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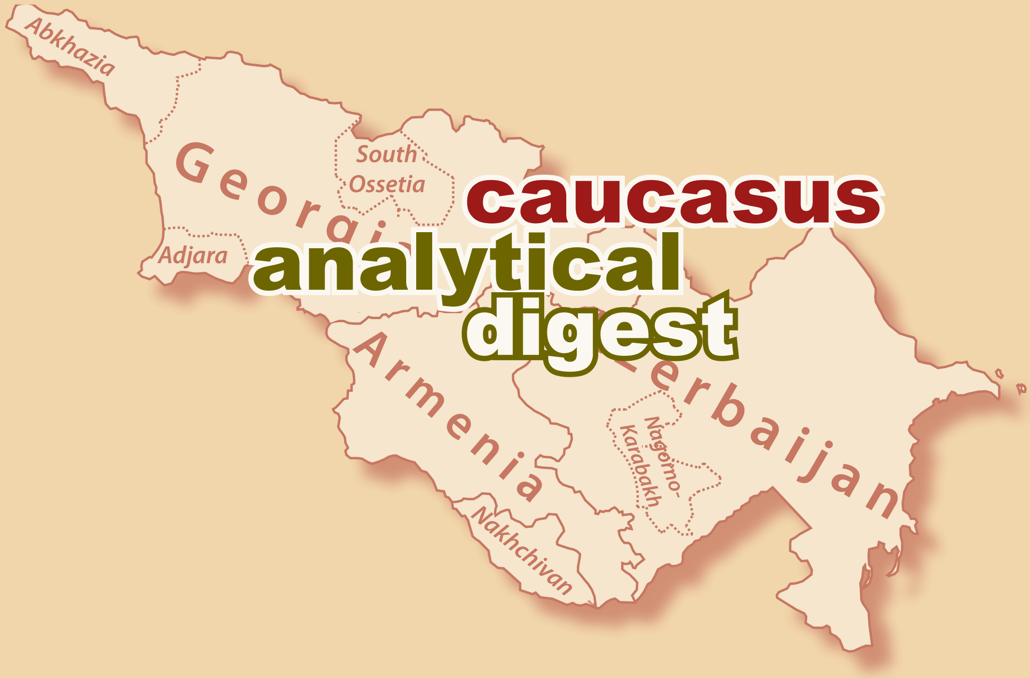


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## THE SOUTH CAUCASUS AFTER THE GLOBAL ECONOMIC CRISIS



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# Armenia: A Strange Crisis With an Optimistic Outcome

By Haroutiun Khachatrian, Yerevan


## Abstract

Armenia was one of the countries most severely hit by the global crisis of 2009. However, despite the sharp decline in GDP, the consequences for the larger economy were not as dramatic as initially expected. This was mainly due to the specific nature of the crisis which affected almost exclusively the construction sector, as well as the result of anti-crisis measures implemented by the Armenian government which managed to stabilize the situation through international loans. Moreover, it seems that the crisis of 2009 resulted in an overall structural adjustment of the country's economy which could have positive effects for the future.


## 2009: A Steep Decline in GDP

Armenia's economy suffered severely from the global economic crisis in 2009.[1] In the first quarter of 2009, GDP declined by 6.1% against the levels of the previous year. By July, GDP shrunk by an astounding 18.7%. Overall, Armenia's GDP level for 2009 was 14.4% below that of the previous year (see Figure 1 on p. 18). This was the second worst result in the world after Latvia. Moreover, this decline was even more astonishing because, as noted in an earlier article published in this journal,[2] this decline followed an eight year-period of impressive GDP growth, mostly at rates above 10% a year.

However, this decline did not, so far, result in a catastrophe for the overall economy, or in severe social consequences, as one could expect. This outcome had as much to do with the specific features of Armenia's economy as the anti-crisis measures adopted by the government led by Prime Minister Tigran Sargsyan.

## The Pillar of Construction

In early in 2010, the National Statistical Commission of Armenia examined the different factors contributing to the catastrophic decline of GDP in 2009. The analysis revealed that most of the decline (11.4% of the 14.4%) was due to the crisis in a single sector of the economy: construction, which shrunk 36.4% against the level of the previous year. Had construction volumes in 2009 remained at the same level as in 2008, Armenia's GDP would have decreased by only 3%, including just 1% due to the fall in industry, where production fell by 7.8%. In fact, if not for these two sectors (construction and industry), Armenia's economy would have performed fairly well in 2009. Indeed, production of agriculture was almost stable (minus 0.1%) and services (without retail trade) showed a 1.3% growth during 2009.

