

# Caucasus Business Forecast Report Q2 2014

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## Abstracts

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### Core Views

The Armenian economy is set for a short-term boost as a result of the country's accession to the customs union of Russia, Belarus and Kazakhstan, which is expected in H214. This will open up the Armenian economy to increased foreign investment, as well as bolster export levels. However, in the longer term we believe that the pivot away from deeper EU integration will hinder greater levels of FDI, as Armenia will not face the same pressures to reform institutions or challenge monopolies as would be the case if the country were seeking EU member status.

An increase in production at the ACG oil field will boost Azerbaijani economic activity in 2014 and 2015, before production peaks in 2016. Following this, the Trans-Adriatic Pipeline, which will supply gas through to Western Europe, will provide a notable boost to real GDP growth. In addition, despite an increase in the number of skirmishes on the border of the disputed Armenian-occupied Nagorno-Karabakh region in early 2014 we do not expect an escalation to widespread armed hostilities. Azerbaijan has much to lose and little to gain in economic terms from a renewed conflict with Armenia, with any outbreak of violence likely to dissuade further FDI.

The Georgian economy is set to continue to reap the benefits of the relaxation of trade restrictions with Russia, although the country's drive towards deeper European Union integration could halt this trade renaissance in its tracks. Georgia is set to sign an Association Agreement with the EU in August at the earliest, taking the country a step further down the path towards EU member status. However, this could spur Moscow into re-imposing the trade restrictions in an attempt to halt a country that it sees as part of its historical economic and political sphere of influence pivoting towards Russia.

## Major Forecast Changes

We have revised up our forecast for Azerbaijani real GDP growth in 2014 and 2015, from 5.5% and 4.6% to 5.6% and 5.7% respectively, on the back of our Oil & Gas team's projections for output at the ACG oil field to increase after several years of stagnation. We have also revised our forecast for the Azerbaijani policy rate, and no longer expect a 25 basis point cut in 2014 with the rate set to remain at 4.75%, as rising demand-pull pressures increase consumer price inflation.

## Key Risks To Outlook

If Russia uses its position as the host of the 2014 Winter Olympics to assert the independence claims of breakaway regions South Ossetia and Abkhazia in a prominent manner, we would expect to see a significant deterioration in Georgian-Russian relations. While the Georgian government has not stated what the retaliation would be in the face of this, we cannot rule out the Georgian government attempting to influence the breakaway regions more forcefully. This could become especially precarious given that South Ossetia is planning to hold elections for its de facto parliament in May, and, although very unlikely, any perception of interference could prove a touch-paper for a deterioration in relations beyond a war of words or trade blocks.

The Armenian government has attempted to argue that accession to the customs union will prove beneficial to exporters, which we believe will be the case. However, it also exposes domestic producers to competition from cheaper imports from the customs union states. If this significantly damages Armenian industries, resulting in an increase in unemployment (already estimated to be around 20%) and suppressing wage growth we could see more widespread political protest against the government.

## Contents

Core Views  
Major Forecast Changes  
Key Risks To Outlook

### **CHAPTER 1.1: POLITICAL OUTLOOK – ARMENIA**

Armenia Domestic Politics

Customs Union Accession Masks Long-Term Concerns

Armenia will likely join the Russia-Kazakhstan-Belarus customs union in the second half of 2014, providing not only a short-term economic boost, but also an implicit security guarantee with regard to the frozen conflict with Azerbaijan. In the long term, however, by turning its back on potential EU accession, Armenia's political and economic development is likely to be hindered.

Table: ARMENIA – Political Overview

Long-Term Political Outlook

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.

### **CHAPTER 1.2: ECONOMIC OUTLOOK – ARMENIA**

Armenia Economic Activity

Customs Union To Provide Short-Term Boost

Armenia is set to benefit in the short term from a boost to exports and investment as it joins the Russian-led customs union in 2014.

However, with the trade, investment and institutional benefits of EU membership now lost we fail to see any long-term growth drivers, with Armenia's continued reliance on foreign remittances exposing the economy to slowdowns in source countries.

