agreement (AA) between some countries and is one of EU's most ambitious projects. Currently, The EU has a DCFTA with Ukraine(2014), Georgia (2014) and Moldova(2016).

The DCFTA² lets countries to develop their economy, the infrastructure of industries, services, transport and to empower the rule of law. Additionally, it helps eliminating corruption, to access to new sources of financing, transfer of new technologies, improve efficiency and quality, diversify the economy and to give the opportunity to SMEs to develop new businesses. The EU provides legal support, financing and capacity building for the structure of the governments that sign up with the the DCFTA, helping them to reach the international standards and especially the EU ones. Countries that enter in the DCFTA receive huge amount of financial assistance.

This trade area lets countries to enter in competition with the European companies and to reach all EU countries, plus, members of the DCFTA.

Azerbaijan could be benefited so much from entering the DCFTA. Especially at this time, the joint to the DCFTA could mean a support for the diversification of the economy and would help promoting the sectors of tourism, agriculture, transport and industry.

¹ European Commission. Trade. Policy. <http://ec.europa.eu/trade/policy/>

² European Commission. Trade. Benefits of the EU-Ukraine DCFTA – factsheet. Web. <http://trade.ec.europa.eu/doclib/press/index.cfm?id=1426>

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However, Azerbaijan encounters some political obstacles due to the very close ties with Russia and the debate to enter the Euroasian Economic Union, which is not compatible with the DCFTA of the EU.

The DCFTA is much more than a tariff liberalisation agreement. The DCFTA consists of 15 Chapters, 14 annexes and 3 protocols. It covers a wide and complex range of topics including:

- Market access (tariffs): the EU and Azerbaijan would eliminate the import duties charged on the majority of imports from each other.
- Rules of origin: Azerbaijani products entering the EU duty free can use inputs from Ukraine, EU and selected Mediterranean countries to source competitively.
- Technical regulations: Azerbaijan will align EU regulations and procedures so that certified products will be assumed to comply with EU requirements with no further checks.
- Sanitary & phytosanitary measures: Azerbaijan will align with EU agriculture and food safety measures so that certified products will be assumed to comply with EU requirements with no further checks.
- Trade in services: Azerbaijan business will be able to sell selected services to EU countries on better terms than any other countries and in some cases, be accorded national treatment. The agreement provides for a right of establishment of Ukrainian services providers subject to a number of reservations) and extends automatically to new services in the future.
- Public procurement: Azerbaijan will apply EU rules on Public procurement. In return, Ukrainian businesses can compete for government contracts and be treated exactly the same as EU companies.
- Trade facilitation: Co-operation between customs authorities to simplify documentation and procedures at the borders whilst still having adequate measures in place to prevent fraud.

Other issues:

- Trade-related energy issues
- Trade defence and safeguard measures
- Intellectual property
- Competition policy
- Movement of capital
- Transparency
- Trade and sustainable development

2.2. Literature Review

The cost-benefit analysis of the possible socio-economic impact of the Azerbaijan's accession to DCFTA has been carried out for several countries which are currently negotiated for Association Agreements (AA). Some research works are confined with the qualitative assessment of the potential benefits and implications of the free trade agreements, while others have conducted comprehensive quantitative analysis by employing advanced assessment tools.

One of the first feasibility studies carried out in this direction was prepared by CASE Moldovan Foundation in 2004³. The study discusses legal and conceptual framework of the Free Trade Agreement and its possible effect on Moldovan economy and trade in specific. The authors conclude that the European Union (EU) is likely to benefit more in case of the simple tariff reduction, but more comprehensive measures such as liberalization in services and the administrative reforms will facilitate more beneficial for both parties.

Another qualitative study was conducted by Movchan and Shprotyuk (2012)⁴ for Ukraine. After giving a general picture of trade links of six member countries – including Azerbaijan – of Eastern Partnership with EU, the general rules for Ukraine accession to DCFTA⁵ are described. The authors state that the inclusion in the free trade area will enhance trade output by facilitating the access to the large export market and thus, lead to the overall welfare improvement. However, some potential costs related to the low competitiveness of some of the

³ CASE (2005). Feasibility Study: Trade liberalisation between Moldova and the European Union. Web. http://expert-grup.org/ro/biblioteca/item/download/812_52db0254536832d1c28809572d8103cf

⁴ Movchan V. and Shprotnyuk V. (2012). EU-Ukraine DCFTA: the Model for Eastern Partnership Regional Trade Cooperation. *CASE Network Studies & Analyses* No.445. Web. <http://www.case-research.eu/en/node/57857>

⁵ ECORYS and CASE (2007). Trade Sustainability Impact Assessment for the FTA between the EU and Ukraine within the Enhanced Agreement. Web. http://trade.ec.europa.eu/doclib/docs/2008/january/tradoc_137597.pdf

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local producers and the administrative costs associated must also be considered, at least for the short term.

The quantitative research works have substantiated the above mentioned thoughts in some extent. One of the first empirical works has been carried out by Francois and Manchin (2009)⁶. The authors have conducted numerical simulations based on computable general equilibrium model for the scenario of establishment of free trade area between Commonwealth of Independent States (CIS) and EU; moreover, they have also conducted simulations for 7 CIS countries separately: Armenia, Azerbaijan, Georgia, Kyrgyz Republic, Russia, Kazakhstan and Ukraine. 2004 year was selected as a base year for calculations. Three different scenarios of free trade agreements were prepared and calculated: 1) FTA-1 – the free trade agreement captures non-food traded goods only, 2) FTA-2 – the scenarios covers liberalization of trade in non-food and food products and 3) Full-FTA – the scenario suggests full liberalization of all traded goods and services. Changes in income levels also differ according to the scenario assessed. The general results imply that the parties will be able to benefit from free trade agreements if the third scenario, that is, full liberalization of goods and services will occur. Moreover, CIS experiences larger increase in general output and income levels in comparison with EU side. In terms of sectorial output, all scenarios forecast an increase in sectorial output levels except light manufacturing industry. Again, the improvement is most profound in case of Full-FTA scenario. Trade flows also increase as a result of liberalization measures conforming to the theoretical expectations. While EU will experience some reduction in services export, CIS side shows positive changes in all sectors except for light manufacturing and gas exports. Welfare implications are also worth noting. The level of GDP, also unskilled and skilled wages exhibit an increase, being more profound for unskilled labor.

The results for Azerbaijan are also reported separately. The most noteworthy outcome is that the results for Azerbaijan are higher for all indicators in comparison with CIS average. Full liberalization measures would result in 0.58% increase in net income. In terms of sectorial output, the largest reduction would be seen in heavy manufacturing in all three scenarios; albeit smaller, a decrease is also observed in textile and apparel, processed food and agricultural sectors. Other sectors experience relative growth, especially services sector. In terms of trade links, the parties would benefit mostly from full liberalization. GDP will increase by less than 1% under partial FTA and 2.32% under full FTA agreement. The wages of unskilled and skilled labor also rise, although in different manner. While unskilled wages rise mostly under full FTA,

⁶ Francois J. and Manchin M. (2009). Economic Impact of a Potential Free Trade Agreement (FTA) Between the European Union and the Commonwealth of Independent States. *IIDE Discussion Paper* 200908-05. Web. http://trade.ec.europa.eu/doclib/docs/2007/march/tradoc_134017.pdf

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skilled labor experiences largest increase in wages under FTA-2 scenario. Dwelling upon the results, the authors conclude that the benefits of free trade agreements will be more profound for Azerbaijan rather than EU.

Recently, the series of quantitative cost-benefit analysis have been conducted as Trade Sustainability Impact Assessment (TSIA) reports prepared by CASE and ECORYS foundations for the countries which are actively engaged in DCFTA negotiations. The potential impact of trade liberalization was first conducted for Ukraine in 2007. In 2012 report, the case study was carried out for Moldova and Georgia; the same assessment was applied for Armenia in 2013.

TSIA report conducted for Ukraine in 2007 is a comprehensive and in-depth analysis and implications of possible economic and social effects of free trade agreement between Ukraine and European Union. The report not only covers these issues, but also constructs two possible scenarios as extended FTA (full liberalization) and limited FTA (partial liberalization). In addition, short-run and long-run effects are also distinguished. The model findings predict overall increase in national income levels and trade volumes. As a result of free trade relations, the consumer prices are expected to go down and wages to rise. Also, country's poorest regions would increase their welfare as a result of both wage increase and price cut on different food and non-food products.

TSIA report conducted for Moldova and Georgia⁷ shows the overall positive effects of the potential accession to free trade area with EU. The income increase for Georgia constitutes 292 million euro, while for Moldova this figure is halved to 142 million constituting 4,5% of GDP (base year is 2010). Export volume increases by 12-16%, while imports go up by 7.5-8% for both countries. The model results for Georgia also shows that, although slightly, neighboring countries such as Azerbaijan and Russia also benefit from the free trade agreement of Georgia with EU. For both economies, the consumer prices are expected to go down and in combination with the wage increase; it offers prospects for overall levels of welfare increase. However, one of the implications of the estimations is that, although overall price levels are lower, the prices for food will increase. The latter statement mainly harms the most deprived social strata in society meaning that the poverty levels may go up. Moreover, the larger increase in wages of skilled labor in comparison with unskilled labor implies a potential increase in income inequality.