Hence, the decline in construction was the principal factor driving the overall economic decline in Armenia. A more thorough analysis of the situation shows that in 2008, 71.1% of all construction works were funded by the population (the term used by the statistical service to designate funding from private means, including households). In the following year, the total allocations to construction fell drastically, as population funds for construction purposes fell to a third of their previous level (by 415 billion AMD (Armenian drams) or 1.12 billion USD). An increase in funding from other sources, such as the state budget, organizations, and international loans, only partially compensated for the sharp decline in private construction orders.

The decline in investments in construction correlated with the decline in the private remittances from abroad, especially from migrant workers, the majority of whom are living and working in Russia (80%). According to data from the Central Bank of Armenia, the inflow of these non-commercial funds sent via bank transaction amounted to 929 million USD in 2009, which was 33% (or 464 million USD) less than in the previous year. Yet strange as it may seem, the decrease in cash remittances were practically the only decrease in overall income for the population in Armenia. In fact, the average salaries in Armenia did not suffer in the year of the crisis; moreover, they rose, as shown below. It is very likely that the decrease of these remittances combined with psychological factors (insecurity) presented the principal trigger for the population to stop investing in construction, resulting in the sharp overall decline in this sector.

Hence, the principal impact of the global economic crisis on the Armenian economy in 2009 can be summarized as follows: The global crisis diminished for-

1 All the data and the comparisons are presented in this article for the periods from January to the month mentioned. For example, "GDP level in July" means the data for the period January–July. This is the usual method used by the National Statistical Commission of Armenia.

2 Haroutiun Khachatrian, "Armenia: How a Small Country Counters the Global Crisis," Caucasus Analytical Digest, No. 6, 21 May 2009, pp. 5–7.

eign remittances to an extent which was sufficient for the population to stop investing in construction, but they remained high enough to prevent any significant decrease in its living standards. A sensitive factor that demonstrates the unchanged living standard is the retail trade turnover, which grew by 1.1% during 2009.[3] In short, the huge drop in GDP, which would probably have meant a catastrophe for most other countries, did not result in any serious social problems for Armenia in 2009.[4]

At the same time, the nature of the Armenian crisis also serves to illustrate the country's highly unbalanced economic development. The rapid economic growth in 2001–2008 was caused mainly by strong growth in the construction sector, whose overall share in Armenian GDP grew from 13.9% in 2002 to 27% in 2008. Some economists warned of a "construction bubble," which was especially dangerous as it was highly dependent on the inflow of funds from abroad. When the decrease in that inflow resulted in the collapse of construction, its share in GDP almost halved in 2009 to 19%. In other words, the global economic crisis resulted in the burst of the "bubble" and the elimination of the construction sector as the "pillar" of Armenia's economic growth. Armenian Minister of Finance Tigran Davtyan mentioned in an interview in *Golos Armenii Daily* on 21 June 2010 that the economic decline last year was in a sense, a simple "technical recession," which, however, demonstrated with clarity that the diversification of the Armenian economy is an urgent task.

## Other Spheres

As I argued in my earlier *Caucasus Analytical Digest* article, the global economic crisis would bring two principal challenges to the economy of Armenia: namely, a decrease in cash remittances to Armenia and a decrease in exports. As demonstrated above, almost the whole decline of the economy can be linked to the decline in money remittances from abroad. However, decline in exports also played a role. In 2009, exports saw a 34% drop compared to the previous year, while imports only marginally declined. The import/export ratio—which was already on the worrying level of 4.11—jumped further to 4.17, meaning an additional decrease in the net money inflow to the country. The government tried to help the main exporters; in particular, it extended loans to several copper mining companies.

Finally, an important factor during the crisis was the decrease in tax collections, which was a natural consequence of the decline in production and foreign trade turnover. This factor caused a drop in budgetary revenues to 74% of the planned amount during the crisis year. However, the government managed to escape reducing its expenditures significantly, as it took extensive loans abroad to fulfill its budgetary commitments. As a result, the state debt increased dramatically in 2009, from 17% of GDP in 2008 to 32% at the end of 2009 (or 2.72 billion USD in nominal terms). This is still a debt which can be serviced safely (for comparison, Greece's debt is 110% of GDP).

