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A report was commissioned by the EU to determine whether an FTA between the EU and Georgia would be both economically viable and feasible. The CASE/GI team identified and analyzed various degrees of trade integration between Georgia and the EU to determine, which if any, would benefit the country. Though written in the spring of 2008, before the eruption of the military conflict in South Ossetia, hence reflecting the situation up to early 2008, the report refers to long-term solutions and outcomes and its main message remains valid.

For the full report on the Economic Feasibility, General Economic Impact and Implications of a Free Trade Agreement Between The European Union and Georgia, see CASE Network Report series No. 79

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

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At least up to mid-2008, Georgia had been enjoying rapid GDP growth, notwithstanding the very serious economic sanctions imposed on it by Russia since 2006. This growth is expected to continue, but will depend on increased inflows of FDI and adherence to liberal trade policies. Internationally, Georgia has been a member of the WTO since 2000 and has also signed free trade agreements (FTAs) with the CIS countries and most recently with Turkey. Regarding trade with the European Union, Georgia has fully liberalized trade for non-agricultural products and significantly liberalized trade for agricultural goods due to its 2006 tariff reductions. Georgia has qualified for the enhanced preferences for sustainable development and good governance (GSP+) offering it very advantageous access to the EU market.

The CASE/GI report identified and analyzed various degrees of trade integration between Georgia and the EU to determine, which if any, would benefit the country. The first two scenarios, Simple FTA and Simple FTA BIS, are variants of a simple free trade agreement (FTA), which assume the elimination of tariffs and quantitative restrictions in bilateral trade. The next three are Deep FTA scenarios (FTA+, Deep FTA, and Deep FTA+), which combine the principles of a Simple FTA with varying degrees of change in the domestic policy and business environment affecting trade and investment. The FTA+ combines a Simple FTA with a consolidation of domestic reforms such as unilateral recognition of EU and international product standards and facilitation of customs procedures. Next, the Deep FTA involves a more complete elimination of barriers to trade and investment throughout various sectors of the economy. Finally, the Deep FTA+ includes a comprehensive set of reforms along with flanking measures *e.g.* on competition and corruption that could lead to a rebranding of Georgia as a favourable investment location.

The report finds that although Georgia has made considerable strides in its current trade policies and domestic reforms, any major future welfare gains are likely to come from a continuing process of deepening regulatory and institutional approximation with the EU.

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

Over the last decade, Georgia has advanced significantly in terms of its integration with the world economy. Currently, the country has some of the region's most liberal trade policies, having made hefty unilateral tariff cuts in 2006 (90% of tariff lines are already bound at 0% MFN rates with the WTO). Georgia has achieved substantial liberalization of all four freedoms (goods, services, capital and labour). It has also largely eradicated petty corruption. Georgia has also attempted to become a regional trade and business leader, by making substantial investments in oil and gas pipelines, new regional railway connections, and the construction of a new airport and various "international" caliber hotels in and around Tbilisi.

Georgia becomes more open. Trade flows in percent of GDP, 2001-2006

	2001	2003	2006	% CHANGE 2001-2006
Exports of goods and services as % of GDP	24.5	31.8	32.9	+34.3
Imports of goods and services as % of GDP	38.9	46.4	56.9	+46.3
Total Trade as % of GDP	63.3	78.3	89.8	+41.9

Source: ADB, 2007.

Before analyzing the economic benefits of any future EU-Georgia FTAs (Simple or Deep), the CASE/GI team decided to study the effects of previous trade liberalization measures in order to provide a comparable baseline scenario. The team used a comparative static computable general equilibrium (CGE) model to consider the implications of trade liberalization in Georgia between 2004 and 2006 as well as deeper EU-Georgia integration. The CGE model incorporates three types of non-tariff barriers, including costs of complying with foreign technical requirements, costs related to customs and border delays, and barriers to foreign provision of services on the domestic market. The CGE model's results indicated that Georgia's 2006 trade liberalization and customs reforms would lead to annual welfare gains of about 1% of GDP. However, these gains will take several years to fully materialize.