⁷ ECORYS and CASE (2012). Trade Sustainability Impact Assessment in support of negotiations of a DCFTA between the EU and Georgia and the Republic of Moldova. Web. http://trade.ec.europa.eu/doclib/docs/2012/november/tradoc_150105.pdf

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The estimations on the economy of Armenia⁸ produce results similar to the findings of previous TSIA reports. The average national income increases by 146 million which is equal to 2.3% of GDP rise. Both exports and imports go up. The rise poverty and inequality levels are also forecasted by the model. However, the environmental impact of the free trade is more profound for Armenia in comparison with other studies. While Georgia and Moldova would experience negligible adverse effects on environment, the range of effects and the intensity is larger for Armenia. As a result, the reports suggest focusing on the regulation of the negative effects by pursuing relevant distributive socio-economic and environmental policies.

All these country assessments also report the general improvement in the quality of both food and non-food products which must be achieved as a precondition of compliance with the FTA obligations. Moreover, some reports also connect these improvements to improved healthcare and the increase in life expectancy. The general improvement in labor standards and human rights issues are also expected to take place. Another implication of the literature review concerns the level of trade liberalization. All reports conclude that the optimal welfare level is achieved by fully liberalizing the trade relations between the parties.

2.3. Bilateral legal trade framework

The legislative basis for the trade relations between Azerbaijan and European Union was established mainly by two documents: Partnership and Cooperation Agreement (PCA) and European Neighborhood Policy (ENP) Action Plan.

The Partnership and Cooperation Agreement (PCA) was established in 1999 for the regulation of several socio-economic and political issues among which a special place is devoted to trade relations. Articles 9-19 define general rules under which both parties assign Most Favorite Nation (MFN) trade regime to each other, and the trade of goods is carried out within this regulatory framework. This regime considers special concessions on tariff and non-tariff trade barriers. Although the document deals closely with the customs duties and charges on imported exported goods, the rules for purchase, transportation, and distribution and their use, the creation of a customs union or free trade area is not considered in the document.

Another legal document, the ENP Action Plan, was concluded in 2006. This agreement considers the further enhancement of trade and economic relations between Azerbaijan and the

⁸ ECORYS and CASE (2013). Trade Sustainability Impact Assessment in support of negotiations of a DCFTA between the EU and the Republic of Armenia. Web. http://trade.ec.europa.eu/doclib/docs/2013/october/tradoc_151862.pdf

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European Union through trade facilitation and full implementation of PCA. Security of imports and exports and customs control, as well as reforms on the harmonization and standardization of food safety and sanitary and phytosanitary regulations, are considered to be effective tools for convergence towards EU food safety and rules. Capacity building and staff training on international trade relations for those working towards accession to the World Trade Organization (WTO) is seen as an important task to be carried out on a bilateral basis. Most importantly, the document mentions the possible establishment of a free trade area between the parties upon Azerbaijan's accession to the WTO. The document states the following:

“The EU and Azerbaijan to jointly explore possible options for further enhancing bilateral trade relations, once Azerbaijan has joined the World Trade Organization, including the possible establishment of a free trade agreement between the EU and Azerbaijan. In this context, the Commission will undertake a feasibility study which will also look at regional trade and economic integration aspects”. (*EU / Azerbaijan Action Plan, 2006*⁹).

Another framework for enhancing economic and trade relations between Azerbaijan and the EU is discussed within the Eastern Partnership (EaP) initiative. Six eastern countries: Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine are closely engaged in a new level of trade and travel facilitation. EU proposes the enhancement of relations in three dimensions¹⁰:

- a) Association Agreements (AA)
- b) Deep and Comprehensive Free Trade Area (DCFTA)
- c) Visa Facilitation and Readmission requirements

These measures not only consider the regulation of trade, non-trade relations and travel issues, but also envisage the standardization and harmonization of economic and political legislation in the implementation of related projects. Moreover, the prospective engagement in a free trade area with the EU is one of the opportunities introduced for EaP countries to achieve greater international integration and sustainable socio-economic development.

The EU has already concluded several agreements with Ukraine, Georgia and Moldova and initiated negotiations with Armenia. Closer attention is also being paid to Azerbaijan; however, no agreements or negotiations have yet been initiated.

2.4. Trade regime between Azerbaijan and European Union

Currently, the parties trade under the “Most Favored Nation (MFN)” regime, which is applied to all WTO members. This regime requires the equal treatment of all WTO-member trade partners.

⁹ *EU / Azerbaijan Action Plan, 2006*. Web. Web.

http://eeas.europa.eu/enp/pdf/pdf/action_plans/azerbaijan_enp_ap_final_en.pdf

¹⁰ European Union External Action. EU relations with Eastern Partnership. Web. Retrieved from

http://eeas.europa.eu/eastern/about/index_en.htm

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Although Azerbaijan has only the position of an observer in WTO, the country has been granted this regime by the European Union. The tariff rates for various product groups will be discussed in Chapter 2.

Starting from the early 2000's, some Eastern European countries, including Azerbaijan, were entitled to the Generalized System of Preferences (GSP) by the European Union. The goal of this trade regime was to give a preferential trade status to some developing countries in order to promote their trade relations with the EU and, thus, contribute to their economic development. The regime envisaged a 66% cut to all EU tariff lines; 6,350 products were included in this list. Two product categories were defined for trade: "non-sensitive" and "sensitive" products. Non-sensitive products were the product groups which were subject to full tariff reduction and enjoyed duty-free entry to the EU market. Sensitive products – the product groups which are considered of special importance to the EU and must be protected to some extent – are subject to a 3.5-percentage-point tariff reduction compared to MFN rates. The groups of sensitive products mainly include agricultural and processed food products; that is, for Azerbaijan, some part of non-oil exports to European Union were subject to only partial tariff reduction. This tariff cut also differed for some product groups; such that, textile products are subject to only a 20% tariff reduction in comparison with MFN tariff rates¹¹.

As of 9 December 2008, Azerbaijan was included in the group of countries entitled to the GSP+ trade regime. The GSP+ regime is the enlarged version of GSP, where both the number of products and the tariff reductions are enhanced. In this case, duty-free access was applied to both non-sensitive and sensitive products, with the condition that, tariffs paid for sensitive products are composed of both ad-valorem tariffs and specific duties and the total amount paid is equal to the specific duty.

By the decision of February 2013, Azerbaijan was no longer considered to be eligible for GSP+ status according to the graduation conditions from the trade regime, which stated that the country's income level is higher than the level defined for the countries eligible for preferential trade partner status. As of 22 February 2014, the country was deferred from preferential trade partner status and returned to MFN trade regime.

¹¹ Generalized System of Preferences: Handbook on the Scheme of the European Community. *United Nations*, 2008. Web. http://unctad.org/en/Docs/itcdtsbmisc25rev3_en.pdf

3. Trade flows between EU and Azerbaijan

After the collapse of the Soviet Union, Azerbaijan initiated other liberalization measures. Price controls were gradually lifted and by the end of 1990's, full liberalization in this sphere was achieved. The exchange rate regime was also liberalized and the local currency – the manat (AZN) – has become fully convertible by the end of 1990's. By the abolition of the state monopoly on free trade in 1997, trade has become one of the main tools of economic development in the country. The average tariff rate was substantially decreased to around 15% from 60% in 1996¹². The same year, negotiations regarding the WTO accession of Azerbaijan were initiated. The country has achieved the high grade of 4.0 of trade liberalization and forex index developed by European Bank of Reconstruction and Development (EBRD) indicating the substantial level of liberalization in trade policy, though some restrictive measures are still in place¹³ (EBRD, 2014).

From the beginning of independence, trade has constituted a prominent share of the country's GDP. If in 1995 this number was 69.4%, in 2004 the indicator has reached its maximum level of 121% as a share of GDP¹⁴.

3.1. Azerbaijan trade activity: general insight

Azerbaijan is a country with rich mineral resources and the economy is mainly based on the extraction of natural resources such as oil and natural gas. These products also constitute the lion's share of the country's exports, alone accounting for 92.3% of its total exports according to the latest data¹⁵. Alongside with the oil and gas sector, chemicals such as polyethylene products, cane and beet sugar and fresh fruits constitute the remaining share of total exports.

Imported products mainly consist of some processed products, agricultural products, and machinery and equipment, products that Azerbaijan does not possess a competitive advantage to produce. A substantial share can also be attributed to construction materials in recent years, likely due to the boom in the construction sector and hosting of international events such as the European Games and Formula-1, which was held for the first time in Baku in June, 2016.

¹² *Azerbaijan Building Competitiveness*, Vol. 1, 2003. The World Bank. Retrieved from <http://documents.worldbank.org/curated/en/2003/11/2821319/azerbaijan-building-competitiveness-integrated-non-oil-trade-investment-strategy-inotis-vol-1-2-summary-report>

¹³ European Bank of Reconstruction and Development.

¹⁴ *World Development Indicators* database, 2004.

¹⁵ *World Trade Organisation. Trade Profiles*, 2014.