## The Anti-Crisis Measures of the Government

The most important anti-crisis measure of the Armenian government was its decision to keep its expenditures at the level of the principal targets, set before the crisis began, thus keeping expenditures as high as possible, despite the subsequent decrease in the tax revenues. To finance this deficit spending, the government managed to obtain the following major international loans:

- From the International Monetary Fund (IMF): 800 million USD as anti-crisis support of which a total of 500 million USD was allocated in 2009.
- From Russia as a 500 million USD inter-state loan in June 2009 (at a rate of LIBOR+3 for 15 years).
- From the World Bank which had allocated 350 million USD out of a total of 760 million USD pledged aid for 2009–2012.
- From the Asian Development Bank which allocated a total of 80 million USD in aid. A larger loan of 500 million USD for construction of the North-South motorway connecting the Black Sea port Batumi with Iran will be allocated later.
- From the European Union which allocated 100 million USD for different assistance programs.

Thanks to the international funds, the Armenian government managed to fulfill almost all of the commitments defined in the initial version of the 2009 budget. As a result, the average salary in the country grew by 9.8% during the crisis, and all the pensions and other social payments were maintained at previous levels. In addition, the government of Tigran Sargsyan was also able to implement a number of measures aimed at stimulat-

3 Typically, the amount of remittances registered by the Central Bank is more than one third of the total retail trade turnover. In 2008, for example, these amounted to 1.4 billion USD and 3.4 billion USD respectively.

4 According to the estimates of the World Bank, the number of poor people in Armenia grew in 2009 from 25.6% of the population to 28.4%, or by 90,000 people. This was considered to be a fairly good result, as according to WB experts, with such a large GDP decline, the number of people living in poverty might have grown three times more than the level actually observed.

ing the different sectors of the economy and business. Among them were: initiating and continuing a number of infrastructure projects (in particular, in the zone of the 1988 earthquake) and the provision of funds to what the government considered to be promising business endeavors (a total of 14 billion AMD or 38 million USD were allocated to 44 projects). In particular, the government provided loan guarantees worth a total of 12 million USD to developers for finalizing unfinished construction projects. This action played a significant role in re-activating the construction sector, although it will take time for these measures to take effect. While the other sectors of the Armenian economy again showed rapid growth during the first quarter of 2010, the construction sector continued to shrink, with its apparent revival beginning only in April.

### Conclusion

After the drastic fall of the economy during the crisis of 2009, the government was cautious about it future development. The draft budget for 2010 was based on a scenario of 1.5% GDP growth, which in late 2009 seemed cautiously optimistic. In the meanwhile, however, the Armenian economy showed strong growth of 8.8% during January–June 2010, thus much higher than expected. Most importantly, all major sectors of the economy contributed almost equally to this positive result. Thus the crisis to some extent corrected the highly unbalanced economic development of the previous growth period of 2002–2008, which was dominated by expansion in the construction sector. Thus, it looks as if the sharp economic decline or, as Armenia's Minister of Finance put it, the "technical recession," has resulted in serious structural changes in Armenia's economy. Whether this structural change is indeed sustainable and will have long-term positive effects for the country's economy is the subject for another analysis.

*About the Author*
Haroutiun Khachatrian is an editor and analyst with Noyan Tapan news agency in Yerevan.

# As If Nothing Happened?

## How Azerbaijan's Economy Manages to Sail Through Stormy Weather

By Gerald Hübner, Frankfurt am Main

### Abstract

Since Azerbaijan seems to have coped with the impact of the global financial crisis far better than initially expected, it is worth taking a closer look at this country which seems far away from the stormy international fore of private sector and sovereign crises. Azerbaijan's financial sector had only limited exposure to international markets and the country's sovereign balance sheet is strong with a public debt ratio that is one of the lowest of all transition countries. However, the country depends heavily on its oil exports, so Azerbaijan felt the crisis directly through the high volatility of world oil prices. As a consequence, state authorities had to design effective policies to steer the economy through stormy weather.

### Spring 2010: Rating Upgrade for Azerbaijan

First of all the good news. Fitch, one of the world's top three rating agencies, upgraded Azerbaijan's sovereign credit rating at the end of May 2009 from BB+ to BBB-.[1] Azerbaijan is thus now playing in the same league as Brazil, Peru, Bulgaria and India and even one category higher than Turkey, Iceland and Latvia. Why did Fitch upgrade Azerbaijan to investment grade?

