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Veröffentlichungsversion / Published Version

Zeitschriftenartikel / journal article

Empfohlene Zitierung / Suggested Citation:

Kalkschmied, K. (2023). China's Infrastructure Investment in the South Caucasus before and after Russia's Invasion of Ukraine. *Caucasus Analytical Digest*, 132, 7-13. <https://doi.org/10.3929/ethz-b-000613995>

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China's Infrastructure Investment in the South Caucasus before and after Russia's Invasion of Ukraine

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DOI: 10.3929/ethz-b-000613995

Abstract

Russia's invasion of Ukraine has shifted China's interest in the *Trans-Caspian International Transport Route* from being a complementary side corridor to becoming a main corridor for trade with Europe. Thanks to Chinese investment in the last twenty years, a network of rail, road, pipeline, and ship infrastructure exists to transport goods and energy from Asia through the South Caucasus to Europe. Yet, the existing physical and economic infrastructure needs to be enhanced in order to enable the transportation of a much larger volume of goods than initially intended at a faster speed. This requires transnational cooperation among the South Caucasus states that may become infeasible due to resurgent instabilities within the region also resulting from Russia's invasion of Ukraine.

Introduction

Benefitting from strategic integration into world markets, China has risen to become a major economic power and an important trade, investment, and development partner for the South Caucasus states. From 2010–2020, total regional trade with China almost tripled from 1.33 to 3.7 billion USD, China's direct investment stocks increased fivefold from 0.16 to 0.82 billion USD, and 1 billion USD of Chinese official finance was used for development projects in Armenia, Azerbaijan, and Georgia.¹ For China, the South Caucasus states are more than export markets for consumer goods and import markets for oil, gas, and metals that have to be developed: the South Caucasus states are gateways to much larger European markets that offer profitable infrastructure investment opportunities.

A large fraction of China's infrastructure investment in the South Caucasus flows under the umbrella of the Belt and Road Initiative (BRI), established by China in 2013 with the declared goal to enhance connectivity among countries for mutual benefits.² The connectivity approach is multidimensional, but requires the building of physical infrastructure as a basis.³ From 2013–2022, Beijing channeled via the BRI around 962 billion USD into construction contracts and investment worldwide (Nedopil Wang 2023). About 23% of construction projects and 15% of investment were focused on six Central and Western Asian trade corridors that together constitute the *Silk Road Economic Belt*.⁴ The cor-

ridors connect countries within and across the Asian and European continents. The most advanced and heavily trafficked corridor is the *New Eurasian Land Bridge* that takes cargo from China to Europe via two routes: the first route connects China (various cities, Urumqi, Alashankou)–Kazakhstan (Dostyk, Mointy, Nur-Sultan, Petropavl)–Russia (Yekaterinburg, Moscow)–Belarus (Brest)–Poland (Małaszewicze)–Germany (Duisburg). The second route connects China (various cities, Urumqi, Khorgas)–Kazakhstan (Altynkol, Almaty, Shu, Zharyk, Zhezqazghan, Saksaulskaya, Shalkar, Beyneu, Aktau)–Azerbaijan (Baku/Alyat, Ganja, Beyuk Kesik)–Georgia (Gardabani, Tbilisi, Akhalkalaki)–Turkey (Kars, Istanbul).

Until recently, 80–90% of cargo traffic between China and Europe took the first route via Russia that is often called the *Northern Route*. It is well and broadly developed and allows the transport of large volumes of freight between China and Europe via a direct rail service and relatively few border crossings. The second route is also known as the *Trans-Caspian International Transport Route* or the *Middle Corridor*. It was intended as a complementary route that is faster in reaching Turkey and Southeast European countries, but requires ships to cross the Caspian Sea (Devonshire-Ellis 2021). Russia's invasion of Ukraine was a game changer in the China–Europe transportation strategy. Immediately after Russian troops invaded Ukraine, 50% of the transport operations on the Northern Route were suspended by the

1 See statistics in the appendix on the growing importance of China for South Caucasus states' economies.

2 Armenia and Azerbaijan joined the BRI in 2015 and Georgia joined in 2016.

3 'Vision And Actions On Jointly Building Silk Road Economic Belt And 21st-Century Maritime Silk Road', Belt and Road Portal, 30 March 2015, <https://eng.yidaiyilu.gov.cn/qwyw/qwfb/1084.htm> (accessed 8 February 2023).

