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Connectivity, Trade and Financial Integration of the South Caucasus Via the Belt and Road Initiative (BRI)

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Abstract

The lack of connectivity is one of the impediments to progress for Armenia, Azerbaijan and Georgia—the countries of the South Caucasus (SC) region. Due to open conflicts and political tensions, cooperation between the three has been extremely difficult. However, there are examples of positive bilateral cooperation, mostly in infrastructure-related projects, as all three countries are trying to attract more foreign direct investment (FDI) and cargo, to enhance trade relations and to diversify their trading partners. Thus, it is no surprise that countries in the SC have expressed interest in participating in China's Belt and Road Initiative. The initiative may lead to improved cross-country coordination, and the countries in the SC may eventually be able to harmonize their trade policies under one umbrella. Achieving both of these goals involves the development of soft infrastructure tools and building and improving a hard infrastructure. Soft infrastructure tools, such as well-established legal and regulatory frameworks, as well as a good hard infrastructure are much needed in the SC.

The BRI in the South Caucasus: Regional Conditions

Announced in 2013, China's Belt and Road Initiative (BRI) was aimed at promoting bilateral relations between China and neighbouring countries. However, the initiative has gradually grown into a global project having an impact on an estimated more than 4 billion people in over 65 countries across Asia, Europe and Africa. Currently, the initiative is open to all interested parties and entails multi-layered collaboration between governments, businesses, and civil society (Minghao, 2016). Thus, Georgia, Armenia and Azerbaijan, the three countries in the South Caucasus (SC) that are situated at the crossroads between Europe and Asia, ultimately became a focus of the BRI (Ismalov and Papava, 2018).

Despite their geographical proximity and shared history, differences in development trajectories in all three countries in the SC are evident: Azerbaijan has the largest economy due mainly to its oil and gas reserves and population size—the country's economy is bigger than the economies of Armenia and Georgia combined. Azerbaijan is engaged in military conflict with neighbouring Armenia; however, Azerbaijan tries to have close ties with Turkey and to have good relations with Russia. Armenia, being largely dependent on Russia, joined the Russian-led Eurasian Economic Union (EAEU) in 2015 (Ministry of Foreign Affairs of the Republic of Armenia,

2015) and had to refuse to sign an Association Agreement with the EU. However in 2017 Armenia signed a Comprehensive and Enhanced Partnership Agreement (CEPA) with the EU, providing a framework for both to work together (European Union, 2019). Armenia has a new government, which came to power following mass demonstrations in 2018. As Shirinyan (Shirinyan, 2019) argues, Armenians in general are increasingly worried about being overly dependent on Russia, and they are looking to diversify their alliances and trading partners by strengthening relationships with two of Armenia's direct neighbours (Georgia and Iran) and one of the country's major trading partner (China). Georgia, which ranks best among the three SC countries in the Ease of Doing Business Index, the Index of Economic Freedom, and the Corruption Perceptions index, is seeking Euro-Atlantic integration to have closer ties with NATO and other western partners. Georgia plays a pivotal role in regional connectivity and coordination due to its advanced relationships with Azerbaijan, Turkey and Armenia (German, 2016).

As the SC suffers from conflicts and territorial disputes, cooperation between the three countries in the SC has been extremely difficult¹. However, there are examples of positive cooperation, mostly in infrastructure-related projects between Georgia and Armenia and between Georgia and Azerbaijan; these projects were launched long before the BRI. As a result, some

¹ Conflict between Armenia and Azerbaijan over Nagorny-Karabakh rules out cooperation opportunities between the countries. As a result, Armenia seeks close ties with Russia and hosts a Russian military base, thus creating mistrust between Armenia and Georgia, as Russia occupies two of Georgia's regions.

basic infrastructure connectivity (railways, pipelines, highways) is already in place. As connectivity and trade facilitation are at the core of the BRI, it is no surprise that all three countries in the SC have expressed their interest in participating in the initiative². It has been suggested by Chinese officials (National Development and Reform Commission, 2015) that the BRI and BRI-related projects may create an environment to diversify economic activities; attract more investment; improve cross-country coordination; and even eventually harmonize China's and the SC's trade policies under one umbrella. Creating such an environment would involve developing soft infrastructure tools as well as building and improving a hard infrastructure base.