The most recent financial crisis resulted, like financial crises before it, from excessive lending to the private sector. The key consequence was excessive household and banking sector borrowing throughout the advanced

1 A credit rating estimates the credit worthiness of a country. With a rating of BBB- Azerbaijan joins the ranks of investment-grade countries, meeting the minimum grade required by many institutional investors worldwide.

industrial world. This financial crisis, which started in summer 2007 with the US-sub-prime crisis, affected step-by-step all but a handful of advanced industrial countries and contributed to a significant impairment of their fiscal positions.

## Before the Crisis

Azerbaijan, whose capital and credit markets were and still are underdeveloped and only have very limited exposure to the international financial markets, did not feel the effects of the crisis immediately. However, these effects began when the global financial crisis turned into a crisis for the real economy. The wave reached Azerbaijan when prices for crude oil and natural gas started to fall dramatically during the second half of 2008 from an all-time high of 146 USD per barrel to below 40 USD per barrel towards the end of 2008. However, this downturn in prices did not hit Azerbaijan instantly as the annual average price of crude oil in 2008 was 97 USD per barrel, a price that was above government expectations, especially considering the substantially lower prices of 73 USD per barrel in 2007 and 65 USD per barrel in 2006.

In Azerbaijan, hydrocarbon production only started to increase significantly after 2004 and tripled in volume by 2008. At the same time oil prices almost doubled. As a result, Azerbaijan's local economy was almost overwhelmed by trying to absorb the huge amount of revenues from that industry in 2007 and especially when the oil price overheated in 2008. Between 2005 and 2008 nominal GDP tripled and reached 40.1 billion AZN[2] (50.1 billion USD), half of it resulting from hydrocarbon extraction and export. Government budget expenditures increased five-fold during that time to 10.7 billion AZN (12.9 billion USD) and spurred growth in all economic sectors, particularly construction and trade, through increased infrastructure investments and household consumption. Banking sector assets more than quadrupled from 2.3 billion AZN in 2005 to 10.3 billion AZN in 2008 thanks to the tremendous growth in loans to costumers, which were financed through an increasing volume of deposits and refinancing funds from global commercial banks as well as international financial institutions. However, this rapid growth on all levels of the economy also pushed inflation to 20.8% in 2008, the highest since 1995. Over the same period, the Azerbaijani currency Manat further appreciated against the US dollar, which made production outside the hydrocarbon industry prohibitively expensive for export, a condition typically described as the Dutch Disease.[3]

## The Impact of the Global Crisis on Azerbaijan Since 2009: Real GDP Growth Versus Nominal GDP Decline

So far, the Azerbaijani economy has handled the impact of the global crisis rather well. Despite a decrease in prices for oil and other export products (chemicals, aluminium and ferrous metals) in 2009, the Azerbaijani economy grew by 9.3% in terms of real GDP. This was the highest growth rate among all transition countries. At the same time Azerbaijan had a current account surplus for the 5$^{th}$ year in a row, albeit at 20.7% of GDP a considerably smaller one than in the previous 2 years (2008: 35.5%, 2007: 27.3%). The reason for this reduction in the current account surplus was a decline in exports by roughly 30% due to a much lower average annual oil price of 64 USD in 2009 than in the year before and falling remittances from abroad.

The cut in exports led also to a decline of the nominal GDP of approximately 14%. This sounds quite paradoxical since the country had a real GDP growth. In fact, Azerbaijan had a considerably lower influx of US dollars from oil exports. Since the Manat did not devaluate against the dollar, nominal GDP in Manat also declined. But to measure real GDP growth one has to adjust nominal GDP by inflation. High levels of Manat inflation in 2007 and 2008 led to a huge distortion between nominal and real GDP figures (see Figure 1 on p. 9 and Table 1 on p. 10). Despite a statistical real GDP growth, household and businesses did not gain more disposable income.

## Intervention of the Central Bank of Azerbaijan to Keep the Manat Stable

Against the background of fluctuating and unpredictable demand for local and foreign currencies, the Central Bank of Azerbaijan (CBA) had to closely monitor and intervene in 2009 and 2010 to keep the Manat stable against the US dollar. It first had to overcome strong depreciation pressure at the beginning of 2009[4], which

2 AZN or Manat: Azerbaijani Manat, the official currency of the Republic of Azerbaijan. As of 29 June 2010 one Azerbaijani Manat was equal to 1.01 EUR and 1.24 USD.

3 Compare: Gerald Hübner and Michael Jainzik, "Splendid isolation? Azerbaijan's economy between crisis resistance and debased performance," Caucasus Analytical Digest, No. 6 (The Caucasus in the Global Financial Crisis), 21.05.2009, pp 12–13.