4 The six trade corridors are (i) the New Eurasian Land Bridge, (ii) the China–Central Asia–West Asia Corridor, (iii) the China–Mongolia–Russia Corridor, (iv) the China–Pakistan Economic Corridor, (v) the China–Myanmar–Bangladesh–India Corridor, and (vi) the China–Indochina Peninsula Corridor.

rail and logistics providers.⁵ As the European Union (EU) put economic sanctions on Russia, the Northern Route became practically inoperable. A redirection of trade through the Trans-Caspian International Transport Route is in the focus of not only China, but also the EU, which seeks substitutes for Russian oil and gas imports. Although ports on both sides of the Caspian Sea and a complex system of railways, roads, and pipelines exist and are operable throughout the South Caucasus, the infrastructure in its current state does not allow the transportation of merchandise and energy in the volume, at the speed, and at the costs as the Northern Route did.

China's Changing Roles and Interests

China and Russia had a clear division of labour in Central and Western Asia over the last twenty years: China provided the finance, material, and labour to carry out large-scale infrastructure projects, while Russia positioned troops to ensure stability and security in the region (Yang 2022). Insufficiencies in infrastructure, stability, and security in Central and Western Asian economies proved important bottlenecks to development not only for the respective countries but also for the trade-reliant regional hegemony. The Sino-Russian strategic partnership to direct regional development was applied in particular in Kazakhstan, which borders both regional hegemony and through which both routes of the New Eurasian Land Bridge pass.

China also had a clear vision of economic cooperation with the South Caucasus states. With infrastructure investment, China aimed at turning Georgia into a hub for distributing Chinese manufacturing products to European markets. Chinese finance was used for enhancing railway inspection and customs inspection equipment, but also for establishing the Hualing International Special Economic Zone in Tbilisi and the Hualing Free Industrial Zone in Kutaisi. Chinese direct investment in Georgia intensified after the EU-Georgia Deep and Comprehensive Free Trade Area entered into force in 2016. The agreement allows Chinese-owned companies in Georgia to engage in free trade with EU member states. New aspirations formed to develop Georgian industries that match Chinese components with Turkish and Caucasian manufactured parts, especially in the automotive sector, and sell the products on European markets (Devonshire-Ellis 2022a). Correspondingly, China established its first free trade agreement with Georgia in 2018.

In Azerbaijan, Chinese efforts focused on energy projects. China funded the enlargement of the natu-

ral gas production in the Shah Deniz gas field and the building of the South Caucasus gas pipeline from the Caspian Sea to the Turkish-Greek border, which were necessary investments to establish the *Southern Gas Corridor*. China also provided official finance to build the Baku-Tbilisi-Ceyhan oil pipelines to Turkey's Mediterranean coast (Kalkschmied 2022). Chinese finance for energy projects came in the form of loans. The loans were offered at standard market rates and were thus highly profitable for the involved Chinese financial institutions.

Chinese official finance flows to Armenia were much more restricted. They came in the form of aid to acquire buses and customs equipment and to build schools and housing for the elderly. The *North-South Road Corridor* that will connect Armenia with Georgia and Iran is financed with loans from Asian Development Bank (ADB), the European Investment Bank, and the Eurasian Development Bank. Yet, the Talin-Lanjik and Lanjik-Gyumri sections of the corridor were implemented by the Chinese hydropower engineering and construction company Sinohydro International. Thus, in all three South Caucasus states, China profited from infrastructure projects by earning interests and by creating demand for Chinese construction materials, industrial output, and labour (Malik et al. 2021: 23–36).

Since Russia's invasion of Ukraine, the traditional division of labour between Russia and China no longer works. This has had severe consequences for security in the South Caucasus, where Russia positioned peacekeeping forces to end the Second Nagorno-Karabakh War between Armenia and Azerbaijan in 2020. As Russia became increasingly embroiled in its invasion of Ukraine and redeployed more experienced peacekeepers to the front lines, Azerbaijan rekindled its efforts to reclaim territory by force in Nagorno-Karabakh (Bushuev 2022). Resurgent conflicts jeopardize the new economic endeavors of China and the EU with the countries of the South Caucasus. Already in the course of the Second Nagorno-Karabakh War, Armenian shells were hitting the Tovuz area of Azerbaijan as well as the Azerbaijani city of Ganje, far from the front line and close to the Baku-Tbilisi-Ceyhan oil pipeline and the gas pipeline of the Southern Gas Corridor. This move was interpreted as an open Armenian provocation against oil and gas trade that was in the national interest of Azerbaijan and Turkey. Prior to this move, Azerbaijan and Turkey had made efforts to exclude Armenia from regional projects (including the Baku-Tbilisi-Kars railway project) and to install a transport blockade to harm the economic development of Armenia (Mammadov 2020). The reawakened territorial fights have created

