

# Caucasus Business Forecast Report Q4 2013

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## Abstracts

### Core Views

The Armenian government remains caught in two minds over its decision on how foreign and economic policy will be oriented in the future. The government is set to sign a Deep and Comprehensive Free Trade Area agreement with the EU in November, taking the country another step towards EU accession. However, Armenia relies on Russian demand for its exports, as well as remittances from the Armenian diaspora in Russia to sustain domestic demand, and Russian gas via Gazprom's subsidiary ArmRusGazprom. Therefore, in the short to medium term it will not be able to alter its economic focus enough to remove itself from Moscow's sphere of influence.

The selection of the Trans-Adriatic pipeline (TAP) for the export of gas from the Shah Deniz II field in the Caspian Sea is set to provide a significant boost to Azerbaijan's GDP growth prospects in the long term. The pipeline will provide a link from Turkey's Western border, via Greece and Albania, to Italy and the markets of Western Europe beyond. Construction is due to begin in 2015 and scheduled for completion in 2018. We do not anticipate any rebalancing of the Azerbaijani economy away from hydrocarbon exports during our forecast period.

In the run up to, and likely in the aftermath of, Georgia's presidential election, we believe that political bickering between the governing Georgian Dream coalition and President Mikheil Saakashvili's United National Movement will prove a deterrent to fixed investment and will lead to a slowdown in economic activity. The poll is scheduled for October 27, and we believe that Georgian Dream candidate Giorgi Margvelashvili will emerge as the victor. Following the vote Prime Minister Bidzina Ivanishvili is set to step down from his post, although no successor has been named at the time of writing.

### Major Forecast Changes

We have revised down our forecast for Georgian real GDP growth in 2013 and 2014, from 4.8% and 5.4% to 2.7% and 4.4% respectively. The downward revision has come of the back of real GDP growth slowing to 2.8% y-o-y in Q113, and flash estimates of growth slowing further in Q213, to 1.3% y-o-y. Political strife has weighed heavily on fixed investment, and deflation continues to hamper growth prospects.

As a result of the improving industrial picture in Azerbaijan we have revised up our end-2013 real GDP growth forecast, from 3.6% to 4.4%. We refrain from raising the forecast further, with our Oil & Gas team forecasting global oil prices to moderate in H213. This will mean that despite net exports remaining positive, the lower price garnered for oil will impede a faster rate of real GDP growth.

### **Key Risks To Outlook**

Azerbaijan is reliant on the construction of the Trans-Anatolian pipeline (TANAP) to enable its gas to reach the future TAP pipeline, and Western Europe beyond. The tender for TANAP's construction was announced on August 6, however, should interest not prove sufficient or if the plans for the pipeline break down, it would lead to a substantial downgrade to our macroeconomic forecasts for the country.

The government of Prime Minister Bidzina Ivanishvili has made a habit of arresting former state officials from the opposition United National Movement party. The most senior among these was former Prime Minister Ivane Merabishvili in May on charges of corruption. There is the risk that following the presidential election in October current President Mikheil Saakashvili, who is constitutionally barred from standing again, could face charges. This would lead to a severe escalation in political tensions within the country and could lead to an uptick in violence between the supporters of the respective parties.

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##### Government Under Pressure On All Fronts

Armenia's government will have to confront a number of obstacles in the coming months, with an 18% hike in consumer gas prices likely to increase political tensions as well as rile the impoverished Armenian public. In addition, deeper integration with the EU may progress at a slower pace, with Russo-Armenian military ties remaining strong in light of increasingly belligerent Azeri rhetoric.

##### 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. 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**

#### Fiscal Policy

##### Rising GDP Poses Inflationary Risk

Armenia's economy is set to post moderate real GDP growth of 4.5% in 2013, revised upward from 4.0% previously, on the back of resilient private consumption figures and an increase in government expenditure as a result of increasing revenues from VAT and import duties. However, given the 18% hike in gas prices implemented by Gazprom, we expect consumption to slow in 2014, impacting real GDP growth, and we are forecasting a 3.9% expansion.

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