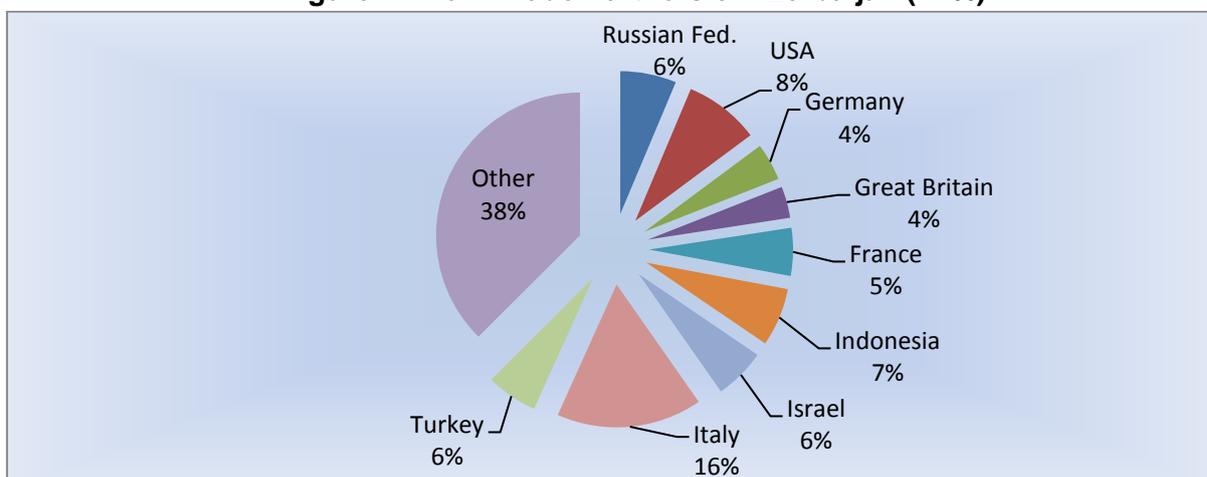
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Products	2015		Products	2015	
	Millions	%		Millions	%
Total Exports <i>of which:</i>	11424.5	100	Total Imports <i>of which:</i>	9221.4	100
Mineral fuels, minerals oils and products thereof	9881.9	86.5	Cigarettes, vinegar and alcoholic beverages	688.8	7.47
Plastic and articles thereof; rubber and articles thereof	112.9	0.99	Wheat	343.4	3.72
Base metals and articles of base metal	133.8	1.2	Raw sugar and sugar	149.9	1.63
Cane or beet sugar, in solid form, nes.	202.2	1.77	Chemicals	705	7.65
Animals or vegetable fats and oils	153.3	1.34	Machinery and Transport	2465.3	26.73
Vegetables products	335.9	2.94	Metal products	1872.4	20.31
Chemicals	79.9	0.70	Stone, glassware and ceramics and articles thereof	213.6	2.32

Source: National Statistical Committee of the Republic of Azerbaijan

Azerbaijan's trade partners are mainly developed European countries, of which Italy accounts for the largest share by total trade volume. The main exports to these countries were oil and oil products, while machinery and transport and other manufactured goods were the main imports. The United States and Israel are also among its main trade partners. Trade links with Turkey and the Russian Federation also serve as important economic partners, not only in terms of trade, but also as regards employment migration and small business activities of residents of both Azerbaijan and these partner countries.

Figure 1. Main Trade Partners of Azerbaijan (in %)

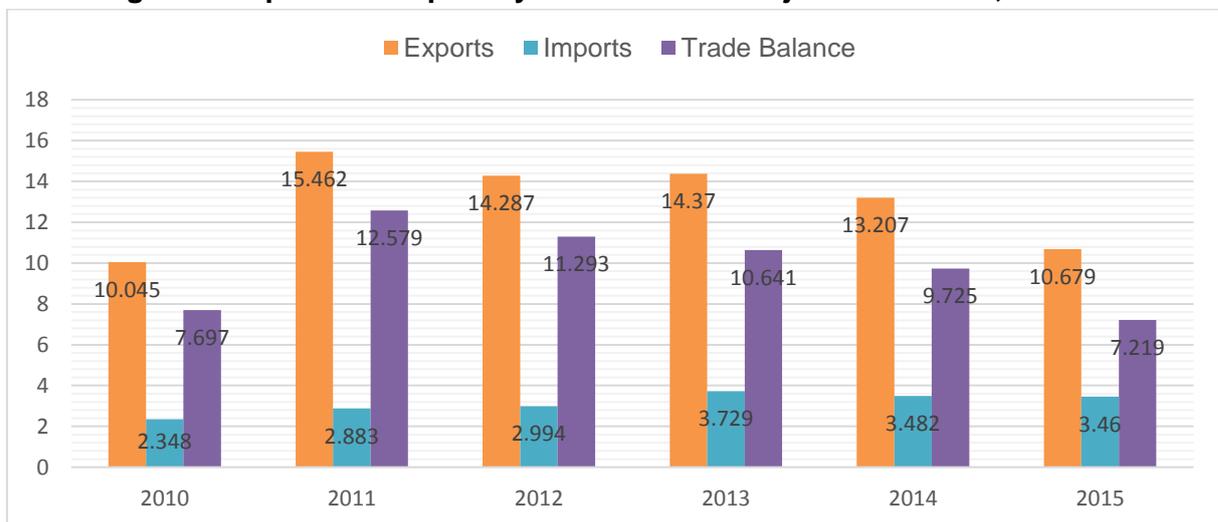


Source: State Statistical Committee of the Republic of Azerbaijan

3.2. Trade flows with the European Union

Trade relations between the EU and Azerbaijan have been expanding with the conclusion of several agreements, such as the Partnership and Cooperation Agreement. Currently, the EU is the biggest trade partner of Azerbaijan, constituting 53% of its exports and 34% of its imports¹⁶. In 2011, trade turnover with EU member states increased by 60.7% compared to the previous year. In particular, export growth stood at 56.1% while imports increased by 88.4% (*EU trade statistics*, 2016). The trade volume in 2014 grew by around 8% compared to prior years, although compared with 2013 this volume substantially decreased. The latter decrease is directly related to the plummeting oil prices, Azerbaijan’s main export product.

Figure 2. Import and Export Dynamics of Azerbaijan with the EU, billion USD



Source: European Commission Directorate-General for Trade 2016.

Despite the EU’s large share in Azerbaijan’s trade turnover, the share of Azerbaijan trade is very low compared to the share of world trade with the European Union. That is, Azerbaijan contributes only 0.8% of world exports to the European Union; for imports, this share is even lower. The exceptional product category is oil, where Azerbaijan is the fifth largest oil supplier, sending the EU 4.7% of the latter’s oil imports¹⁷.

As shown in the diagram, the share of oil exports in total is so large that it can be considered to be the only product supplied to the EU market. Other product= groups represent a negligible share in total exports and amount to less than 1% (*SSCRA*).

¹⁶ European Union, Trade in goods with Azerbaijan. *European Commission Directorate*. 2016. Retrieved on http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_113347.pdf

¹⁷ Liargovas P. EU trade policies towards neighboring countries. *7th European Community Framework Programme FP7-SSH-2010.2.2-1*, Working Paper 2/01.2013.

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In terms of diversification for each product class, EU holds the advantage, trading in almost all product categories of harmonized system. According to European Union trade statistics⁸, EU exports to Azerbaijan range from agricultural and processed food products to medical supplies, machinery and transport. While the exports of EU to Azerbaijan includes the products from twenty-one product groups out of twenty-two according to the classification of harmonized system, this number merely reaches seven in Azerbaijan total exports to EU, most of which has the export volume less than 5 million Euros (*EU trade statistics, 2015*).

Table 2. Main export and import products of Azerbaijan with EU in 2015

Product group	Export shares (in %)		Product Group	Import shares (in %)	
	Million	%		Million	%
Mineral fuels, lubricants, etc.	10449	97.8	Mineral fuels, lubricants, etc.	30	0.9
Machinery and transport	86	0.8	Machinery and transport	1656	47.9
Agriculture and processed food products	66	0.6	Agriculture and processed food products	200	5.8
Chemicals	26	0.3	Chemicals	290	8.4
Manufactured goods	20	0.2	Manufactured goods and miscellaneous	1225	35.4
Others	32	0.0	Others	788	1.6
Total	10679	100	Total	3460	100

Source: European Commission Directorate-General for Trade⁸

An analysis of Azerbaijan's trade relations reveals a serious deficiency in product diversification. While rich in natural resources, the country relies heavily on their production and export, paying negligible attention to industry and agriculture. The low level of diversification not only increases the dependency on imported products in such sectors as agriculture, food and daily-use products, but also makes the local economy susceptible to external shocks. The slump in energy prices observed over the last two years justifies this statement; while causing Azerbaijan's terms of trade to deteriorate, it also caused a significant loss in national bank foreign reserves and led to the 50% depreciation of the local currency.