5 'The Belt and Road in Europe: Between Tragedy in Ukraine and Hope in Serbia', Brixsweden, 20 March 2022, <https://www.brixsweden.org/the-belt-and-road-in-europe-between-tragedy-in-ukraine-and-hope-in-serbia/> (accessed 8 February 2023).

insecurities that hinder cooperation within the region. As a result, new transnational infrastructure investment deals could become infeasible.

While China declared that it will work with the international community to make constructive efforts to de-escalate Armenia-Azerbaijan border tension, the EU has sent three foreign ministers to the South Caucasus to signal its willingness to take on a more active role. Chinese and EU efforts to restore peace not only aim to end the humanitarian crisis that has resulted from Azerbaijan's blockage of the Lachin corridor, which cuts Armenian residents in Nagorno-Karabakh from a regular supply of food and medicines: Chinese and EU efforts to restore peace also aim to secure their own interests to turn the region into a functioning trade corridor. The Trans-Caspian International Transport Route remains the second-best way to connect European with Asian markets. It is less costly and more secure compared to land routes via Iran, a country under heavy US-led sanctions (Devonshire-Ellis 2022b). Additionally, the exclusive reliance on the sea route via the Suez Canal would contradict China's strategy to diversify both trading partners and trading routes in order to decrease dependencies. In the course of resurgent trade-related disputes with the United States, China fears that it may use its military presence in the Mediterranean and Persian Gulf to block the Suez Canal and disrupt China-EU trade.

While Chinese and EU interests lie in maintaining the East-West trade connection, Russia may seek to enhance the North-South trade connection to Iran, the Middle East, and North Africa as the war continues and Russia remains sealed off from Western markets. The East-West and the North-South trade routes cross in the South Caucasus. This gives the South Caucasus states a critical geopolitical and geoeconomic position. A functioning North-South trade route connecting Russia with Iran may be a thorn in the side of Western countries a priori. China, which has intensified trade with Russia since Russia's invasion of Ukraine, will be indifferent to Russia's trading through the South Caucasus as long as this does not disrupt China's ambitions for East-West trade through the region. Yet, such disruptions may arise due to the limited trading infrastructure: competition for access to the infrastructure may become heated.

China-EU Cooperation in Infrastructure Investment

It requires cooperation and coordination of domestic and foreign actors to build functioning economic and energy

corridors through the South Caucasus. Until recently, EU bodies remained highly sceptical and distanced themselves from the BRI. In a 2021 briefing, the European Parliament described the BRI as a 'foreign policy tool of China to expand its economic and political influence across the world that challenges the Western-led rules-based international order' (Grieger 2021: 2). In reaction to the BRI's success, the EU formulated the Europe-Asia Connectivity Strategy in September 2018 and launched the Global Gateway in December 2021 as an alternative. Yet, within the first year of the latter's existence, efforts remained fragmented and slow, and details on Global Gateway projects have not been provided yet (Lau/ Moens 2022). Under the pressure of energy scarcity and trade disruptions resulting from Russia's invasion of Ukraine, the EU has become more friendly towards the BRI and signals more willingness to cooperate with China.

On 14 July 2022, the European Commission signed a deal with Azerbaijan to double natural gas imports by 2027.⁶ Significant EU funding can be expected to expand facilities at Romania's Constanta port and Bulgaria's Burgas and Varna ports at the western end of the Black Sea, as well as ports in Greece, Italy, and Malta at the Mediterranean to prepare EU ports for integration with trading infrastructure in Georgia and Turkey.⁷ Azerbaijani gas will be delivered to the EU via the Southern Gas Corridor. The enlargement of the Shah Deniz gas fields was financed by a consortium of Eastern and Western financial institutions including Bank of China, ADB, European Bank of Reconstruction and Development (EBRD) and European commercial banks.