Connectivity

The lack of connectivity has been named as one of the bottlenecks for the SC region. According to the World Bank's multidimensional connectivity index, which measures connectivity through trade, investment, migration, communications, and transport, Western Europe has the best connectivity, while the SC has the worst. Nonetheless, an analysis of the data for 2000–2014 shows that the SC's connectivity has increased by nearly 75 percent (Gould et al., 2018). This improvement cannot be attributed to a single project or a single investor; rather, this improvement stems from a series of interventions and development partners, including the EU-led Transport Corridor Europe–Caucasus–Asia (TRACECA); the Asian Development Bank-led Central Asia Regional Economic Cooperation (CAREC) Programme; and, most recently, the China-led Belt and Road Initiative (BRI).

Though it is somewhat difficult to accurately list all possible routes through “Belt” and “Road”, the land connectivity (“Belt”) between China and Europe has been discussed in the context of six trade corridors,³ some of which are already functioning or still under construction. The SC countries can be seen as a part of those corridors, which enable the transportation of goods from East Asia to Western Europe, thereby leading to larger trade and cargo flows through the region. The East–West direction,

especially through the Baku–Tbilisi–Kars (BTK) railway, is more relevant to Georgia and Azerbaijan. Other East–West projects more relevant to Georgia and Azerbaijan are ongoing regional projects, such as the Trans-Caspian International Transport Route (TITR) and the Lapis-Lazuli transport corridor. For Armenia, due to its tense relationship with two neighbouring countries (Azerbaijan and Turkey), it has open borders only with Georgia to the north and Iran to the south. Taking this into consideration, limited options are available to Armenia under the BRI. One such option may be the ongoing north–south corridor development, which connects the Indian Ocean and the Persian Gulf to the Black Sea through Iran, Armenia and Georgia. Other projects relevant to the BRI (part of north–south connection) is the Meghri–Yerevan–Bavra highway, which links Armenia's southern border with Iran to its northern border with Georgia⁴. Chinese interest in this project can be linked to the current involvement of Sinohydro. The Chinese state-owned construction firm has assumed responsibility for completing a stretch of road connecting Gyumri, Armenia's second-largest city, to the Georgian border, thus helping to accelerate the much-delayed project (EC, 2019). In Armenia, road transport is the most common mode of transport, including transit to ports in Georgia for trade relations with the EU and other countries. Therefore, the Meghri–Yerevan–Bavra highway is much needed as an impetus for improving transport connections and for boosting trade. While Armenia seeks to improve land connectivity, Georgia, apart from highway and railway projects, also aims to boost trade with the EU by constructing a deep-sea (16-meters deep) port in Anaklia; this port is expected to handle vessel types, such as Panamax, Handymax, and Aframax, with capacities of up to 10,000 TEUs (Khishtovani et al., 2019).

However, there are also some major challenges for the countries in the SC in their effort to attract more cargo. Studies show that nearly all (99%) of the cargo transported from the Asia-Pacific to Europe are transported via sea routes. Only an insignificant amount of cargo is transported via railway (Davydenko et al., 2012). The most frequently used train routes are those running

2 For example, to express its strong interest, Georgia started organizing an annual forum on BRI. In the SC context, this forum can serve as a potential meeting place for the countries to develop a common strategy. These types of platforms are essential, as studies (Khishtovani et al., 2019)[include references] found the success of the initiative in the SC heavily depends on the successful cooperation between the countries.