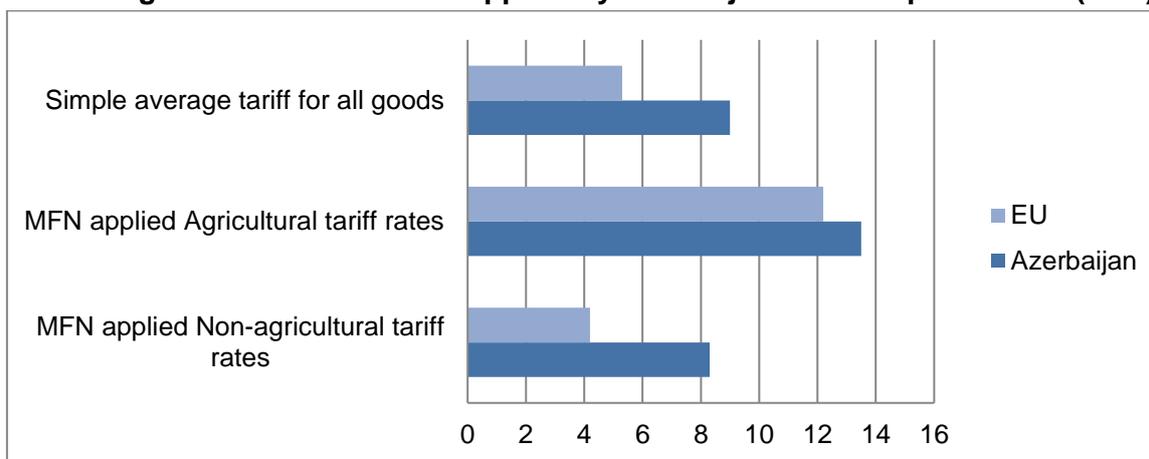
3.3. Tariff scheme between EU and Azerbaijan

The trade regime between European and Azerbaijan is regulated in accordance with tariff and non-tariff regulations adopted within the scope of cooperation documents such as PCA, EaP and ENP. Starting from 1997, the country obtained the status of "Most Favored Nation" in trade

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with the European Union¹⁸. Later, Azerbaijan was deemed eligible for the Generalized System of Preferences, which is granted to low and middle income developing countries according to the World Bank classification. This trade regime classified as “sensitive” exports for which the average tariff rate was 3.5 percentage points lower in comparison with MFN and “non-sensitive” products. However, as of 1 February 2014, Azerbaijan was again promoted from GSP and GSP+ to the “Most Favored Nation” tariff regime. The simple average tariff rates for EU and Azerbaijan are given in the Diagram below.

Figure 3. MFN tariff rates applied by Azerbaijan and European Union (in %)



Source: WTO tariff profiles, 2014

Azerbaijan imposes relatively higher tariffs in both the agricultural and non-agricultural sectors, although the range of tariff rates is not large. In general, 78% of all agricultural tariff lines are traded within 10-15% tariff range under the MFN tariff regime, which constitutes 38% of total imports. Around 29% of total imports are traded under a duty-free regime, mainly with CIS countries as a part of established free trade agreements (*WTO tariff Profiles*, 2014). As for non-agricultural products, 48% of all non-agricultural products are traded within 10-15% tariff range under the MFN tariff regime, which amounts for 21,9%. The largest share of import volume (56%) is imported with up to a 5% tariff rate.

On the EU side, the average MFN rates are relatively low. However, the dispersion of tariff rates is larger. For agricultural products, approximately 31% of all product lines are imported duty-free which constitutes 45.5% of all overall agricultural imports. On the other hand, 25% of imported products is assessed 10-25% tariff rates, and 15% are imported under tariff rates exceeding 25%. The picture is completely different for non-

¹⁸ Liargovas P. (2013). EU trade policies towards neighboring countries. *7th European Community Framework Programme FP7-SSH-2010.2.2-1*, Working Paper 2/01.

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agricultural products. Almost all products are imported at tariff rates well under 15%. Moreover, 60% of all non-agricultural imports are imported duty-free.

Table 3. MFN applied tariff rates for Azerbaijan and European Union

Product groups		European Union		Azerbaijan	
		MFN applied	Duty free in %	MFN applied	Duty free in %
1	Animal products	20.0	27.3	13.9	3.8
	Dairy products	52.8	0	15.0	0
	Fruit, vegetables, plants	10.7	19.7	13.3	0.5
	Coffee, tea	6.2	27.1	14.6	0
	Cereals and preparations	17.1	13.8	12.5	5.5
2	Oilseeds, fats and oils	6.1	48.1	8.6	1.6
	Sugars and confectionary	29.7	0	12.8	8.8
	Beverages and tobacco	20.8	18.8	22.8	0
	Cotton	0.0	100.0	13.0	0
	Other agricultural products	4.4	65.0	12.0	2.1
3	Fish and fish products	11.8	9.4	11.8	0
	Minerals and metals	2.0	50.2	8.4	2.7
	Petroleum	2.8	24.8	11.4	16.7
	Chemicals	4.6	21.3	12.0	3.9
4	Wood, paper, etc.	1.0	80.8	10.9	0
	Textiles	6.6	2.1	12.3	0.2
	Clothing	11.5	0	15.0	0
	Leather, footwear, etc.	4.2	22.8	12.1	0
5	Non-electrical machinery	1.9	21.3	3.3	8.9
	Electrical machinery	2.8	20.5	8.7	3.6
	Transport equipment	4.3	12.8	4.2	5.3
	Manufactures	2.6	20.9	9.7	6.2

Source: WTO tariff profiles, 2014.

Despite the high share of EU imports and exports in Azerbaijan overall trade activity, some issues are worth mentioning. For example, the applied MFN tariff rates by the EU for agricultural products such as animal products and plants harms Azerbaijan's potential to expand its production and export of the mentioned products; fruits and plants are one of the main non-oil export product groups. The same matters can also be attributed to another product group, namely, sugars and confectionary.

This product group is also among the top non-oil export products. The roughly 30% tariff rate applied by the EU for such products narrows the range of options for Azerbaijan expanding its trade¹⁹.

Secondly, the lack of diversification in production in Azerbaijan is another obstacle for the broadening of trade relations. The priority given to the oil and gas sector in exports and the concentration of large volumes of government and foreign investments in this sector has led to

¹⁹ World Bank. World Tariff Profiles 2014.

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the neglect of other industrial sectors, thus narrowing the export potential of the country. On the one hand, due to the lack of such diversification, Azerbaijan was unable to utilize the benefits of the GSP and GSP+ trade regimes fully, to which the country was entitled until the past two years²⁰. GSP and GSP+ regimes have not included trade concessions for the petroleum and gas sectors, the tariffs for which were already quite low in the European Union; these products were still traded within the MFN regime. Although Azerbaijan was eligible for trading 66% of the product categories under the GSP scheme, only one quarter of the potential was utilized²¹.

Also, during the Soviet era, Azerbaijan had advanced sectors such as oil processing and the production of several chemical product lines. The latter were mainly manufactured from raw materials obtained as a result of oil processing, which enabled the country to add more value and produce less industrial waste. Another sector was machinery manufacturing, mainly in the oil processing and chemical industries, which was also abandoned with the rapid de-industrialization after the fall of the Soviet Union. Hence, considering the potential in natural resources, the presence of an abundant labor supply in Azerbaijan and low tariff rates for such products imposed by the European Union, those sectors can be restructured and become export-oriented.

In conclusion, it can be said that Azerbaijan has the potential to utilize the advantageous tariff rates provided by the MFN scheme. Large imports of capital goods into the country can be seen as a positive trend in increasing the capital stock of the country, which can stimulate the development of industrial sectors with a potential comparative advantage. However, the tariffs affect the trade expansion only partially, while other barriers such as non-tariff measures and hidden barriers to trade must also be addressed.

4. Barriers to Trade with EU

The development of trade between Azerbaijan and the European Union is very challenging and in the coming years will hardly happen due to the current geopolitical situation of the country, the existing tariffs and non-tariff barriers among both parties. The political ties of Azerbaijan with Turkey and Russia will pull the countries in different directions, towards different interests. The lifting of sanctions on Iran also will impact new trends of trade competing with Azerbaijani products in international markets.

²⁰ Azerbaijan: Building Competitiveness. An Integrated non-oil Trade and Investment Strategy (INOTIS). *World Bank Report*, 2003. Web. <http://documents.worldbank.org/curated/en/2003/11/2821319/azerbaijan-building-competitiveness-integrated-non-oil-trade-investment-strategy-inotis-vol-1-2-summary-report>

²¹ EBRD Transition Report 2014. Web. <http://www.ebrd.com/news/publications/transition-report/transition-report-2014.html>

4.1. Non-tariff barriers (SPS etc.) / Technical barriers to Trade between European Union and Azerbaijan

Tariff barriers to trade are not the only obstacles present in the trade relations between the parties considered. The non-tariff trade barriers must be subject to examination as well while assessing EU-Azerbaijani trade. Those barriers include import licenses, tariff and import quotas, sanitary and phytosanitary regulations, eligibility issues of a particular country or establishment for importing, and so on. Some of these issues affecting both parties are described below.

Exporting to European Union

Azerbaijan's exports to the European Union are conducted based on the partnership agreements described in Chapter 1. As a first step, the firms and organizations must meet the eligibility requirements imposed by the EU Customs Union, and eligible candidates must obtain the appropriate import licenses.

Import licenses must be issued for all products to be circulated within the borders of the European Union for commercial purposes. For products of non-commercial nature and the products for the tariff quotas are specified and the volume of particular import transaction does not exceed the specified quota threshold. Moreover, the licenses for some products may not be required under the specified articles of Regulation of 800/1999 and Regulation 918/83. Nevertheless, licenses can still be obligatory under the preferential agreements which are granted through licenses. The license usually contains information about the importing party and the volume of the import. If the import volume is larger than that indicated in the document, but does not exceed and fall below the 5% of the volume shown, the import transaction is carried out in accordance with this license²².

Imports to the European Union are subject to some restrictions in the form of **import and tariff rate quotas**. *Import quotas* are the volume restrictions imposed on products to be imported to the European Union. The purpose of the import quotas is to protect local manufacturers and restrict unfair trade conditions practiced by the trading countries. Currently, European Union exercises several import quotas mainly for agricultural products such as cereals, beef and veal, sheep and goat meat, dairy products, etc.

Notwithstanding the restrictive nature of quotas, those can also be applied in order to promote the imports from some developing countries through favorable conditions.