4 All neighboring transition countries, including Russia, Ukraine, Kazakhstan, Georgia and Armenia depreciated their local currencies roughly by around 20% during the first quarter of 2009. At the same time, the Azerbaijani banking system faced large deposit outflows and an exchange of deposits from Manat into foreign currencies, mainly US-Dollar and Euro.

it successfully resisted by making foreign exchange sales totaling 1.26 billion USD in February and March 2009. This step was necessary to mitigate inflation expectations, reverse increasing dollarization and avoid the negative impact on households' and banks' balance sheets caused by the depreciation of deposits and appreciation of debts in foreign currency.

In the first quarter of 2010 this situation reversed, as the trade surplus, capital inflows and investors' confidence started to strengthen. The CBA again successfully intervened on the foreign exchange markets by purchasing 480 million USD and continuing the Manat's peg to the US dollar at an unchanged exchange rate of 1 USD/ 0.8 AZN. Due to this stable exchange rate, lower oil prices and lower domestic and external demand, inflation substantially cooled down from more than 20% in 2008 to 1.5% in 2009. The intervening policy, which led to a stable Manat and a sharp decline in inflation, last but not least also helped to stabilize confidence in the national currency. On the other hand, as mentioned above, the strong Manat makes the export of goods and services apart from extractive industries even more expensive and may hamper attempts by the government to diversify the local economy.

## Economic Stimulus Resulting From Reforms, Reduction of Tax Obligations and Facilitation of Business Activities

To support economic activity, profit and income taxes were cut from the beginning of 2010 to 20% (profit tax) and 30% (income tax) respectively. Financial sector institutions can even make use of a 3-year profit tax holiday from 2009–2011 if they use their profits to increase their shareholders' capital base. Azerbaijan improved its formal business environment by creating a "one-stop-shop" for entrepreneurs willing to open a business, adopting a more flexible labor code, strengthening contract enforcement procedures and expanding the existing simplified tax regime to a broader circle of small and medium-sized entrepreneurs. For its efforts Azerbaijan ranked as one of the top reformers in the World Bank's 2009 Doing Business Report.

## Strong sovereign balance sheet and Azerbaijan's sovereign wealth fund SOFAZ

As noted above, the government injected significant amounts of revenue into the local economy in the years after oil production accelerated in 2005/2006. Nevertheless, the authorities showed strong fiscal discipline in their use of hydrocarbon windfall profits. Between 2001 and the end of 2009, the government built up official reserves via the CBA to 4.3 billion AZN (10.7% of GDP). These reserves further increased to a comfortable 4.7 billion AZN during the first quarter of 2010.

With the establishment of the Sovereign Wealth Fund SOFAZ (State Oil Fund of Azerbaijan Republic) in 1999 the central government had, and maintains, a vehicle for employing oil revenues. The Fund not only absorbs a significant part of public oil revenues by investing them overseas in highly rated foreign currency assets but also proved itself as a handy instrument in counterbalancing the volatile public oil revenues and hence to steadily co-fund the governmental budget.[5] While SOFAZ transferred one third of its revenues to the state budget in 2008, it increased this share to 60% in 2009. Nevertheless, the Fund could still build up its asset base by almost 3 billion AZN to 12 billion AZN or 34.6% of GDP at the end of 2009, from only 7.4% in 2007 (see Table 2 on p. 10).[6]

Public external debt in percent of GDP has declined substantially since oil production took off in 2005. It accounted for 3.4 billion AZN (8.5% of GDP) at the end of 2009. Two third of this external debt were long-term loans from international financial institutions and bilateral donors such as Germany. Together with the assets of Azerbaijan's sovereign wealth fund, all external assets and liabilities combined were 12.8 billion AZN (32% of GDP) at the end of 2009, up from virtually zero in 2001. As the system enjoys decent medium-term prospects for macroeconomic growth, it is likely that Azerbaijan's fiscal position will further strengthen over the next decade with low levels of external debt.

## Stable Central Government Budget and Social Spending During 2009

Due to SOFAZ's transfers to the central government budget, revenues remained almost the same between 2008 and 2009. The authorities did not have to cut expenditures in general but decided to shift spending priorities. They cut expenditures on financing the local economy by 12% (halting or postponing expensive infrastructure investment projects) but increased spending for social services by 20% (see Table 3 on p. 10).