3 The BRI establishes 6 international economic corridors: 1)the New Eurasia Land Bridge Economic Corridor, 2) the China–Mongolia–Russia Economic Corridor, 3) the China–Central Asia–West Asia Economic Corridor, 4) the China–Indochina Peninsula Economic Corridor, 5) the China–Pakistan Economic Corridor, and 6) the Bangladesh–China–India–Myanmar Economic Corridor (HKTDC Research, 2019)

4 The EU's Neighbourhood Investment Facility (NIF), the EIB and the Asian Development Bank are providing loans to support upgrading part of the 556-kilometre North–South Road Corridor running from the border with Georgia at Bavra to the border with Iran at Meghri via the cities of Bavra, Gyumri, Ashtarak, Yerevan, Goris, Kapan and Meghri. In addition, a 145-km stretch of road along the North–South Road Corridor between Yerevan, the capital of Armenia, and Bavra will be rehabilitated.

along Siberia⁵. Although the length of those routes is longer than the length of those that can pass through the SC, the main benefit of the Trans-Siberian routes is that they have the capacity for additional freight services. In addition, unlike the countries in the SC, Russia, Belarus, Kazakhstan and Mongolia have the same technical railway standards (with respect to gauges, safety systems, etc.).

The development of alternative routes, in general, faces a range of challenges because nearly two-thirds of the countries involved in the Belt and Road Initiative have very low credit ratings that fall below an investable level and have high operational risk⁶ (Economist Intelligence Unit, 2015). However, the expansion of alternative routes is very much in agreement with China's overall strategy, which is mainly aimed at developing China's landlocked western provinces, and these provinces lag behind the eastern ones close to the sea. Thus, despite some challenges along the corridor passing through the SC, increased connectivity and coordination may help Armenia, Georgia and Azerbaijan attract more cargo into the region.

Trade

The trade relationship between countries in the SC depends largely on political factors. For instance, Armenia and Azerbaijan have no trade turnover due to the Nagorno-Karabakh conflict. Georgia, however, has close and growing trade relationships with both countries. From 2010 to 2018, the trade turnover between Georgia and Azerbaijan and Georgia and Armenia increased by 48% (to 1.1 billion USD) and by 189% (to 614 million USD), respectively. As a result, Azerbaijan and Armenia rank 3rd and 6th among Georgia's top trade partners, respectively (GEOSTAT, 2019).

Trade turnover between Georgia and China has been increasing since 2002 and reached 1 billion USD in 2018 (compared to a conservative 10 million USD in 2002), thereby making China Georgia's 4th-top trading partner. Another important milestone in Chinese-Georgian trade relations has been the China-Georgia Free Trade Agreement, signed in 2017, which is expected to further promote trade (PMC Research and UIBE, 2015).

Similarly, bilateral trade between China and Azerbaijan and between China and Armenia has been increasing. From 2015 to 2018, the trade turnover between Azerbaijan and China more than doubled (the trade turnover reached 1.3 billion USD) and China became one

of Azerbaijan's top trading partners (China ranked 4th in 2017). The positive trend continued in 2019, with a 2.6% increase in the first five months of 2019 (Azernews, 2019a).

Armenia's trade turnover with China is also increasing. According to official Armenian statistics, Chinese-Armenian trade increased by over 29% in 2018 to \$771 million, with Chinese exports accounting for 86% of the total turnover (MassisPost, 2019).

It is too early to evaluate the impact of the BRI on the trade turnover between China and the countries in the SC. Nonetheless, this increasing trend in trade relations can be linked to the proactive stance from all three governments to further strengthen ties with China. For instance, during his recent visit (May 2019) to Beijing, the prime minister of Armenia, Nikol Pashinyan, confirmed Armenia's interest in the BRI and noted that bilateral cooperation will soon deepen in the areas of trade, industry, transport and culture. In addition, in 2015, the government of Georgia began hosting a biannual BRI-related forum with high-level participants from almost all BRI-related countries (the upcoming forum will take place in October 2019 (Tbilisi Silk Road Forum, 2019)). For Azerbaijan, in 2015, a MoU was signed to support construction of the Silk Road Economic Belt; the agreement mainly focused on securing a series of deals in areas such as trade, education, transportation and energy (Xinhuanet.com, 2015).

