

## Azerbaijan's Integration in the Belt and Road Initiative Middle Corridor. Is World Trade Organization Accession Needed<sup>1</sup>?

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### Abstract:

Azerbaijan's accession to the World Trade Organization (WTO) has been under discussion since the late 1990s, however this process is not any closer to being achieved today. Despite the government's multiple economic reforms and the implementation of strategic roadmaps, the same cannot be said about Azerbaijan's commitment to bilateral and multilateral market access negotiations (WTO 2017).

The objective of this article is to investigate the potential impact of WTO accession on the economic strategy of Azerbaijan. Contrary to other WTO members, China does not automatically apply the Most-Favored Nation (MFN) tariff rate to non-members. The cost-benefit analysis in this paper suggests that the Azerbaijani goods with the highest untapped potential in China suffer from the application of the General Tariff Rate (GTR) versus the MFN tariff applied to all WTO members (China Customs 2021, International Trade Center 2021). Findings suggest that Azerbaijan's WTO accession is required for this country to integrate into the Middle Corridor and reap its benefits fully.

**Keywords:** trade; Azerbaijan; China; World Trade Organization; customs; tariffs; middle corridor.

**JEL Classification:** F13; F17; O19; O53.

### Introduction

The World Trade Organization (WTO) was created in continuation of the General Agreement on Tariffs and Trade (GATT) to achieve several goals, one of which was to create a global system of trade rules. Today the WTO counts 164 member countries, and only 14 countries worldwide are neither members nor observers. Most of Azerbaijan's neighbors are members of the organization. However, Iran, Iraq, Syria, and Turkmenistan are still negotiating accession just like Azerbaijan.

The objective of this article is to investigate the potential impact of WTO accession on the economic strategy of Azerbaijan. Some existing literature advises natural resource-endowed countries to prioritize regional integration and economic diversification before WTO accession (Carrère *et al.* 2012). However, here it will be argued that accession to the WTO is essential for Azerbaijan to maximize BRI benefits and increase its exports to China. China is highly discriminatory towards goods imported from non-WTO member countries. Contrary to other WTO members, China does not automatically apply the Most-Favored Nation (MFN) tariff rate to non-members. The cost-benefit analysis in this paper suggests that the Azerbaijani goods with the highest untapped potential in China suffer from the application of the General Tariff Rate (GTR) versus the MFN tariff applied to all WTO members (China Customs 2021, International Trade Center 2021). Findings suggest that Azerbaijan's WTO accession is required for this country to integrate into the Middle Corridor and reap its benefits fully.

The paper is structured as follows. First it reviews the literature related to WTO accession benefits for resource-rich economies. Then it investigates the current tariff barriers Azerbaijan suffers from vis-à-vis its exports to China using a trade policy partial equilibrium methodology. Finally, it presents the findings and discusses their economic significance.

### 1. Literature Review

Azerbaijan's accession to the World Trade Organization (WTO) has been under discussion since the late 1990s. However, this process is not any closer to being achieved today. Despite the government's multiple economic

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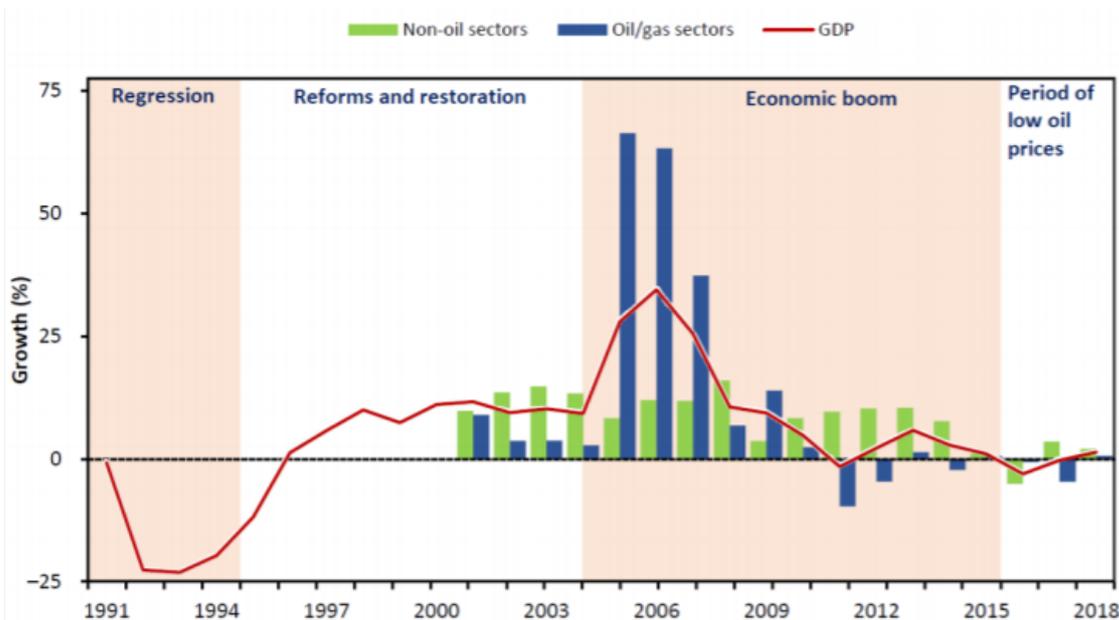
reforms and the implementation of strategic roadmaps, Azerbaijan's commitment to bilateral and multilateral market access negotiations is not clear.