5 The substantial drop of oil prices caused fiscal oil revenues to fall by 35% during 2009.

6 Although this development looks quite impressive per se, one can also compare these amounts with the upper end of sovereign wealth funds. With a population of nearly 5 million people, Norway's sovereign wealth fund is now worth nearly 400 billion USD (80.000 USD per capita against 1.440 USD per capita in Azerbaijan). This matches exactly with Norway's GDP of 2009. The fund is thus the world's largest sovereign fund outside the Middle East.

This also had a positive impact on the poverty rate in Azerbaijan. According to the State Statistical Committee, the official poverty rate declined from 50% at the beginning of the millennium to 13% in 2008 and further to 11% at the end of 2009. On a political level, this strong sovereign position, the intensive public spending on social welfare as well as the above described state support to the economy has helped to strengthen the authority of President Ilham Aliyev.

## Crisis Impact on the Financial Sector and the Government's Intervention

Apart from the extractive industry, the Azerbaijani financial sector remains the country's main economic sector exposed to the international financial and economic crisis. Howsoever, the actions taken by the authorities, particularly the Central Bank mitigated the impact of the crisis. So far, no private commercial bank has failed as a result of the crisis. Besides, the state authority's appropriate policy response to keep the local currency stable, the government and CBA have implemented a whole set of measures and stimulating actions to provide support and liquidity to the banking system since autumn 2008:

### *1) Reduction in Reserve Requirements and Refinancing Rate*

The CBA reduced the mandatory reserve requirement on deposits between October 2008 and March 2009 from 12% to 0.5% and on foreign liabilities from 5% to 0% and has kept them at this level ever since. This move resulted in a long-term cash injection of approximately 420 million AZN. At the same time, the Central Bank further cut the refinancing rate from 15% to 2%.

### *2) Loans from the Central Bank and Further Funds*

A number of amendments were made to the law "On the Central Bank of Azerbaijan Republic" on June 19, 2009. According to the new law, the Central Bank of Azerbaijan now has the right to extend state-guaranteed and subordinated loans to local banks and can independently define its terms and conditions. The amendments enable the Bank even to provide finance to (state-owned) enterprises with critical refinancing needs via the banking sector. This goes now much beyond the Central Bank's traditional function as lender of last resort in emergency situations when banks face short-term liquidity problems such as the Unibank case in 2008.[7] In such situations, the Central Bank could (and still can) extend loans for a term not exceeding 6 months with the option to extend them for another 6 months.

In total, the CBA provided almost 1 billion AZN in liquidity support to banks and another 900 million AZN as a loan backed by a government guarantee.[8] Due to this market intervention policy, the share of Central Bank funds to total banking sector liabilities increased from 2.7% in 2008 to 15.2% in 2009.

The Azerbaijan Mortgage Fund (AMF), which stopped lending due to lack of finance in 2007, resumed its lending activities in July 2009. This was financed through provision of budget funds as well as the (ongoing) emissions of long-term AMF bonds. As a result, from July 2009 up to now, an amount of approximately 100 million AZN was injected into the sector.

### *3) Tax Holiday*

To further stipulate the capitalisation of banks, the president issued a decree implementing a 3-year profit tax holiday between 2009 and 2011, in case banks use their profits for recapitalization purposes. So far, several of the top 15 banks that had relevant profits in 2009 planned to make use of this tax holiday. It still remains to be seen, to what extent this decree helped or stimulated the capitalization of banks.

### *4) Increase of the Amount of Insured Deposits*

In order to avoid bank runs on deposits, the government decided to increase the maximum amount of insured deposits via the Azerbaijan Deposit Insurance Fund. The insured amount per deposit in one bank was raised from 6,000 Manat to 30,000 Manat. In conjunction with the stable currency exchange rate, this decision might also have helped to dispel the most severe scepticism of a population worried about the global economic crisis and a sharp decline in oil prices. Finally, household deposits grew by 30% from 1.9 billion AZN to 2.5 billion AZN between the end of 2008 and end of April 2010.

## Financial Sector Impacts and Development since 2009

The relatively small and immature financial sector was not exposed to risky and speculative overseas investments and businesses. On average, banks are predominately active in their home market and use a relatively straightforward set of financial instruments on both the

7 Compare: Gerald Hübner and Michael Jainzik, "Splendid isolation? Azerbaijan's economy between crisis resistance and debased performance," Caucasus Analytical Digest, No. 6 (The Caucasus in the Global Financial Crisis), 21.05.2009, p 15.

8 This loan was extended to the state-owned International Bank of Azerbaijan for on-lending to SOCAR, the state oil company and AZAL, the state-owned aluminium company.

assets and the liability/equity side. Consequently, the governmental interventions had a significant impact and apparently reached their target.