In the upcoming years, we will likely see more EU-China cooperation in setting up the physical infrastructure that is needed for developing the region's energy and economic corridors. This cooperation may not take place under the roof of the BRI or the Global Gateway initiative, but rather run unlabeled via multilateral financial institutions. One such project has already taken place in 2021, when the Asian Infrastructure Investment Bank and the EBRD approved a syndicated loan for the construction of a high-speed railway line from Istanbul to the Bulgarian border (Devonshire-Ellis 2021). Similar cooperations may lie ahead for investments in Georgia. The ADB has announced the financing of 50 million USD to develop the Baku-Tbilisi-Kars rail route from Azerbaijan via Georgia to Turkey and the Georgian Black Sea ports Batumi and Poti. An involvement of the EU to develop the Baku-Tbilisi-Kars rail route would

6 'EU agrees deal with Azerbaijan to double gas exports by 2027', Euronews, 19 July 2022, <https://www.euronews.com/my-europe/2022/07/18/von-der-leyen-heads-to-azerbaijan-to-secure-new-gas-import-deal#:~:text=The%20European%20Commission%20signed%20a,of%20natural%20gas%20by%202027> (accessed 9 February 2023).

7 'Kazakhstan, Azerbaijan and Georgia To Establish "Eurasian Rail Alliance" Joint Venture', Silk Road Briefing, 10 May 2022, <https://www.silkroadbriefing.com/news/2022/03/10/kazakhstan-azerbaijan-and-georgia-to-establish-eurasian-rail-alliance-joint-venture/> (accessed 23 March 2023).

be a strong sign that, under the new circumstances, the EU chooses to partner rather than compete with China.

Conclusions

China's interests in turning the South Caucasus into a trade hub predated Russia's invasion of Ukraine. With the closing of the Northern Route, new interests emerged. The Trans-Caspian International Transport Route is envisaged to become the new main land corridor for China-EU trade. Thanks to Chinese investment in the last twenty years, there exists an infrastructure network to transport merchandise and energy from Asia through the South Caucasus to Europe. Yet, the infrastructure needs to be enhanced in order to enable the transportation of a much larger volume of goods than initially intended. Given the free trade agreements of Georgia with both China and the EU, the EU's energy deal with Azerbaijan, and new individual and joint infrastructure projects in Georgia and Turkey, we can expect more China-EU coordination and cooperation in infrastructure investment in the South Caucasus in the coming years. Stability within the region is a prerequisite.

Azerbaijan has already profited from the changed geopolitical situation with new energy deals and rapidly increasing cargo traffic at Baku's port. Khudayar Hamsanli, head of strategic planning and development at Baku International Sea Trade Port, announced plans to build new terminals and expand the port to keep up with rising shipping demand.⁸

Georgia's wins from the enhanced interests in the region are less immediate and more insecure. Chances to be integrated into European economic structures are

rising, so are China's direct investment and development projects in Georgia. What remains unclear is how this will affect the Georgian economy. Georgia needs to carefully manage the new investment offers that come with the free trade possibilities to ensure that a maximal proportion of the gains from trade liberalization accrue to domestic firms and workers rather than Chinese and European ones. Some of the previous Chinese direct investment inflows went into projects that proved unproductive for the Georgian economy. Whether Georgia gets its piece of the pie now will depend on who will own and operate the new trade and logistics infrastructure, whether industries that create value-added products and generate jobs and income for locals will develop, and whether local firms and workers will receive technical training and upskill.

For Armenia, which is not directly on the Trans-Caspian International Transport Route, the consequences of new Chinese endeavors are most unsure. China's interests and investment in Armenia have been far more restricted as compared to the other South Caucasus states, among other reasons because China relies on good relations with Azerbaijan and Turkey to make the corridors work. What we can expect for all South Caucasus states, given that sufficient regional security allows the corridors to come into full operation, is enhanced access to European and Chinese markets and reduced economic dependency on Russia. The economic effects will vary among the South Caucasus states for sure. In their fight for limited foreign funds, not all of them can come out on top. Moreover, coming out on top in collecting foreign funds is no guarantee to come out as a winner from trade liberalization.