²² Commission Regulation (EC) No 376/2008 of 23 April 2008. Web. <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2008:114:0003:0056:EN:PDF>

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Preferential tariff quotas (TQ) are the tariff concessions granted within the framework of trade agreements between the partner countries and the European Union. In this case, the volume of imports of certain products is determined in advance. In this case, according to the place of origin of the product, the importing quota is determined for a specific product and the duty to be applied is determined by the measurement unit of the product, such as tons, hectoliters, etc.

The *Autonomous tariff quota* is one of the applications of preferential trade conditions. In order to stimulate competition in some industries and to compensate for the lack of supply for some agricultural and industrial products, the European Union pursues import this shortage under most favored terms. As stated in COUNCIL REGULATION (EU) No 1388/2013²³:

“The Union production of certain agricultural and industrial products is insufficient to meet the specific requirements of the user industries in the Union. Consequently, Union supplies of those products depend to a considerable extent on imports from third countries. The most urgent Union needs for the products in question should be met immediately on the most favorable terms. Union tariff quotas at preferential duty rates should therefore be opened within the limits of appropriate volumes taking into account the need not to perturb the markets for such products or impede the establishment or development of Union production.”

The management of these autonomous tariff quotas is also established in the aforementioned document. The list of products entitled for autonomous tariff quotas is periodically reviewed and amended (in January and July) and published in Official Journal of European Union. Below are given the autonomous quotas for some product groups. The quota levels for fishery products are designated for 2016-2018 years; for the rest, the quotas took effect on January 1st, 2014.

Table 4. Autonomous tariff quotas and duties for selected products groups

Product Group	Number of product lines	Range of tariff quotas	Quota duties (%)
Dairy products, tonnes	19	0-19 988	-
Fishery, tonnes	63	1000-300.000	0.00-5.00
Tobacco, tonnes	10	6000	0.00
Chemicals, tonnes	68	0.2-35.000	0.00
Processed metals, tonnes	9	500-50.000	0.00
Glassware, m ²	1	3 000 000	0.00
Appliances and manufacture parts	18	120.000-5.8000.000	0.00

Source: Council Regulation (EU) 1388/2013 and 2015/2265

As seen from the table, the autonomous tariff quotas mostly include the product lines from fishery and chemical industry. For tobacco and manufactured appliances and parts, the number of products is relatively low, but can be effectively utilized in case of the granted preferential trade status to a country. As seen from previous chapters, the main exports of Azerbaijan to the

²³ Council Regulation (EU) No 1388/2013 of 17 December 2013. Web. <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02013R1388-20160101&qid=1461757142890&from=EN>

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European Union in the non-oil sector are mostly chemicals, manufactured goods, and appliances. If more favorable trade conditions are established between the trading parties, those product lines can also be applied to Azerbaijani exports.

A very important non-tariff barrier to export to the European Union refers to the Sanitary and Phytosanitary measures²⁴. They ensure the safety and healthy composition and production of the traded products. They are based on the World Trade Organisation SPS Agreement that all member countries of the WTO must sign in order to protect the national rules governing food and feed safety, animal health and plant health. These rules are based on international standards and science-based. Azerbaijan is not a member of the WTO yet and the accession process has now entailed almost 20 years of dialogue²⁵. Many products meet the SPS measures but others would need to be improved.

Importing from European Union to Azerbaijan

Unlike the European Union, Azerbaijan does not apply any quantitative restrictions on the volumes of imports on any products. Therefore, the trade barriers imposed by Azerbaijan are mostly of legislative nature, that is, the document requirements and quality controls are the main instruments for import regulation.

Azerbaijan counts also on *Sanitary and Phytosanitary measures* for imports in order to guarantee the health and safety of traded products. Phytosanitary measures have been established in accordance with the current legislation of the Republic of Azerbaijan in order to prevent the entrance and dissemination of harmful organisms. The provision of phytosanitary control is specified in the “Law on Phytosanitary Control” of the Republic of Azerbaijan²⁶. If the products being imported into the territory of Azerbaijan are not accompanied by the required documents or suspected to carry harmful organisms, those products are subject to phytosanitary inspection. In this case, the customs service informs the phytosanitary offices which, in turn, have the right to test, examine, and, if the required standards are not met, to destroy the imports. The products imported can be stored in quarantine until phytosanitary test results are ready. In some cases, unloading and repeated loading is done in order to eliminate

²⁴ Sanitary and phytosanitary (SPS) issues. European Commission. Web.
http://trade.ec.europa.eu/doclib/docs/2013/april/tradoc_150986.pdf

²⁵ World Trade Organisation. Accessions. Azerbaijan. Status of accession working party. Web.
https://www.wto.org/english/thewto_e/acc_e/a1_azerbaidjan_e.htm

²⁶ Food and Agriculture Organisation of the United Nations. Law on phytosanitary control. Azerbaijan. Web.
http://faolex.fao.org/cgi-bin/faolex.exe?rec_id=068885&database=faolex&search_type=link&table=result&lang=eng&format_name=@ERALL

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the phytosanitary risks. The cost of phytosanitary examination and the value of destroyed imports must be borne by the importing person or organization.

Imports to Azerbaijan also encounter the barrier of *import licenses*. Depending on the product group, the licenses are issued by the corresponding authorities; the Ministry of Agriculture of the Republic of Azerbaijan issues the licenses concerning agricultural products, whereas the import licenses for pharmaceuticals are issued by the Ministry of Healthcare of Azerbaijan. Recently, the process of issuing import licenses has been done in electronic form via e-government technology. The requests for licenses are processed in approximately 3-14 days depending on a product and validity periods can vary from three months to five years. The following table summarizes the figures on obtaining licenses for some import products²⁷.

Table 5. Information on issuing import licenses for selected products

Product	Time of request processing	Validity of the license	Price (AZN)
Tobacco	14 days	5 years	11000
Alcohol	15 days	1 year	11000 (per product)
Pesticides and agrochemicals	3-5 days	3 months	-
Veterinary medicaments and food additives	10 days	5 years	950 (per medicament)
Pharmaceuticals	15-30 days	n.a.	free of charge

Source: *Electronic portal for licenses*:

http://icazeler.gov.az/az/licenses?agency_id=510&page=1

Rules of Origin. The provisions of the rule of origin are set in Articles 24- of the “Law on Customs Tariff” №1064/20.06.1995²⁸⁻²⁹ and updated in the Resolution of the Cabinet of Ministers No. 190 in 2007³⁰. The practice of determining the country of origin of the products is harmonized with international practice as a part of the process of negotiations for Azerbaijan’s WTO accession. Concepts similar to that applied to imported products in European Union Customs policy such as “wholly obtained” and “sufficiently worked and processed” approaches are also used in Azerbaijan Customs legislation. The “wholly obtained” status is given to products produced completely in the country of origin: 1) raw materials extracted from terrestrial and marine areas of the country, 2) agricultural products, cattle and poultry raised and

²⁷ Electronic information portal on permissions. Web. http://icazeler.gov.az/az/licenses?agency_id=510&page=1

²⁸ Law of the Azerbaijan Republic on customs tariff № 1064/20.06.1995. Web. <http://www.customs.gov.az/en/llar1064.html>

²⁹ Ministry of Economy of the Republic of Azerbaijan. Consumer Goods Expertise Center. Limited Liability Company. Web. <http://ekspertiza.az/az/5/35/44/>

³⁰ Articles 24- of the “Law on Customs Tariff” and updated in the Resolution of the Cabinet of Ministers No. 190 in 2007

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manufactured in the country of origin, 3) high-tech products obtained in open space in spaceships owned or rented by the country of origin etc.³¹.

- a) “Sufficiently worked and processed” status is attributed to products that comprise elements and production processes from two or more countries. However, the product is considered to originate from a country where it has gone through the manufacturing process, as a result of four digits of Product nomenclature have changed;
- b) A sufficient production-technological process was implemented for being considered as the country of origin;
- c) The ad-valorem share method – the share of the value of used materials or the value added has reached a certain level in total value of the product.

In this regard, operations related to the storage and transportation of products, simple assembly works, etc. which do not add substantial features to the product do not provide a sufficient ground for the country that carried out these operations to be considered the country of origin of the product.

In order to determine the country of origin of the product, the Customs Office requires the certificate of origin from an importer. The certificate reflects the written form signed by the supplier regarding the corresponding word on the criterion of origin and the written statement of the authorities of the exporting country regarding the validity of information stated on the certificate. The certificate must be presented in two cases: 1) if the imported goods are supplied by a country with preferential treatment and 2) if the imported goods are subject to quantitative restrictions. While Azerbaijan participates in a free trade area with eight countries of the Commonwealth of Independent States, the imports from those countries are given preferential treatment and can be imported to Azerbaijan freely only by submitting the certificate of origin.

4.2. The need for WTO accession

The application for the accession of Azerbaijan to the World Trade Organization has taken almost 20 years. In 1997 Azerbaijan made its first application and since then many negotiation meetings have happened. The current chief of the working party led by H.E. Ambassador Walter Lewalter (Germany) expressed in 2015 the need to speed up the negotiations for the accession of Azerbaijan to the WTO. At national level, H.E. Mr Mahmud Mammad-Guliyev, Deputy Minister of Foreign Affairs and Chief Negotiator of Azerbaijan affirmed that the main challenges

³¹ The Law of the Republic of Azerbaijan on Phytosanitary Control. Web. <http://www.dfnx.gov.az/?r=11&id=6>.