After a fourfold increase of the banking sector balance sheet between 2005 and 2008, sector growth cooled in 2009. Sector assets even shrank by 14% during the first quarter 2009 but recovered quickly thereafter. At the end of 2009, the balance sheet stood at 11.7 billion AZN with a year-on-year increase of 13.5% (2008: 52.7%, 2007: 78.0%). As nominal GDP declined in 2009, financial intermediation, measured by the ratio of total banking assets to GDP, increased from very low 25.6% in 2008 to 33.7% at the end of 2009 (Figure 3/ Table 4 on p. 11). Loans to costumers increased even by 16.8% during 2009. But this increase certainly does not reflect the true picture of the lending situation, keeping in mind the 900 million AZN loan from the CBA to the state-owned International Bank.[9] The sudden increase in loans to costumers during the third quarter can be attributed mostly to this particular engagement (Figure 4 and 5/Tables 5 and 6 on p. 12 and 13). On the contrary, it is very likely that the number of borrowers stagnated or even dropped slightly in 2009 as many banks stopped lending or only lent to repeat costumers.

As already mentioned, as the CBA expanded its lending activity to the banking industry by 1.2 billion AZN during the second half of 2009, its share in sector liabilities increased greatly to 15.2% of total liabilities. Foreign refinancing dropped by 10% over the first nine months of 2009 but increased since then to an all-time high of the equivalent of 2.23 billion AZN (one fourth of this amount is attributable to a loan from one foreign bank from Dubai to the International Bank of Azerbaijan) (Figure 5/Table 6 on p. 13).

## Risk Management and Portfolio Quality as Challenges

One of the bigger challenges banks are facing since 2009 is a deteriorating loan portfolio quality. Currently Central Bank data indicate a modest level of loans (4.26%) are overdue by more than 30 days measured as share of total loan portfolio. However, an analysis of the audited financial statements of ten larger local banks shows a much different picture. Only one of the ten banks was below the CBA reported figure. All other banks had problematic loans[10] ranging from 6.5% to 24% in comparison to their gross loan portfolio. In addition, most banks had also renegotiated a significant amount of loans which otherwise would have been problematic as well. And a third group of loans was structured in a way that borrowers have to repay the loan only at the end of the loan maturity with options to prolong the loan tenor. The quality of these loans is highly unpredictable as there is no repayment at present. Top management of most banks realized this sharp deterioration in loan portfolio quality but started very late to address the problem on an institutional level. The International Finance Corporation (World Bank Group) supports a number of banks in establishing functioning loan risk departments. It also supported the establishment of a new association of risk professionals (ARPA). It remains to be seen to what extent these measures and support on the level of private commercial banks will be fruitful.

## Weaknesses of the Current Economic System and Outlook

In spite of all the successes Azerbaijan can show on a macroeconomic and fiscal level, the system faces severe qualitative and quantitative weaknesses which are currently only covered by the extraordinary high oil revenues. Corruption and an opaque allocation of wealth are still in full swing on all levels of the society and economy. The non-oil business and the political system are highly intransparent and prevent non-oil FDI inflow and growth. The macroeconomic environment and fiscal outcomes are—as seen above—volatile due to the high dominance of oil and the related high dependence on commodity prices in a still small economy with only a limited set of instruments to mitigate the problems. If we exclude the oil-related GDP and budget revenues, we see a high non-oil primary budget deficit of 39% of non-oil GDP in 2009. The non-oil economy and especially the banking sector are still weakly integrated into the global financial system. Notwithstanding the relatively strong official figures of the banking sector in the crisis, the sector now has a bumpy road ahead in managing its asset quality and liquidity (independently from CBA resources) and strengthening risk management as well as improving sector-wide governance. The Central Bank should, on the other hand, also keep an eye on sector liquidity and withdraw liquidity support as financial sector health improves, so as to limit fiscal risks and prevent an up-tick in inflation.

The limited impacts of the global crisis on Azerbaijan proved the government's adequate policy response in principle. It also showed that the country generally is on

9 Developments and statistical analysis in the banking market are always accompanied by a significant level of distortion due to the huge market share of the one state-owned bank with a balance sheet almost half as big as the total sector.

10 Defined as the outstanding loan amount of a loan, which is overdue by more than 30 days (which in case of a standard loan usually means that one monthly installment was not paid).