FDI

To deepen financial cooperation and to mobilize funds for the BRI, new financial institutions, such as the Asia Infrastructure Investment bank (AIIB), the New Development Bank and the Silk Road Fund, have been set up. A main purpose of launching new financial institutions is to build a stable currency and investment system to enable countries along the BRI to actively participate in the initiative.

Analysing FDI from China to the countries in the SC reveals that China, in general, has become a significant investor in transition economies (including those of SC countries). Starting from 2011, China's FDI stock in these countries increased from US\$8 billion to US\$23 billion in 2016 (UNCTAD, 2018).

According to Azerbaijani officials, as of 2018, FDI from China amounted to approximately 800 million USD (Azernews, 2019a). Until recently, Azerbaijan was not particularly active in attracting foreign direct invest-

5 Three routes constitute the Trans-Siberian route: 1) the Kazakh route, which connects via Kazakhstan to western China, offers the shortest distance from Beijing to Moscow; 2) the Mongolian route, via Mongolia, is favorable for connections with western China; and 3) the Manchurian route, via Zabaykalsk, is favorable for connections with western and Northeast China (source (Davydenko et al., 2012).)

6 Operational risks are calculated based on risks across 10 categories (security, political stability, government effectiveness, legal and regulatory environment, macro-economic risks, foreign trade and payment, tax policy, labour market, financial risk, and infrastructure).

ments, especially from China, but the oil price crisis of 2014 showed the importance of extending diversification beyond the oil sector. As a result, during the second Belt and Road Forum for International Cooperation, which took place in Beijing in April 2019, representatives of Azerbaijan signed ten agreements, according to which Chinese companies will invest an additional 821 million in non-oil industries. For example, the China National Electric Engineering Company (CNEEC) will invest \$300 million in a tire factory. The agreement also includes building a 300 ha greenhouse complex (Baghirov, 2019)⁷. However, when considering investing in BRI-related projects, such as the Baku International Sea Trade Port Complex (with a current capacity of 15 million tons of cargo) (Azernews, 2019b) and the Baku–Tbilisi–Kars railway (mostly financed by Azerbaijan), Azerbaijan is trying to avoid a “debt trap”, and, thus, relies on its own funding⁸.

In Georgia, from 2002–2018, Chinese investments accumulated to 643 million USD. The investments are targeted to agriculture, the banking, telecommunications, infrastructure, hospitality and light industry. The biggest Chinese investor is the Hualing Group, which operates free economic zones (one such zone is near the city of Kutaisi) and is engaged in, amongst other areas, the banking sector and real estate. However, no Chinese foreign direct investment has been attracted for Georgia’s large infrastructure projects (Hualing Group, 2019).

Over the past two decades, only an insignificant amount of Chinese investment went to Armenia. However, China emphasized the importance of its partnership with Armenia by initiating the building of a new embassy in Yerevan; the embassy is projected to be the second largest in the post-Soviet space. In addition, since 2012, China’s aid to Armenia amounted to 50

million USD. In addition, the Chinese government spent approximately 12 million USD for the construction of a new school and offered Chinese language classes to Armenian students (MassisPost, 2019).

Conclusion

It could be argued that enhanced relations between China and the SC are mutually beneficial and are in the interest of both partners. China considers Georgia, Armenia and Azerbaijan as trading partners and has increased its presence in the region by providing FDI and by being involved in the development of regional connectivity. Regarding China’s interests, the trade routes traversing the SC, although being less competitive compared to other routes, can diversify trade activity and reduce dependence on the Trans-Siberian routes, which pass mostly through Russia. Regarding the interests of the SC countries, these countries can use the opportunities that the BRI provides to improve regional connectivity and cooperation. Although there are political tensions and open conflicts in the region, increased opportunities from trade and business activities may lead to bilateral cooperation. Infrastructure projects that were already in place and development agencies operating in the SC may help to further deepen the relationships. Stronger relationships among countries in the SC may lead to the development of common soft infrastructure tools, such as a unified trading system, which, it is believed, will improve the competitiveness of the SC and attract more cargo and, eventually, more FDI to the region. Although the impact of the BRI on the SC is not clearly evident, it can be argued that the BRI is positive for the SC region with respect to improving connectivity, boosting trade relations and diversifying trade partners.