Table: ARMENIA – ECONOMIC ACTIVITY

### **CHAPTER 1.3: 10-YEAR FORECAST – ARMENIA**

the Armenian Economy To 2023

Convergence To Stall

Table: ARMENIA Long-Term Macroeconomic Forecasts

### **CHAPTER 1.4: BUSINESS ENVIRONMENT – ARMENIA**

Business Environment Outlook institutions

Table: BMI BUSINESS AND OPERATION RISK RATINGS

Table: BMI LEGAL FRAMEWORK RATING

Table: LABOUR FORCE QUALITY infrastructure

Table: EMERGING EUROPE – ANNUAL FDI INFLOWS

Table: TRADE AND INVESTMENT RATINGS

Market Orientation

Table: TOP EXPORT DESTINATIONS

Operational Risk

## **CHAPTER 2.1: POLITICAL OUTLOOK – AZERBAIJAN**

Azerbaijan Domestic Politics

Threat To Investment To Subdue Border Tensions the escalation in violence on the border of the disputed Nagorno-Karabakh region is unlikely to spur a major conflict between

Azerbaijan and Armenia.

Long-Term Political Outlook

Everything Hinges On Nagorno-Karabakh

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.

Table: AZerbaijan – Political Overview

## **CHAPTER 2.2: ECONOMIC OUTLOOK – AZERBAIJAN**

Azerbaijan Economic Activity

Oil Production Key Until TAP Constructed increased production at the ACG oil field will bolster Azerbaijani economic activity in 2014 and 2015, while the Trans-Adriatic Pipeline will ensure substantial gas revenues post-2019. However, this reliance on hydrocarbons leaves Azerbaijan exposed to fluctuations in global commodity prices, and will hinder government efforts to diversify the economy.

Table: AZERBAIJAN – ECONOMIC ACTIVITY

## **CHAPTER 2.3: 10-YEAR FORECAST – AZERBAIJAN**

the Azeri Economy To 2023

Trend Growth Bolstered During 2018-2023

Over our 10-year forecast period to 2023, we believe Azerbaijan's economy will remain on a positive trajectory. Undoubtedly, energy exports will continue to be the key driver underpinning growth.

Table: Azerbaijan – Long-Term Macroeconomic Forecasts

## **CHAPTER 3.1: POLITICAL OUTLOOK – GEORGIA**

Georgia Domestic Politics

Georgian-Russian Rapprochement Under Threat

While political and economic relations between Georgia and Russia have undoubtedly improved over the past 18 months, Tbilisi's accelerating drive towards EU accession is likely to slow any reconciliation attempts. This will pose risks to Georgian economic activity, with the potential for the recent loosening of bilateral trade restrictions to be quickly reversed.

Long-Term Political Outlook

Pro-Western Path To Continue

We expect tensions between Georgia and Russia to continue to subside over the next 10 years as the Georgian Dream coalition attempt to improve Russo-Georgian relations, but highlight that the potential for social unrest in border areas will remain pronounced.

Table: Georgia – Political Overview

## **CHAPTER 3.2: ECONOMIC OUTLOOK – GEORGIA**

Georgia Economic Activity

Outlook Improving On Russian Trade Renaissance an increase in Georgian-Russian trade will bolster real GDP growth in Georgia in 2014 and 2015, with a trade rapprochement with what was once Georgia's largest trading partner reducing net exports' drag on growth.

Table: GEORGIA – ECONOMIC ACTIVITY

## **CHAPTER 3.3: 10-YEAR FORECAST – GEORGIA**

the Georgian Economy To 2023 foreign Investment Will Support Growth

Over our 10-year forecast period, we project Georgian growth to remain relatively robust, averaging 5.8% 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.

Table: GEORGIA Long-Term Macroeconomic Forecasts

## **CHAPTER 4: BMI GLOBAL ASSUMPTIONS**

Global Outlook

Fairly Benign Prognosis... With Risks

Table: Global Assumptions

Table: Developed States, Real GDP Growth, %

Table: BMI VERSUS BLOOMBERG CONSENSUS REAL GDP GROWTH

**FORECASTS**

Table: Emerging Markets, Real GDP Growth, %

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