Before assessing the effects of a WTO accession on this natural resource-rich country's economy, it is essential to review the features of natural resources. The uneven distribution and scarcity of natural resources make it possible for countries to use them for economic development. However, such endowment in natural resources can bring corruption, a lack of economic diversification, and unstable economies. To use these resources for the sustainable economic development of a country, governments that own these resources need to have a consistent, far-sighted strategy (Venables 2016).

According to the natural resource curse proponents (Auty 1993), resource-rich countries usually have lower economic growth. In this regard, Azerbaijan is different as this country was one of the highest growing economies from the mid-2000s to the mid-2010s. Despite 90% of Azerbaijan's Gross Domestic Product (GDP) being related to oil-and-gas sectors and a high dependency on natural resource exports, this country could leverage these resources for its economic diversification.

While being resource-rich does not seem to automatically lead to poor economic development, oil- and gas-dependent economies are known to be unstable due to factors such as the high price fluctuation of these commodities and the subsequent uncertainty engendered (Frankel 2010). Figure 1 below demonstrates how the GDP growth of Azerbaijan relates to the development of the oil-and-gas sectors, especially during the economic boom from 2004 to 2014. Economic growth engendered by high commodity prices is expected in resource-rich countries, making them more affected by external shocks. The period after 2015 are the result of low oil prices that heavily impacted the Azerbaijani economy.

Figure 1. Economic Growth and Development Periods in Azerbaijan, 1991–2018



Source: Asian Development Bank staff estimates based on databases of Azerbaijan's State Statistics Committee and United Nations Statistical Division 2019.

Due to the uncertainty related to Azerbaijan's endowment in natural resources, the country's possible gains from a WTO accession could be affected. Indeed, the effects of WTO accession on international trade and a country's economic growth are under debate. There is an asymmetry in the effects depending on specific characteristics of the studied country such as: developed or developing, emerging or not, resource-poor, or resource-rich.

Moreover, there is a latecomer effect on the bargaining power of a country seeking to become a WTO member (Pelc 2011). The latecomer disadvantage is present at two levels. The first is related to the terms of accession. Contrary to early adopters, latecomer countries' bargaining power is lower, and the terms can initially be disadvantageous to the new member. The second disadvantage is related to the costs of adhering to the international quality standards. Despite this being a costly initiative, in the long term, it enables the exports of said country to be more competitive, thus, driving economic development.

WTO accession did not impact overall exports of non-emerging resource-rich countries, precisely because of a lack of export diversification and competitiveness. As a result, resource-rich countries with low economic growth turn towards regional cooperation instead of international. This fact in its turn suggests that for non-emerging resource-rich countries such as Azerbaijan, regional integration can act as a first step towards increased productivity and competitiveness outside of the natural resource sectors before they can fully benefit from WTO accession.

However, regional integration has its own set of issues. For example, preferential trade agreements (PTAs) signed with resource-poor countries create trade diversion; Azerbaijan would suffer more as a resource-rich importer and see an increase in non-resource exports (Venables 2011). Tariff preferences introduced with such PTAs would create some trade opportunities for the resource-poor country thanks to the privileged access to the resource-rich country's market and imports the natural resources at a lower rate. The resource-rich country continues exporting natural resources to the world while substituting certain imports from the resource-poor country (Carrère *et al.* 2012). This analytical setup explains why resource-rich countries are generally not initiating regional integration plans as tariff revenue decreases in the importing resource-rich country and increases trade surplus in the resource-poor one.