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7 In addition, financial resources allocated by China-led Asian Infrastructure Investment Bank (AIIB) in 2016 for Trans-Anatolian Natural Gas Pipeline Project (TANAP) can also be considered as indirect involvement of China (Huseynov and Rzayev, 2018)

8 There is an information that Beijing was financially involved Port projects but this information is not official and also representatives of the port have denied it (Schmidt, 2019)

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See overleaf for an overview of ongoing infrastructure projects in the South Caucasus

Table 1: Ongoing Infrastructure Projects in the South Caucasus

Project Name / Launch Date	Link to BRI	Status
<i>Port Related Projects</i>		
Anaklia Development Consortium (Georgia) / 2015	A deep-sea port on the east coast of the Black Sea; the port is expected to handle all vessel types to facilitate trade.	Ongoing
Alayt Port Azerbaijan / 2013	There are three international rail routes into Azerbaijan; all these routes converge at Alyat: 1) to the northwest, passing through Baku to Russia; 2) to the west, passing through Georgia to the shores of the Black Sea and Turkey and 3) to the south and to the border with Iran.	Ongoing
<i>Railway-Related Projects</i>		
Baku–Tbilisi–Kars Railway / 2007	Connects Kars in northeast Turkey to the Georgian capital of Tbilisi and Baku, Azerbaijan’s capital city. Experts predict that the BTK railway line will transport a million passengers and 6.5 million tons of cargo in its initial stage. By 2023, this railway line will carry an estimated 17 million tons of cargo and about three million passengers.	Finished
Trans-Caspian International Transport Route (TITR) / 2013	The countries involved (Kazakhstan, Azerbaijan, Georgia, Turkey) predict that TITR, in its initial operations, will be able to transport up to 5.5 million tons of cargo annually; this weight will rise to 13.5 million tons per year by 2020.	Ongoing
<i>Road Related Projects</i>		
Batumi bypass highway (Georgia) / 2017	The objective of the Batumi Bypass Road Project is to improve regional connectivity in Georgia and to improve the efficiency of road transport along the East–West Highway.	Ongoing
Lapis-Lazuli Transport Corridor / 2017	This corridor aims to enhance regional economic cooperation and connectivity between Afghanistan, Turkmenistan, Azerbaijan, Georgia, and Turkey and expand economic and cultural links between Europe and Asia.	Ongoing
Persian Gulf–Black Sea / 2015	A multimodal transport corridor that is envisaged to connect Iran with Europe via Armenia and Georgia. Iran, Armenia, Georgia, Greece, and Bulgaria are key members of the project.	Ongoing
International North–South Transport Corridor	The International North–South Transportation Corridor (INSTC) is an India-driven initiative connecting India with Russia and Europe via Iran.	Ongoing
<i>Oil / Gas Pipeline-Related Projects</i>		
Baku–Tbilisi–Ceyhan (BTC) oil pipeline / 2005	British Petroleum-led project—The pipeline carries oil from the Azeri-Chirag-Deep-water Gunashli (ACG) field and condensate from Shah Deniz across Azerbaijan, Georgia and Turkey.	Operational
Baku–Tbilisi–Erzurum gas pipeline / 2006	The South Caucasus Pipeline (SCP) was built to export Shah Deniz gas from Azerbaijan to Georgia and Turkey.	Operational
Trans-Anatolian Natural Gas Pipeline (TANAP) / 2015	TANAP combined with the South Caucasus Pipeline (SCP) and the Trans-Adriatic Pipeline (TAP) forms the South Natural Gas Corridor. TANAP aims to transport gas from Azerbaijan’s Shah Deniz II field in the Caspian Sea and from other fields in the South Caspian Sea to Turkey and Europe	Ongoing

Source: (BP, 2019; Daly, 2017; Inan and Yayloyan, 2018; Kenderdine, 2018; Shah, 2018; Shahbazov, 2017; Shepard, 2016; TANAP, 2019)