About the Author

Katja Kalkschmied holds a postdoctoral position at the Chair of International Economics, Ruhr University Bochum, Germany. She earned her Ph.D. in economics at the Institute of Economics, University of Graz, Austria. Her research focus lies in development economics and growth, institutional economics, political economy, and international trade. She is currently investigating the presence of China in developing countries. Work and contact details are available at: katajka@kalkschmied.org

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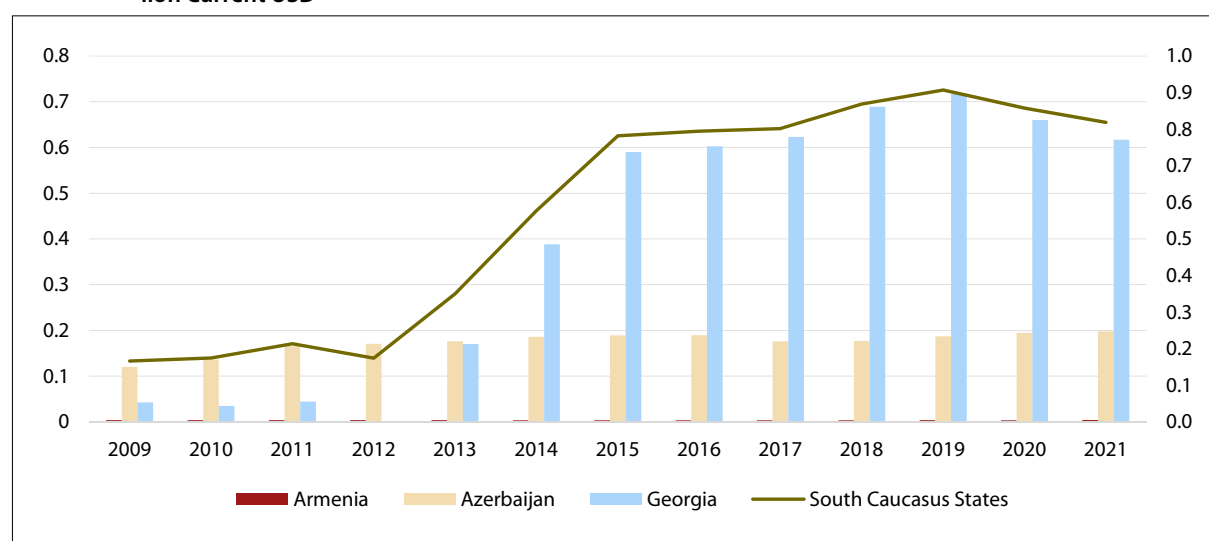
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⁸ 'Baku Int'l Sea Trade Port to expand infrastructure capacities of cargo traffic', Azernews, 4 July 2022, <https://www.azernews.az/business/196326.html> (accessed 23 March 2023).

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Appendix

Figure 1: China's Direct Investment Stocks in Armenia, Azerbaijan, and Georgia over the Period 2009–2021 in Billion Current USD



China's direct investment stocks in Armenia, Azerbaijan, and Georgia over the period 2009–2021 in billion current USD (bars and left axis). Green line indicates development of aggregated stocks for the South Caucasus states in billion current USD as indicated on the right axis.

Source: CDIS dataset of the International Monetary Fund (IMF). Depicted variable: Inward direct investment position.

Table 1a: Top Ten FDI Stock Holders in the South Caucasus States in 2021

Rank	Country	Billion USD
1.	United Kingdom	10.72
2.	Turkey	7.71
3.	Cyprus	4.0
4.	Azerbaijan	3.96
5.	Russia	3.76
6.	Iran	2.96
7.	Norway	2.90
8.	Netherlands	2.80
9.	UAE	1.98
10.	Malaysia	1.83
17.	China	0.82

Source: CDIS (IMF).

Table 1b: Top Ten FDI Stock Holders in the South Caucasus States in 2009

Rank	Country	Billion USD
1.	Russia	2.58
2.	Turkey	2.10
3.	United Kingdom	1.71
4.	Norway	1.65
5.	United States	1.44
6.	France	0.83
7.	UAE	0.81
8.	Iran	0.75
9.	Netherlands	0.74
10.	Italy	0.71
22.	China	0.16

Source: CDIS (IMF).