A simple analysis of economic and political news suggests that the Azerbaijani government sees purpose in regional integration by participating in different international projects. More specifically, infrastructure projects have been carried out on land and sea. However, it is the oil-and-gas industry that has most benefitted from these projects. The Baku-Tbilisi Railway, the Baku-Tbilisi-Erzurum, and Baku-Tbilisi-Ceyhan pipelines, or the Trans-Anatolian Natural Gas pipeline that targeted better market access to new oil-and-gas markets.

Some efforts have been made towards trade liberalization. Several free trade agreements (FTAs) have been signed during recent years. In the last decade, Azerbaijan has shown interest in becoming a transit point between East and West thanks to Turkey's Middle Corridor in the Chinese Belt and Road Initiative.

However, as of 2021, Azerbaijan has a very narrow list of FTAs in place, with only ten countries in total. The lack of regional and international integration and the lack of commitment to become part of the WTO might be the main challenge for Azerbaijan. Some research already suggests that China's accession to the WTO has had positive effects on the post-accession growth in resource-rich countries as WTO market access agreements made it more appeal in gas an oil-and-gas provider (Andersen *et al.* 2013). Joining the WTO and thus benefiting from the MFNrate could help Azerbaijan's trade relations with China.

## 2. Methodology

The trade creation effect of a tariff reduction on Azerbaijani exports to China will be assessed using a Partial Equilibrium Model. The calculations done in this research follow the example of the World Integrated Trade Solutions (WITS) SMART Model (Jammes and Olarreaga 2005) and are based on the Armington assumption that assumes all imports to be imperfect substitutes of each other no matter the country of import. As a result, the import demand elasticity is fixed at 1.51 as per the SMART Model default substitution elasticity.

The formula for the total trade creation is as follows:

$$TC_k = \sum_{i=1}^n TC_k^i = \sum_{i=1}^n \varepsilon_k M_k^i P_k^i \frac{\Delta t_k^i}{1 + t_k^i} \quad (1)$$

where:  $TC_k$  is the total trade created for a good (k),  $\Delta t$  is the change in tariff rate for good (k) imported from Azerbaijan,  $\varepsilon_k$  is the import demand elasticity of good (k), and  $M$  is the trade value of the good (k).

For this study, the WITS tariff database is not applicable as the data does not account for China not applying the MFN rate to non-WTO-members. The tariff data was scraped from the E-To-China website approved by the General Administration of Customs of the People's Republic of China. The trade data is available at the Harmonized System (HS) 12-digit level. However, the average tariff rates were calculated only at the 2- and 4-digit level. Finally, the 2020 bilateral trade data used in the calculations was collected from the United Nations COMTRADE database.

It must be noted that the Partial Equilibrium model uses the current trade value in its' formula. For most categories of goods, there is no trade creation effect as Azerbaijan only exported 37 out of the 99 2-digit level product categories in 2020. For the goods that do not have a trade value for 2020, the model returns 0.

Another limitation of this methodology is the lack of coverage of other factors that can affect trade. Partial equilibrium analysis is only the first step in the assessment of tariff liberalization's impact on trade. The main

advantage of such an analysis is its simplicity in responding to trade policy changes making it a valuable tool in 'first-order' responses for trade policymakers (Laborde and Tokgoz 2013).

### 3. Findings

#### 3.1. Trade Creation Effect

Table 1 shows the 2-digit level goods categories with the highest trade creation effect in US dollars. As expected, the product categories that would benefit most from the tariff cut engendered by a WTO accession are mineral fuels, plastics, and organic or inorganic chemicals. However, other categories appear at the top of this ranking: animal products (4<sup>th</sup>), gums and resins (6<sup>th</sup>), beverages (9<sup>th</sup>), as well as preparations of vegetables and fruits (11<sup>th</sup>).