What became more apparent from the CGE analysis was that Georgia would derive very limited welfare gains from a Simple FTA because of existing low tariff levels. Indeed, Georgia's principal imports from the EU, *viz.*, vehicles, machinery and electrical equipment, pharmaceuticals, instruments and chemicals, are already exempted from tariffs. The same is true on the export side, where low levels of pre-FTA tariffs would bring relatively small economic gains.

Much higher welfare implications would ensue from the removal of existing non-tariff barriers, including regulatory, institutional, and infrastructure impediments, along with the alignment of national standards to those of the EU compared to the gains brought about by a Simple FTA. The effective implementation of the above would bring forth closer relations between Georgian and EU firms leading to technology transfer, the creation of effective supply chains, the improvement of the business environment which would result in the reduction of Georgia's investment risk premium, as well as the development of new industrial structures. This improved level of regulatory and institutional approximation with the EU is considered achievable, but only through deeper integration via a Deep FTA+ scenario.

Deep Integration: Achieving Regulatory and Institutional Approximation with the EU

Although deeper trade integration is far from complete, Georgia has made some progress with regards to regulatory and institutional harmonization with the EU in a relatively short period of time. In many areas, Georgian legislation is already rather close to that of the EU. The most important issues that arise now are in the implementation of the adopted legislation. Georgia still lags behind in implementing its obligations under the ENP (European Neighbourhood Policy) Action Plan, especially in the areas of competition policy, Intellectual Property Rights (IPR), product standards, and food safety. However, by implementing deeper forms of trade integration, flanking measures will probably go along the path outlined in the PCA (Partnership and Co-Operation Agreement) and ENP Action Plan, so the implementation of Georgia's commitments taken under the PCA and ENP AP could serve as a guide to improve the Government's capability to implement a more challenging agreement.

As recent experience shows, Georgia has been progressing in harmonizing its legislation with the EU. However, implementation of statutory laws and obligations remains a problem in many areas. Laws on the books and obligations under the PCA and ENP Action Plan did not stop Georgia from effectively scrapping the enforcement of SPS (Sanitary and Phytosanitary) measures and product standards for domestic producers until the time the markets demonstrated the need for such institutions and export capacity to develop. Therefore, implementation of the flanking measures via deeper integration would be seriously influenced by the stance of the Georgian Government regarding the desirable degree of approximation to the EU *acquis* as well as the ability to implement in practice adopted laws and regulations.

The Georgian Government has greatly liberalized the economy and has undertaken a largely successful anti-corruption effort. At the same time, doubts within the Government remain about the appropriate degree of regulatory harmonization with the EU. Heavy regulations are seen as excessive and burdensome to the economy's development, while the country's institutional structures are deemed fragile and immature. Therefore, a Deep FTA would require finding a balance between the views of the Georgian Government and those of the EU on the feasible degree of harmonization. The position of the EU is that implementation of the ENP AP, particularly on regulatory areas, will prepare the ground for the conclusion of a new generation of deep and comprehensive free trade agreements with all ENP partners. At the same time, despite it being an agricultural country, Georgia is unable to export other food and agricultural products, because Georgian producers cannot meet the SPS and standards requirements of EU countries. The only exception is the export of wine and hazelnuts, which are produced under special arrangement for SPS conformity specification. As a result, the average Georgian company does not export to the EU, partly because it cannot offer an attractive product meeting quality and safety standards in the European market. A Deep FTA could change this by allowing for more FDI, greater cooperation between the EU and Georgian firms and better access to the EU market.

In addition to the agricultural sector the CASE/GI report analyzed selected services sectors in Georgia where increased convergence of legal and institutional oversight may improve the promotion and investment flows to these sectors. Services made up 66% of Georgia's GDP in 2006, considered a high figure for a transition economy. Although many of Georgia's services are labour intensive and low-tech, many are being positioned to become future growth industries by seeking to exploit the country's natural and geographical advantages as well as bringing to bear key technologies to the economy. Among key services that Georgia is looking to develop are tourism, information and communications technology, financial services, and energy related services.

What Are the Long-Run Effects of Deep Integration?