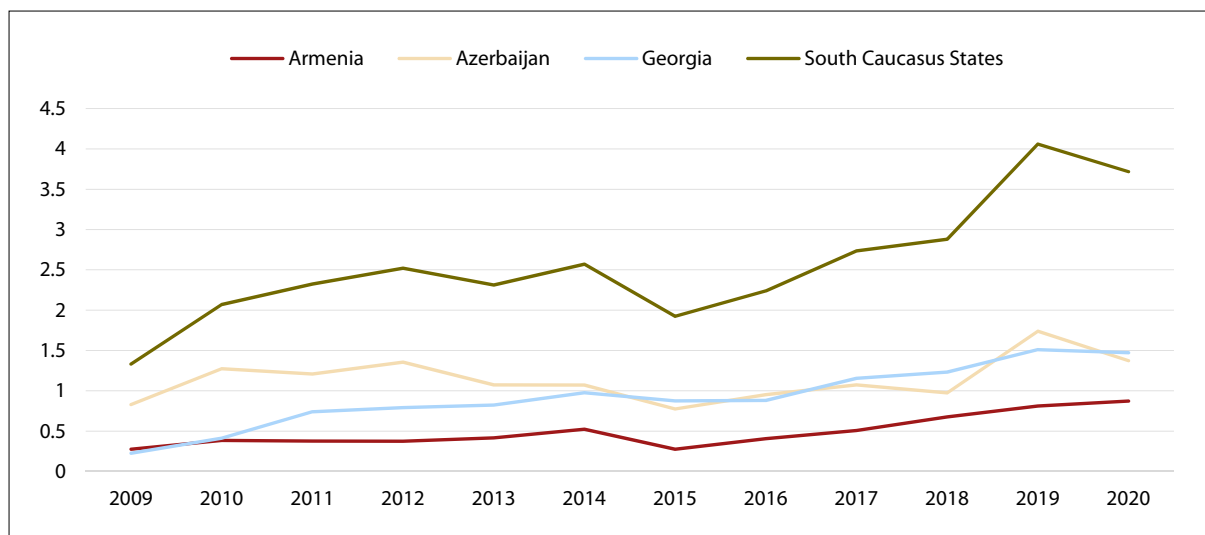
Table 2: Beijing's Official Finance Provided for Development Projects in the South Caucasus States in Million 2017 Constant USD in 2000–2017

	Armenia	Azerbaijan	Georgia	South Caucasus States
Total official development finance	\$90.4	\$580.8	\$423.5	\$1094.6
Development finance per capita	\$31	\$60	\$42	\$48
Number of projects	29	18	36	83
Debt-to-aid ratio	0	18.6	3.4	4.1
Social infrastructure projects	48.6%	2.7%	5.9%	8.2%
Economic infrastructure projects	35.5%	0.4%	85.5%	36.7%
Production projects	6.3%	96.9%	7.6%	55.1%

Note: Development finance per capita divides total development finance with the World Bank reported population size of the country in millions for the year 2017. Social infrastructure projects, economic infrastructure projects, and production projects give the shares of the sum of project values for each sector from total official development finance. Social infrastructure projects contains projects in the sectors education, government and civil society, health, water supply and sanitation, other social infrastructure, and emergency response. Economic infrastructure projects contains projects in the sectors communications, energy, transport and storage, business and other services, banking and financial services, and trade policies and regulations. Production projects contains projects in the sectors agriculture, forestry, fishing, industry, mining, and construction.

Source: AidData

Figure 2: China's Total Trade (Import and Exports) with Armenia, Azerbaijan, and Georgia over the Period 2009–2020 in Billion Current USD



Green line indicates aggregated total trade for the South Caucasus states.

Source: Observatory of Economic Complexity (OEC).

Table 3a: Top Ten Export Markets for the South Caucasus States in 2020 and Growth since 2010

Rank (2020)	Country	Billion USD in 2020	Billion USD in 2010	Export market growth
1.	Italy	4.14	7.01	-41%
2.	Turkey	2.84	0.51	+462%
3.	Russia	1.86	1.05	+78%
4.	China	1.26	0.43	+195%
5.	Switzerland	1.02	0.85	+20%
6.	India	0.69	0.33	+110%
7.	Ukraine	0.60	1.02	-42%
8.	Georgia	0.58	0.50	+16%
9.	Bulgaria	0.55	0.36	+51%
10.	Spain	0.54	0.25	+115%

Source: OEC based on data from BACI that reports the value of trade flows in current USD

Table 3b: Top Ten Import Markets for the South Caucasus States in 2020 and Growth since 2010

Rank (2020)	Country	Billion USD in 2020	Billion USD in 2010	Import market growth
1.	Russia	4.55	2.67	+71%
2.	Turkey	3.73	2.60	+44%
3.	China	2.46	1.64	+50%
4.	Germany	1.10	1.51	-27%
5.	United States	0.97	0.62	+57%
6.	Ukraine	0.84	1.35	-38%
7.	Italy	0.70	0.55	+27%
8.	Iran	0.63	0.67	-7%
9.	Georgia	0.63	0.40	+55%
10.	United Kingdom	0.56	0.77	-27%

Source: OEC based on data from BACI that reports the value of trade flows in current USD