Table 1. Top 15 HS-2 level products with highest trade creation effect (\$)

Rank	HS-2	Category	GTR rate	MFN rate	Trade effect
1	27	Mineral fuels, mineral oils	24%	6%	\$ 332,447,652.88
2	39	Plastics	45%	7%	\$ 28,501,468.60
3	28	Inorganic chemicals	30%	5%	\$ 866,887.93
4	05	Animal originated products	50%	11%	\$ 811,529.24
5	29	Organic chemicals	29%	5%	\$ 656,941.63
6	13	Lac; gums, resins and other	61%	10%	\$ 433,277.75
7	38	Chemical products	32%	7%	\$ 356,612.98
8	90	Optical, photographic, medical or surgical instruments	55%	7%	\$ 296,696.40
9	22	Beverages, spirits and vinegar	136%	15%	\$ 263,401.68
10	84	Nuclear reactors, machinery	28%	7%	\$ 180,332.81
11	20	Preparations of vegetables, fruit	80%	6%	\$ 109,605.74
12	40	Rubber and articles thereof	36%	11%	\$ 81,936.54
13	18	Cocoa and cocoa preparations	46%	12%	\$ 76,490.62
14	85	Electrical machinery and equipment	36%	6%	\$ 54,262.09
15	12	Oil seeds and oleaginous fruits	42%	8%	\$ 40,339.50

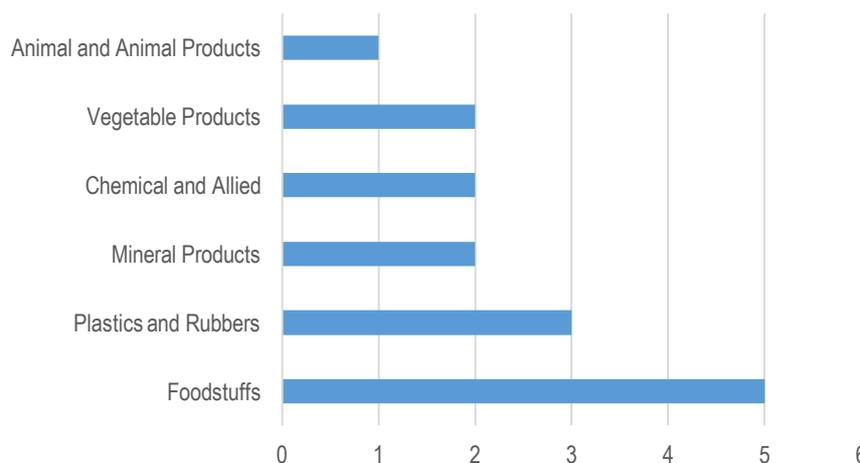
The mineral fuels and oil category stands to benefit the most with over 92% of the generated 335 million USD trade. Plastic follows with almost 7%. The rest of the 37 categories that increased trade after the simulated tariff liberalization represent only 1.12%. At the 4-digit level, the analysis reveals a similar image where the natural resource-related products stand to create the most trade. Table 2 shows the top 15 goods by highest trade effect in US dollars.

Table 2. Top 15 HS-4 level products with highest trade creation effect (\$)

Rank	HS-4	Category	GTR rate	MFN rate	Trade effect
1	3901	Polymers of ethylene	45%	7%	\$ 23,073,858.07
2	2713	Petroleum coke, bitumen	45%	7%	\$ 1,253,188.49
3	3902	Polymers of propylene	19%	4%	\$ 1,161,648.38
4	2801	Fluorine, chlorine, bromine and iodine	43%	5%	\$ 677,409.25
5	0504	Guts, bladders and stomachs of animals	89%	19%	\$ 549,101.90
6	2710	Petroleum oils and oils from bituminous minerals, not crude	19%	7%	\$ 417,153.35
7	1302	Vegetable saps and extracts; pectic substances, agar-agar	70%	9%	\$ 325,575.21
8	2204	Wine of fresh grapes	162%	20%	\$ 88,188.54
9	2009	Fruit juices and vegetable juices	90%	24%	\$ 86,075.34
10	2206	Fermented beverages	180%	40%	\$ 65,256.06
11	1806	Chocolate	50%	9%	\$ 61,771.59
12	1211	Plants and parts of plants of a kind used primarily in perfumery	33%	9%	\$ 38,899.41
13	2207	Ethyl alcohol of an alcoholic strength by volume of 80% vol.	87%	33%	\$ 33,912.42
14	4011	New pneumatic tires, of rubber	51%	18%	\$ 26,741.85
15	3506	Prepared glues	90%	9%	\$ 17,962.33

While the top 4 goods are mineral fuels and oil, plastics, and inorganic chemicals, the rest of the list shows more variety. The 5<sup>th</sup> product could generate over 549,000 USD in trade, 1302 almost 408,000 USD. Prepared food products also show potential: wines of fresh grapes, fruit and vegetable juices, and fermented beverages could generate over 100,000 USD in trade.