When considering the long-run effects of deep trade integration, the CASE/GI team analyzed the merits of three separate scenarios. The FTA+ scenario combined a Simple FTA with a consolidation of recent domestic reforms that take into account unilateral recognition of EU and international product standards as well as the facilitation of customs procedures. These reforms are assumed to positively influence Georgia's image as a safe place to invest by decreasing its risk premium. An FTA+ would lead to economic welfare equivalent to 3.35% of GDP.

The Deep FTA scenario provided a more complete and comprehensive definition of barriers to trade and investment. One of the main differentiators of this scenario is that it looked at the effects of removing NTBs such as border and standard costs and barriers to foreign provision of services. Estimates of the magnitude of those barriers in Georgia were based on a survey of NTBs in Georgia, Ukraine and Russia. Although not perfect, they proved a useful tool to gain insight into the degree and direction of changes in trade, prices, and output by sectors. The impact of a Deep FTA (defined as only the removal of NTBs) would level up economic welfare to 2.74% of GDP.

Welfare, and factor returns results of the CGE simulations

	2006	Simple FTA	Simple FTA BIS	FTA+	Deep FTA	DEEP FTA+
	(1)	(2)	(3)	(4)	(5)	(6)
Welfare (% change)						
Russia	-0.001	-0.001	-0.001	-0.001	-0.001	-0.001
Ukraine	-0.023	-0.024	-0.025	-0.024	-0.026	-0.024
Armenia	-0.019	-0.021	-0.023	-0.017	-0.006	0.002
Azerbaijan	-0.111	-0.112	-0.113	-0.107	-0.109	-0.097
Georgia	**0.973**	**1.085**	**1.007**	**3.352**	**2.736**	**7.509**
Turkey	0.027	0.028	0.027	0.029	0.032	0.036
EU27	0.007	0.007	0.008	0.008	0.006	0.007
CIS	-0.003	-0.003	-0.003	-0.003	-0.002	-0.001
ROW	0.006	0.006	0.006	0.006	0.005	0.006

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

Finally, the Deep FTA+ scenario would generate the highest gains for the Georgian economy as it complimented the elimination of non-tariff barriers with several flanking measures related to competition policy and a larger reduction of the risk premium associated with strengthening Georgia's investment climate, reputation, and country branding. This simulation assumed a 5% decrease in the price of capital resulting in economic welfare gains of 7.51% of GDP, a net effect of 6.54% over the 2006 liberalization scenario.

The services, agro-food, and energy sectors were identified as those that would draw the most advantages from a Deep FTA+. In the services sector, initiating a Deep FTA+ would have a substantial impact on the expansion of the business services and tourism industries since it would complement the implementation of several key measures including strengthening the rule of law, improving the business climate, combating corruption, and reinforcing competition policy. For the agro-food sector, whose biggest trade constraints point to standards and regulations, a Deep FTA+ would increase the incentives to adopt EU product and quality standards. Regarding the energy sector, a Deep FTA+ could help Georgia exploit its geographical position as an energy transportation corridor, by positioning itself as a provider of diverse energy supplies and security to Europe.

Which of these scenarios will materialize, or over what time horizon, cannot be forecasted. It all depends on the actual content of the agreement signed as well as the ability of the Georgian Government to take the necessary policy measures that underlie the scenario computations.

POLICY RECOMMENDATIONS

The CASE/GI team concluded that a FTA between Georgia and the EU is feasible, since Georgia has already taken liberalizing measures going considerably beyond a classic Simple FTA. Based on the analysis of a range of deep integration scenarios, the greatest benefit to both Georgia and the EU would accrue with a Deep FTA+. A Deep FTA+ would involve a significant approximation of law along the priorities of the ENP Action Plan for Georgia, in addition to supplementary flanking measures on competition, rule of law, governance and corruption and their effective implementation, which would mean re-branding Georgia as a safe and attractive investment location. At the same time, given the current progress of the implementation of the ENP Action Plan, serious questions remain as to both the willingness and the institutional capacity of Georgia to undertake further commitments in the regulatory area. From a human resources perspective, Georgia's governmental bodies are uneven in terms of the education, qualifications, and international experience of their European counterparts; however, this situation could be eased with future technical assistance and training.

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