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for Azerbaijan to join the WTO are based on the drop of the oil prices. This situation, according to Mr. Mammad-Guliyev was a big obstacle to diversify the economy of the country³².

The delay for the accession of Azerbaijan to the WTO is excluding Azerbaijan from improvement into international standards and opening to new markets. If Azerbaijan would access to the WTO there would be a restructure in the whole country related to industry, administration, infrastructures, information and technologies, science, etc.

The blockage to access to international standards related to trade are stopping decentralisation processes in the country and promoting monopoly trends, where the current trading leaders will continue to operate internationally but at the same time will not experience competence, therefore there will not be opportunity for new entrepreneurs to provide new products at national or international level.

The reliance on same countries for trading is an obstacle for the export diversification. The commercial relations with more countries would let the development of new SMEs that would have an impact on the regions of Azerbaijan.

The Center for Economic & Social Development already mentioned in different documents^{33 34} the need for the accession of Azerbaijan to the WTO. Some researchers stated that Azerbaijan does not have enough capacity to compete with foreign companies and it is a threat for the imports since better products with lower prices could enter in the Azerbaijan national market and damage the local businesses.

Azerbaijan will have the next working meeting about the accession to the WTO in Geneva from 19 to 23 July 2016. According to the Azerbaijani Deputy Foreign Minister Mahmud Mr. Mammad-Guliyev³⁵, there are some important questions to discuss about.

According to Guliyev it will be positive that Azerbaijan will be considered a developing country at the WTO, therefore will enjoy subsidies not less than 10% of goods cost of agriculture production however WTO is offering just 5% in subsidies for agriculture sector.

³² World Trade Organisation. Azerbaijan accession negotiations need to move beyond routine — Chairman. 06.03.2015. Web. https://www.wto.org/english/news_e/news15_e/acc_aze_06mar15_e.htm

³³ Bayramov, Vugar. Azerbaijan's Accession to World Trade Organization (WTO); Pros and Cons. Center for Economic & Social Development. 2010. Web. <http://cesd.az/new/wp-content/uploads/2011/05/CESD-Azerbaijan%E2%80%99s-Accession-to-World-Trade-Organization-WTO.pdf>

³⁴ Bayramov, Farhad. Ibrahimova, Narmin. Babazadeh, Isgandar. Azerbaijan's Accession to the WTO. Assessin the macroeconomic consequences for the economy of Azerbaijan. 2014. Web. <http://cesd.az/new/wp-content/uploads/2011/05/CESD-Azerbaijan%E2%80%99s-Accession-to-World-Trade-Organization-WTO.pdf>

³⁵ Azerbaijan may join the WTO if oil prices continue to remain low. Center for Economic & Social Development. 24.06.2016. Web. <http://cesd.az/new/?p=10341>

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The CESD research team agrees that the drop of the oil prices is a very important factor in order to speed up the negotiations with WTO and therefore sign the membership. The unstable situation at the economy of Azerbaijan caused by the fall of oil prices is positive to move towards economic reforms in the country.

Azerbaijan has bilateral negotiations with the United States, Japan, Brazil, Ecuador, Sri Lanka, European Union, Norway, India, South Korea, Taiwan Province of China, Canada and Switzerland nowadays.

4.3. The current standards and the harmonization of standards

The European Union has created some standards and organizations that ensure the harmonization of such standards³⁶. These standards contain rules for the production and trade of chemicals, Conformity assessment and management systems, construction, Consumers and workers' protection, energy efficiency, Electric and electronic engineering, healthcare engineering, measuring technology, Mechanical engineering and means of transport, services and sustainability.

These standards ensure the safety of workers, chemical ingredients, production processes, monitoring, certification, working rules, etc. They extremely important to satisfy the needs of the European Union standards. When countries get association status with the European Union (like the case of Georgia, Ukraine, Montenegro, Turkey, etc.) must comply with the standards requested by the European Union in order to access to the Deep and Comprehensive Free Trade Area (DCFTA).

5. Assessment – The model

5.1. Computable General Equilibrium (CGE) model

The cost-benefit analysis of the impact of free trade agreement between European Union and Azerbaijan is carried out by applying Computable General Equilibrium (CGE) Model. The model is widely used in the assessment of possible impact of environmental, fiscal and trade shocks on economy in general, and production factors and final product sectors in specific (Melo, 1989). The model can be adjusted for a large, as well as a small country case, and different product disaggregation level.

The model is based on several assumptions. The main assumption is that all sectors, markets and industries in the economy are interconnected. Consumers are assumed to maximize their

³⁶ European Commission. Growth. Internal Market, Industry, Entrepreneurship and SMEs. Web. <https://ec.europa.eu/growth/single-market/european-standards/harmonised-standards/>

utilities by maximizing their consumption subject to their income and the commodity prices given. In turn, producers maximize their profit subject to factor and commodity prices. Moreover, several neoclassical assumptions such as full employment in the economy and “the law of one price” implying that domestic prices of tradable goods are set by world prices. The latter is seen as one of drawbacks of this modeling approach which has been altered or mitigated in various model applications.

Taylor (2006) also emphasized some drawbacks of the general equilibrium approach such as full and “fixed” employment of labor and capital and completely flexible tax rates which downgrade the accordance with the real world. Notwithstanding these points, the model is able to give a general overview of the possible changes in the economy as a result of various policy shocks.

1-2-3 CGE model

One of the applications of CGE modeling is simple 1-country, 2-sector, 3-commodity model applied for small economy country, the name of which is taken from its structure. The model was developed by Salter and Swan in 1960's. This paper will follow the theoretical summary introduced by Devarajan et al (1997) and the model is adapted for multi-sector (seven sectors) and two foreign agents' case, which are European Union and the rest of the world (ROW).

A small country produces two commodities for each of sectors: D_i , which is non-traded good consumed domestically and E_i , an exported good. The third commodity is M_j , imported good not produced domestically. \bar{X} represents the total output in the country which is fixed:

$$\bar{X} = G\left(\sum_{i=1}^n E_i \sum_i D_i^s; \Omega\right)$$

D_i^s - is the share of the product consumed domestically. This formula is an expression of production possibility frontier showing the possible combinations of production of domestic and export good. The fixed output also represents the economy with full employment. The function is assumed concave with constant elasticity of transformation Ω . In this model's case, the aggregate output, as well as sectoral outputs is included.

A homogenous consumer consumes all commodities which are constituted of imported and domestically produced goods. An economy is a price taker; hence, it faces fixed world prices. The formula also employs Armington assumption: domestic and imported products are given different preference; that is, imperfect substitution is assumed. The total consumption is described with the following formula:

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$$Q_s = F\left(\sum_{j=1}^n M_j \sum_{i=1}^n D_i^d; \mu\right)$$

D_i^d - is the total demand for domestic products; μ - is the constant elasticity of substitution. In formulas, i denotes industries that produce domestic and export goods, while j represent the commodity sector not produced domestically or exported.

The flow of goods and services take place between three entities: households, government and the rest of the world. Part of the composite good is consumed by households and another part by the government. Households receive factor payments and pay taxes to government; in return government pays transfers and subsidies to households. A share of domestic production is exported to the rest of the world; also, some goods are imported which constitute a part of composite good consumed by households. Import tariffs and export duties are also received by the government. Public savings, that is, budget deficit or surplus is the balance of tax revenue plus foreign grants and government expenditures (consumption and transfers). The difference between exports and imports is current account balance represented by foreign savings adjusted for transfers from abroad. Foreign savings are fixed, so the model is savings-driven.

The equilibrium condition is based on the Walrasian general equilibrium. So, the model achieves an equilibrium level in which the income generated in the economy is equal to the total expenditure adjusted for savings.

The model distinguishes exogenous and endogenous variables. Exogenous variables are those taken as given and do not alter as a result of policy shocks. Endogenous variables are determined by exogenous variables and model parameters, and are subject to change as a result of a policy shock. The calibration parameters are import substitution and export transformation elasticities mentioned above.

The full list of equations and elements of the model are given below. While the analysis is conducted both at aggregate and sectorial level, the equations as well as exogenous and endogenous variables are also constructed accordingly. Firstly, seven sectors are distinguished: agriculture; processed food; chemicals; fuels; minerals and metals; machinery, transport and appliances; other manufactured goods. The import tariffs and export duties are distinguished as of European Union (EU) and Rest of the World (ROW). The model equations can be grouped in four sections:

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Table 5. Equations

Real flows		Nominal Flows	
Indicators	Equations	Indicators	Equations
\bar{X}	$G(\sum_{i=1}^n E_i \sum_{i=1}^n D_i^s; \Omega)$	Y	$Px * \bar{X} + tr * Pq + re * R$
Q_s	$F(\sum_{j=1}^n M_j \sum_{j=1}^n D_i^d; \mu)$	TAXEQ	$R * tmeu * wm^{EU}(\sum_{i=1}^n M_i^{EU}) + R * tmrow * wm^{ROW}(\sum_{i=1}^n M_i^{ROW}) + teu * Pe(\sum_{i=1}^n E_i^{EU}) + terow * Pe(\sum_{i=1}^n E_i^{ROW}) + ts * Pq * Qd + ty * Y$
Q_d	$Z+Cn+G$	CONS	$Y(1 - ty - sy)/Pt$
M/D^s	$g(Pe, Pd)$	SAVINGS	$sy * Y + R * B + Sg$
E/D^d	$f(Pm, Pt)$		
Sectoral Real flows		Prices	
X^{AGR}	$G(E^{agr} D_{agr}^s; \Omega)$	Pm	$R * wm * (1 + tmeu + tmrow)$
X^{FOOD}	$G(E^{food} D_{food}^s; \Omega)$	Pe	$R * we/(1 + teu + terow)$
X^{CHEM}	$G(E^{chem} D_{chem}^s; \Omega)$	Pt	$Pq * (1 + ts)$
X^{FUELS}	$G(E^{fuels} D_{fuels}^s; \Omega)$	Px	$\frac{Pe * (\sum_{i=1}^n E_i) + Pd * Ds}{\bar{X}}$
X^{MACH}	$G(E^{mach} D_{mach}^s; \Omega)$	Pq	$\frac{Pm * (\sum_{i=1}^n M_i) + Pd * Dd}{Qs}$
X^{MM}	$G(E^{mm} D_{mm}^s; \Omega)$	Numeraire	R
X^{OM}	$G(E^{om} D_{om}^s; \Omega)$		
		Equilibrium Conditions	
Q_s^{AGR}	$G(M^{agr} D_{agr}^d; \mu)$		$\sum_{j=1}^n D_i^d - \sum_{i=1}^n D_i^s = 0$
Q_s^{FOOD}	$G(M^{food} D_{food}^d; \mu)$		$Qd - Qs = 0$
Q_s^{CHEM}	$G(M^{chem} D_{chem}^d; \mu)$		
Q_s^{FUELS}	$G(M^{fuels} D_{fuels}^d; \mu)$	\bar{B}	$wm^{EU}(\sum_{i=1}^n M_i^{EU}) + wm^{ROW}(\sum_{i=1}^n M_i^{ROW}) - we^{EU}(\sum_{i=1}^n E_i^{EU}) - wm^{ROW}(\sum_{i=1}^n E_i^{ROW}) - ft - re$
Q_s^{MACH}	$G(M^{mach} D_{mach}^d; \mu)$	GBUD	$TAX - G * Pt - tr * Pq + ft * R = 0$
Q_s^{MM}	$G(M^{mm} D_{mm}^d; \mu)$		
Q_s^{OM}	$G(M^{om} D_{om}^d; \mu)$		
M^{agr}/D_{agr}^s	$g(Pe, Pd)$	E^{agr}/D_{agr}^d	$f(Pm, Pt)$
M^{food}/D_{food}^s	$g(Pe, Pd)$	E^{food}/D_{food}^d	$f(Pm, Pt)$
M^{chem}/D_{chem}^s	$g(Pe, Pd)$	E^{chem}/D_{chem}^d	$f(Pm, Pt)$
M^{fuels}/D_{fuels}^s	$g(Pe, Pd)$	E^{fuels}/D_{fuels}^d	$f(Pm, Pt)$
M^{mach}/D_{mach}^s	$g(Pe, Pd)$	E^{mach}/D_{mach}^d	$f(Pm, Pt)$
M^{mm}/D_{mm}^s	$g(Pe, Pd)$	E^{mm}/D_{mm}^d	$f(Pm, Pt)$
M^{omm}/D_{omm}^s	$g(Pe, Pd)$	E^{omm}/D_{omm}^d	$f(Pm, Pt)$
		Identities	
			$Px * \bar{X} = Pe * (\sum_{i=1}^n E_i) + Pd * (\sum_{i=1}^n D_i^s)$
			$Px * Qs = Pe * (\sum_{i=1}^n M_i) + Pd * (\sum_{i=1}^n D_i^d)$

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Table 6. Exogenous variables

w_m	world price of imports	tr	government transfers
w_e	world price of exports	ft	foreign transfers to government
t_m^{EU}	tariff rates of EU imports	re	foreign remittances to private sector
t_m^{ROW}	tariff rates of ROW imports	\bar{s}	average savings rate
t_e^{EU}	export duties paid for EU exports	\bar{X}	aggregate output
t_e^{ROW}	Export duties paid for ROW exports	X^{agr}	total output of agricultural products
ts	sales tax	X^{food}	total output of processed food products
ty	indirect tax rate	X^{chem}	total output of chemicals
\bar{G}	government consumption	X^{agr}	total output of fuels products
\bar{B}	balance of trade	X^{mm}	total output of minerals and metals
μ	elasticity of import substitution	X^{mach}	total output of machinery and transport
Ω	elasticity of export transformation	X^{oth}	total output of other manufactures

Table 7. Endogenous variables

<i>E</i> – Export	<i>M</i> - Import
E^{agr} – agricultural products exports	M^{agr} – agricultural products imports
E^{food} – processed food exports	M^{food} – processed food imports
E^{chem} - chemicals exports	M^{chem} - chemicals imports
E^{fuels} - fuels exports	M^{fuels} - fuels imports
E^{mm} – minerals and metals exports	M^{mm} – minerals and metals imports
E^{mach} - machinery and transport exports	M^{mach} - machinery and transport imports
E^{oth} - other manufactures exports	M^{oth} - other manufactures imports
D_{agr}^s - domestic supply of agricultural products	D_{agr}^d - domestic demand for agricultural products
D_{food}^s - domestic supply of processed food products	D_{food}^d - domestic demand for processed food products
D_{chem}^s - domestic supply of chemicals	D_{chem}^d - domestic demand for chemicals
D_{fuel}^s - domestic supply of fuel products	D_{fuel}^d - domestic demand for fuel products
D_{mm}^s - domestic supply of minerals and metals	D_{mm}^d - domestic demand for minerals and metals
D_{mach}^s - domestic supply of machinery and transport	D_{mach}^d - domestic demand for machinery and transport
D_{oth}^s - domestic supply of other manufactured goods	D_{oth}^d - domestic demand for other manufactured goods
D_s – total supply of domestic good	D_d – total demand for domestic good
Q_s - supply of composite good	Q_d - demand for composite good
Y – Total Income	P_m – domestic price of imported good
T – Taxes	P_e - domestic price of exported good
S_g – Government revenues	P_d – domestic price of domestic good
C – aggregate consumption	P_t – sales price of composite good
S – aggregate savings	P_x – price of aggregate output
Z – aggregate real investment	P_q – price of composite good
	R – Exchange rate

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The model closure is achieved when the number of equations is equal to the number of endogenous variables. In our model, considering the sectorial disaggregation of imports and exports, 47 equations and 47 endogenous variables are present. Thus, the closure assumption is not violated.

5.2. Data and variables included

The data on total output, wages, total imports and exports, government revenues and expenditures were collected from State Statistical Committee of Republic of Azerbaijan. Sectorial imports and exports from and to European Union were taken from EU Trade Commission³⁷. The data on tax revenues is collected from Ministry of Taxes of the Republic of Azerbaijan. The data on other variables were gathered from World Bank and International Monetary Fund's databases.

6. Results and Discussions

6.1. Results

The results of simulations for general macroeconomic indicators are given in *figure 10*.

Table 8. Macroeconomic Indicators

Macro indicator	Benchmark	Experiment	Change (in %)
Income	1.098124	1.097779	-0.03
Consumption	0.457416	0.457724	0,07
Aggregate savings	0.280963	0.280887	-0.02
Government savings	-0.033202	-0.033844	1.93
Tax revenue	0.061802	0.061061	-1.20
Investments	0.182045	0.182685	0.35
Exports	0.287264	0.293205	-50,32
Imports	0.140674	0.221923	57.76

As observed, the trade liberalization between Azerbaijan and EU will cause only modest changes in general welfare indicators. Such that, only consumption will experience a mere increase by 0.07%, implying that, the households will benefit at minor extent from this process. Other indicators such as Income and Aggregate savings will experience reduction, although the change will be quite small, 0.03% and 0.02% respectively.

³⁷ European Commission. European Union, Trade in goods with Azerbaijan. Web. http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_113347.pdf

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Changes in other variables are as expected as a result of changes in welfare indicators mentioned above. Tax revenues are expected to fall by 1.2% as a result of income reduction and a small change in consumption accompanied with the reduction in tariff revenues collected. In contrast, government savings are forecasted to increase. On the other hand, the total investment is expected to increase as well, probably as a result of the trade facilitation between the parties. Total imports and exports are changed disproportionately. The imports are expected to increase by 57.7%, whereas exports exhibit a sharp reduction of 50.3%.

The results for sectoral simulation are given in Table 5.2. According to the results, the sectoral disaggregation of changes in imports is quite notable. The largest change is expected to occur in Fuels and oil products amounting to 574%. On the other hand, the agricultural products imports expected to increase by 203%. Processed food and chemicals are also forecasted to experience a large increase of 81% in both sectors. In contrast, machinery, transport and appliances which are the main product group between Azerbaijan and EU are expected to show only a moderate increase of 5.6%. This is due to the fact that, the tariff rates on other product groups are relatively high, while tariff rates for machinery, transport and appliances products are low; so, the elimination of already low tariff rates will lead to minor changes. On the other hand, although changes are quite large for some product groups (over 200%), the overall change in imports volume is not so large, due to the initial small share of those in total imports.