Figure 2. Number of HS-4 products with highest trade effect per industry



From Figure 2, the foodstuffs industry appears most in the top 15 products at the 4-digit level. Together with vegetable and animal products, these industries represent most of the highest-ranking products by trade effect.

Figure 3. Change in Azerbaijani exports to China (USD)

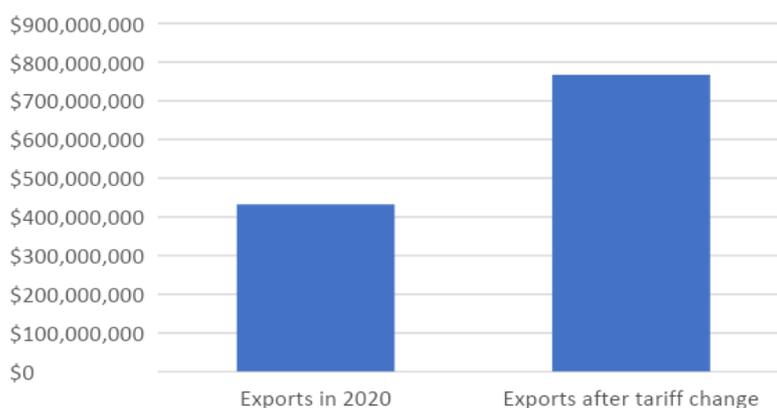
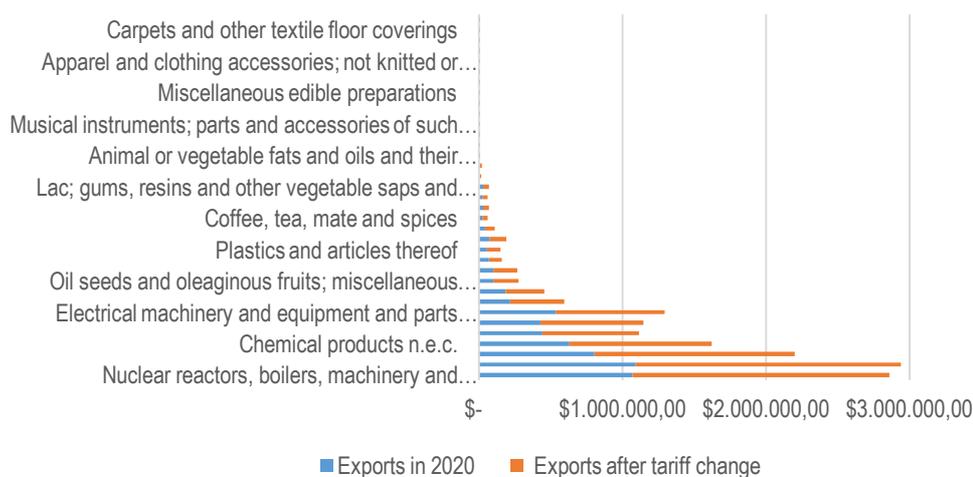


Figure 4. Change in Azerbaijani exports to China, non-oil-and gas, nor minerals (USD)



The analysis done in this paper indicates that if Azerbaijan were to become a full member of the WTO and benefit from applying the MFN rate, the overall export value to China could increase by almost 80% (see Figure 3). Figure 4 above shows the same change in export value for 2-digit level product categories other than oil and minerals.

### 3.2. Higher Margins and/or Competitiveness for Azerbaijani Exports to China

On top of the trade creation effect, Azerbaijani exports stand to gain margin or competitiveness. If the MFN rates were applied on the exports in 2020, China would have lost a total of \$87,154,180 in tariff revenue. At the same time, Azerbaijani exporters would have paid \$26 million in tariffs instead of the \$113 million paid.

All 37 of the currently exported HS2 level categories stand to gain from the tariff cut. Table 3 below shows which HS2 categories with exports of over \$10,000 in 2020 benefit most from the decrease in tariff barriers.

