

Caucasus Business Forecast Report Q1 2015

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Abstracts

Core Views

Despite a reduction in political tensions across the South Caucasus in H214 we still highlight potential conflict between Armenia and Azerbaijan over the disputed Nagorno-Karabakh region, as well as the possibility of a deterioration in Russo-Georgian relations as a significant threat to social and economic stability in the region. The Armenian economy is likely to receive a short-term boost from its accession to the Eurasian Economic Union (EEU) in January 2015. Membership of the EEU will facilitate trade and investment flows from Armenia's primary export destination and source of FDI, Russia. Nevertheless, in the long term we believe EEU membership will hold back Armenia's economic growth potential as the economy remains reliant on Russian demand.

Georgian real GDP growth will remain relatively robust over the coming quarters as the finalising of an Association Agreement and Deep and Comprehensive Free Trade Agreement opens up the EU market for exporters. There is the risk that less inhibited trade with the EU sees the increase in imports outweigh the rise in exports, but in the long term we hold to our view that deeper integration with the EU will benefit the Georgian economy as European FDI flows increase.

While Georgia has signed a number of agreements with the EU, fostering closer links between Tbilisi and Brussels, and Armenia is on course to join the EEU, tying the country into Russia's sphere of influence, we believe Azerbaijan will continue to tread a fine line between siding with either Russia or the EU. Azerbaijan's economic interests can be better served by increasing trade and energy routes with the EU, while maintaining good relations with Moscow will likely assist in keeping the autocratic regime of President Ilham Aliyev in power.

Major Forecast Changes

We have revised up our forecasts for real GDP growth in Georgia to 4.8% in 2015 and 4.6% in 2016, from 4.2% and 4.0% previously. The deals signed with the EU will assist in boosting exports and fixed investment, while the threat of a trade embargo imposed by Russia on Georgia has reduced significantly.

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Government Faces Difficulty In Passing Amendments

Armenia's ruling party will face many obstacles in its attempt to push through constitutional amendments that would shift most executive power from the president to the prime minister. In the event the measures pass it could lead to an erosion of checks and balances, given that the prime minister does not face term limits.

Table: Political Overview

Long-Term Political Outlook

Q1 2015 - Mitigation Of Regional Tensions Key To Stability

Armenia will continue to have difficult relations with neighbours Turkey and Azerbaijan through the medium term, as a result of sensitive historical grievances and strong domestic pressure groups on both sides. Nagorno-Karabakh will remain a particular potential flashpoint given the high profile of the region and ongoing talks, which are set to test commitment to peace in both Yerevan and Baku. The heavy troop presence on both sides of the border will remain a key risk. That said, the willingness of regional heavyweights Russia and Turkey to support the ongoing peace process means that a 'hot war' is not inevitable.

CHAPTER 1.2: ECONOMIC OUTLOOK - ARMENIA

Economic Activity

Growth Increasingly Determined By Russia

Armenia's economic growth model will become increasingly interlinked with Russia over the coming years on account of the former's accession to the Eurasian Economic Union in 2015. Although this will provide a modest short-term boost in trade and structural funding, Armenian integration with Russia will ultimately prove an impediment to growth.

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Our relatively pessimistic medium-term view on the Armenian economy continues through our long-term forecast to 2023. We believe the lack of economic and political reforms enacted by the government and the pivot away from the EU will hinder long-term economic activity, and as such we forecast real GDP growth to average 3.5% between 2018 and 2023. Moreover, we caution that political tensions with neighbouring Azerbaijan and Turkey are expected to remain a key risk to the country's economic outlook over the next 10 years.

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Table: Political Overview

Long-Term Political Outlook

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Attempts to win back the Nagorno-Karabakh enclave will remain the defining issue of Azerbaijani foreign and domestic policy through the medium term. No quick resolution is likely and, therefore, heightened tensions with Armenia have the potential to result in further small-scale armed clashes, with escalation not ruled out. This will continue to weigh heavily on Azerbaijan's long-term risk profile, which will deter investment despite progress on other fronts.

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Azerbaijani real GDP growth will show increasing signs of recovery in the coming quarters, despite ongoing hydrocarbon production issues and weak global oil prices. The non-oil sector will remain the primary engine of growth, with robust foreign investment flows supporting fixed capital formation, and a low interest rate-low inflation environment set to encourage greater private consumption.

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Table: Political Overview

Long-Term Political Outlook

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We expect tensions between Georgia and Russia to remain frosty over the next 10 years as the Georgian government continues to attempt deeper integration with the EU and highlight that the potential for social unrest in border areas will remain pronounced, especially in the aftermath of the Ukraine crisis and Georgia's shift towards the EU and NATO. In domestic politics, the outlook is more stable, thanks to a broad political consensus on economic liberalisation and further Western integration, while Georgia's increased importance as a transit route for oil, gas and military supplies is likely to ensure continued Western financial and diplomatic support.

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Security Risks To Economic Growth Diminishing

The threat of a Russian ban on Georgian exports, or even an annexation of Georgia's breakaway regions, has fallen in H214. This will help to bolster fixed investment levels as business confidence returns, while exports to the EU will receive a boost in 2015 and 2016 as agreements signed with the bloc eliminate trade barriers.

Table: Economic Activity

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Over our 10-year forecast period, we project Georgian growth to remain relatively robust, averaging 4.5% per annum through 2018-2023. Georgia will continue to rely heavily on foreign direct investment as a key driver of growth over the long run, which will be enhanced by continued economic and structural reforms. Political risk - particularly instability in the breakaway regions of South Ossetia and Abkhazia - will continue to pose the greatest threat to sustained macroeconomic convergence.

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