Table 9. Sectoral imports and exports³⁸

Sectors	Imports			Exports		
	Change (in %)	Share in total imports (%)		Change (in %)	Share in total exports (%)	
		Initial	After lib.-tion		Initial	After lib.-tion
Agriculture products	202.95	5.91	11.34	5.06	1.51	3.19
Processed food	81.33	9.99	11.48	8.43	2.39	5.21
Chemicals	81.39	10.01	11.51	87.90	0.23	0.87
Fuels and oil products	574.31	2.92	12.48	-54.98	93.55	84.79
Machinery, transport and appliances	5.58	36.60	24.50	25.35	0.45	1.14
Minerals and Metals	23.82	18.91	14.84	34.09	0.74	1.99
Other manufactured goods	30.37	16.76	13.85	22.99	1.13	2.81

On exports side, the largest changes are observed in chemical products, machinery, transport and appliances, and minerals and metals; 178%, 94.9% and 38.6% respectively. In contrast, the main export product group, namely fuels and oil products are expected to decrease by 54.98%. So, the sharp reduction in total exports despite substantial positive changes in some sectors is not surprising. The large share of fuels and oil products in total exports before and after

simulation affects the overall changes in total exports; the increase or decrease of the latter is mostly affected of this product group. Although the export volume of other product groups experience large increase, these changes are unable to have a noteworthy effect due to their tiny share in total exports.

6.2. Discussions and Implications

The results show that, the establishment of free trade area between Azerbaijan and the EU will only have a marginal positive effect on general welfare of citizens. Although the consumption grows at very small extent, the fall in income levels would mean lower purchasing power of households; the fall in aggregate savings is also a result of combination of growing consumption and falling income.

Another implication of the results is linked to trade activity of the country. The results imply that imports will rise substantially as a result of tariff elimination. In this case, import of some products at lower prices such as agricultural and processed food products will not only create a stricter competition between local and foreign producers; incapable to endure this competition, local producers will eventually be forced to go bankrupt and leave the market. As a result, the demand for such products will be mostly met by foreign manufacturers, and the profit returns and employment opportunities will gradually go down. This outcome can also be implied for other manufacturing sectors, especially for chemicals.

This situation might also result in the decrease of tax revenues collected, while the bankruptcy of local producer means the decrease in the number of economic subjects who are taxpayers. Combined with tariff elimination, it may exacerbate the problem of budget deficit. Unable to raise higher tax revenues, the government will be forced to cut spending on various projects. As shown in practice, the cut is usually carried out in social spending such as education, healthcare and social security.

On the exports side, the growth in sectors such as chemicals, and machinery, transport and appliances has a little impact on overall changes in total exports. This emanates from the problem of lack of export diversification. The main export products of Azerbaijan to the European Union are fuels and oil products. For the observed year (2014), it constituted around 98% of total EU exports. The large cut in total exports as a result of the reduction in fuels exports will narrow income generated from this sector. While this sector is mainly owned by state enterprises, several projects carried out by the means of oil revenues will be interrupted; social protection and employment opportunities will be at risk.

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The problem of diversification does not relate to exported products only. The economy of Azerbaijan in whole suffers from the lack of diversification of economy. The economy is heavily dependent on natural resources extraction. The oil sector is the main manufacturing sector of the country, where the largest value added is generated. In contrast, agriculture and food processing sectors, also chemicals sector has a smaller share in total value added. Although the share of non-oil manufacturing has substantially risen in recent years, this share is very small in comparison with oil sector. The heavy reliance of oil sector not only narrows the opportunities of income generation and economic development, but it also makes the country more susceptible to external economic and political shocks.

Some conclusions can be drawn in this regard. The benefits of the establishment of free trade area between Azerbaijan and the European Union will not be large for Azerbaijan unless economic and legislative reforms are implemented. Considering that the tariff elimination and harmonization of legal framework are carried out in step-by-step manner while establishing free trade areas, this would allow Azerbaijan to adjust the structure of the economy to prospective changes in trade relations and investment opportunities. The promotion of dynamic comparative advantages in sectors such as agriculture, processed food and chemical industry will strongly contribute to economic development in many aspects. That is, these sectors can firstly be developed in order to satisfy local demand for such goods; after these sectors have reached a sufficient level of specialization and competitiveness, the sectors can become export-oriented. During the Soviet period, Azerbaijan had a large agricultural production and light industry. Moreover, some type of machinery and appliances manufacturing was also developed associated with prospering oil industry. With substantial capital investment and temporary protection, those sectors can be revived again.

The effective and comprehensive state support is very important in this regard. Firstly, the state support will protect infant manufactures in these spheres and help those to reach the level of scale economies when the production is competitive and generates large profits. On the one hand, this will efficiently restructure the economy and will play a role of import substitution; on the other hand, the attraction and facilitation of private and foreign direct investments will be relatively easier.

6.3. Conclusions and policy recommendations

The Deep and Comprehensive Free Trade Area could modernize Azerbaijan's economy, with improvement of technologies and infrastructure, and with new regulations with international standards that would allow products to be exported not only to EU countries but also to the rest

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of the world. Due to its well-recognized standards it would position Azerbaijan in a good place in terms of international trade.

The accession to the WTO is a prerequisite for applying for the status of associated country to the EU, and therefore accessing the DCFTA. The drawn-out negotiations with the working party for the accession to the WTO are blocking the improvement of the economy of the country. The drop in oil prices and the unstable economic situation of Azerbaijan has motivated the acceleration of negotiations with WTO. However, the working party still has not agreed on the percentages of subsidies for the agriculture sector that would be given in the case of WTO accession.

Countries that previously joined the DCFTA (Moldova, Ukraine and Georgia) counted on enormous financial support from the EU in order to empower their intellectual capital, establish stronger rule of law, and change the structure of government and industries. The imposition of and harmonization of international standards could bring better quality and more efficient production to Azerbaijan, diversify the economy and give opportunity to new entrepreneurs and SMEs to start new businesses and to export to the EU.

Tariff and non-tariff barriers are big obstacles to Azerbaijan's compliance with the EU standards, but with the support of the Azerbaijan government and by following all the necessary steps it could be possible to join the DCFTA. In political terms, Azerbaijan holds strong ties with Russia, and acts cautiously and deliberately in order not to create conflict with its very powerful neighbor. Additionally, the Eurasian Economic Union is an attractive option for Azerbaijan in order to export its products.

The introduction in Azerbaijan of international rules from WTO or the EU would promote decentralization of powers and diversification of the economy. Many groups in Azerbaijan may not agree to share their power with newcomers, and that is why the negotiations for accessing international economic organizations are moving so slowly.

Despite the positive aspects discussed above, the potential benefits of free trade establishment between EU and Azerbaijan are not empirically supported. According to our results, the establishment of the free trade area between the European Union and Azerbaijan will not have a positive impact on the economy and the standard of living of Azerbaijan if the current state of the economy persists. As shown, the exports of Azerbaijan will experience a dramatic fall as a result of the free trade area; despite the fact that the exports from all sectors will grow substantially, the large reduction in the primary export, oil, outweighs this positive impact and overall level of exports is halved.

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In contrast, the imports will experience a sharp increase, which can exacerbate the current account deficit. Also, the large influx of imports will crowd out local manufacturers which will not be able to compete with cheaper high-quality products. These results are also backed by the research conducted by the CESD (Bayramov, Ibrahimova and Babazadeh, 2014)³⁸. As a result, income and consumption levels exhibit only a negligible change: the latter is actually decreasing and the consumption is only slightly increasing. It can be concluded that, unless the economy is diversified and comprehensive and strong manufacturing sectors are established, the economy will not achieve a sustainable path of development and involvement in free trade will not be beneficial for Azerbaijan.

Hence, the liberalization of trade and economy must be done with a step-by-step approach that will adapt the economy to the world market and at the same time protect local manufacturers against foreign competition until they become productive and profitable. The state support is of great importance in this case. The government can provide the necessary financial and fiscal, as well as infrastructural support in order to facilitate the emergence of new enterprises and thereafter help to attract private and foreign capital.

RECOMMENDATIONS

- 1) The diversification of the economy away from hydrocarbon sector, e.g. the attraction of investments to tradable sectors which are capable of generating high added-value, such as the manufacturing industry. In the first phases, the diversification can be carried out in a vertical direction by focusing on the sectors in which Azerbaijan possesses a comparative advantage - in other words, resource-related manufacturing products such as chemicals and plastics can be developed first.
- 2) The establishment of short-term and long-term diversification goals; the creation of a transparent and efficient monitoring and tracking system in order to assess the status of the diversification process and whether the goals have been achieved in this regard.
- 3) Speeding up the negotiations with the WTO in order to promote liberalization and decentralization of the economic powers in the country by incorporating WTO rules. This step will be crucial to starting an application of association to the EU and then establishing free trade with the EU.

³⁸ Bayramov F., Ibrahimova N. and Babazadeh I. (2014). Azerbaijan's Accession to the WTO: Assessing the macroeconomic consequences for the economy of Azerbaijan. *Center for Economic and Social Development, Policy Paper*.

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- 4) To provide new opportunities to SMEs by decreasing taxes and increasing grants, transparency and accessibility of information regarding opportunities for entrepreneurs, capacity building and networking activities in order to transform industries into competent economic actors of the country. The provision of access to state and private finance for small and medium size enterprises engaged in the production sectors with the potential of future exportation to regional trade partners - for example, chemicals, food and beverages industry, etc.
- 5) To start a restructuring of the sectors of agriculture, industry, manufacturing, technologies and transport in accordance with international standards in order to be able to compete with foreign companies and to access international markets.

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ISBN 978-9952-81-313-5

CESD Press
Baku, Azerbaijan

September 2016

CENTER FOR ECONOMIC & SOCIAL DEVELOPMENT

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