Table 3. Top 15 HS-2 level products with highest tariff barrier change (%)

Rank	HS-2	Category	Tariff barrier change (%)
1	63	Textiles, made-up articles	-94%
2	62	Apparel and clothing accessories; not knitted or	-94%
3	20	Preparations of vegetables, fruit, nuts	-93%
4	22	Beverages, spirits and vinegar	-89%
5	21	Miscellaneous edible preparations	-88%
6	90	Optical, photographic, medical or surgical	-87%
7	39	Plastics	-84%
8	13	Lac; gums, and other	-84%
9	28	Inorganic chemicals; organic and inorganic	-83%
10	85	Electrical machinery and equipment	-83%
11	35	Albuminoidal substances; modified starches; glues	-83%
12	29	Organic chemicals	-83%
13	15	Animal or vegetable fats and oils	-82%
14	12	Oil seeds and oleaginous fruits	-81%
15	9	Coffee, tea, maté and spices	-79%

## 4. Discussion

The goal of this study was to provide arguments for Azerbaijan's WTO accession. While the literature seems to argue that non-emerging, non-diversified resource-rich countries stand to gain more from regional than international integration via accession to the WTO, no study has focused on the case of Azerbaijan specifically.

Considering the already significant investments in BRI-related projects, Azerbaijan should reconsider its current positioning on the WTO. Accession could grant the country a better situation than that of a simple transit point for re-exports from Eastern to Western markets and vice versa.

Currently, Azerbaijani exports are not competitive enough on the Chinese market. One of the reasons being the higher tariff rate applied on these exports. Furthermore, almost all Azerbaijan's Western and Central Asian partners in the Middle Corridor are part of the WTO and benefit from the MFN rates on their exports to China. These two facts make Azerbaijani exports even less appealing to the Chinese market.

The partial equilibrium analysis carried out in this paper suggests that a WTO accession could greatly help with the competitiveness of Azerbaijani exports to China. Mineral fuels (HS 27) will become more competitive in the Chinese market thanks to the 75% decrease in the tariffs paid on exports. Considering China's complicated relationship with South-East Asia, Azerbaijan can use trade diversion in Chinese import demand and act as a new source of energy imports.

In other sectors, the Azerbaijani exporting companies can also use the tariff cut to increase their margin by keeping the same selling price by paying fewer tariffs or decreasing their selling price to become more price-competitive for their Chinese customers. The gains in quality competitiveness from the adherence to international standards will also, in the long-term, facilitate Azerbaijani exports to the countries in the immediate region.

As follows from the WTO logic, the increase in competitiveness drives GDP growth (Mobariz 2015). The demand for Azerbaijani products in China increases while the production responds with an increase in the supply of said products. Policymakers should support production to keep the terms favorable for increased international trade.

Furthermore, trade liberalization has been proven to affect economic diversification and higher levels of export complexity. As discussed before, Azerbaijan's economy is heavily reliant on the energy and agricultural sectors. Tariff liberalization can positively affect the country's export basket by incentivizing the export of new products.

Finally, the access to the WTO's Trade Dispute Settlement mechanism will counteract fears of unfair trade practices. The settlement system could give opportunities to protect Azerbaijani exporters from non-economically motivated tariff barriers. Currently, the only way to resolve trade disputes is diplomacy. Such cases have been

common with Russia where the Federal Service for Veterinary and Phytosanitary Supervision (Rosselkhoznadzor) decided to block certain vegetable imports from Azerbaijan. If Azerbaijan was a WTO member, the country could have used the settlement mechanism to protect its agricultural sector against unfairly motivated trade barriers.

However, the effectiveness of this settlement system is also under debate (Reich 2017). Capacity-building is required to ensure that the country's companies can defend their interests at the international level when needed. The inability to identify and assess both tariff and non-tariff barriers (e.g., import quantity limits, higher quality standards) can lead to miscommunication with WTO lawyers (Nottage 2009).

## Conclusion

This paper assesses the impact of tariff cuts on Azerbaijani exports to China with Azerbaijan's accession to the WTO. The study suggests that the application of the MFN rate to Azerbaijani exports can double trade with China. More importantly, this paper aims to reassert the importance of diversified trade and international integration in the economic development of Azerbaijan. If this Southern Caucasus country wants to act as not only a transit point for re-exports to Europe and a mere net importer but also increase its exports, WTO accession could help achieving this goal.

Applying this methodology to all WTO-member countries to assess the impact on a global level is not required as most countries apply the MFN rate even to non-members. Further research should focus on assessing other factors that can impact Azerbaijan's economic development if this country were to join the WTO, such as the adherence to international safety and quality requirements.

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