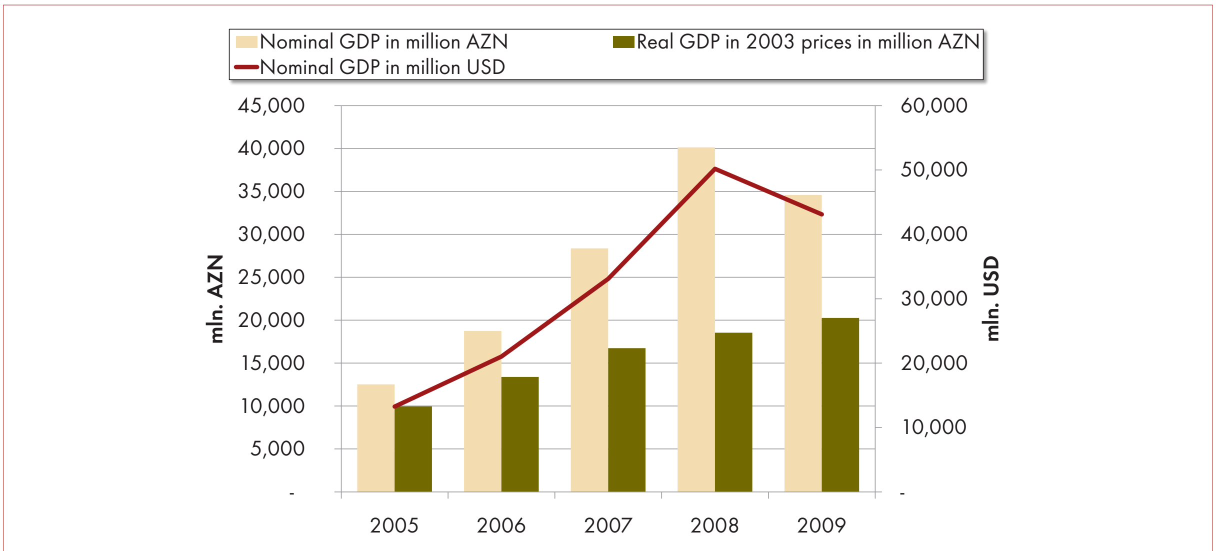
the right path to a stable fiscal and macroeconomic position. Medium-term prospects for growth are also decent. However, government authorities and policy-makers should keep in mind that, with depleting oil resources in the next 15–20 years, this is no perpetual motion machine in the long run. Azerbaijan's economic strategy has to concentrate on one big issue: diversification, diversification and again diversification. This can be accelerated through additional improvements in the business climate. Structural reforms are required through further tax and customs modernization, strengthening of the financial sector and good governance. As a consequence, those reforms should also bring down the still persistent and high level of corruption.

*About the Author*
Gerald Hübner works at KfW Entwicklungsbank, the German development bank. He is project manager for private and financial sector development in Eastern Europe and the Caucasus..This article expresses the opinion of the author and does not necessarily represent the position of KfW.

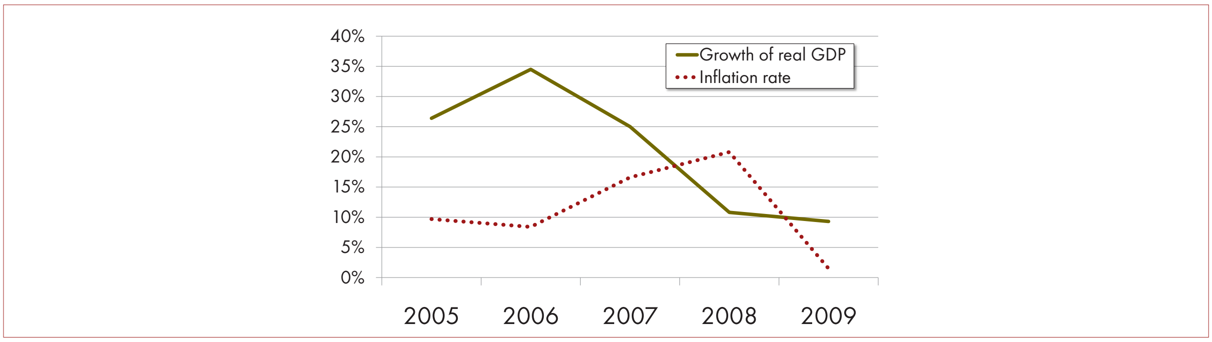
## Tables and Diagrams

# Macroeconomic and Financial Indicators of Azerbaijan 2005–2009

### Figure 1: Nominal and Real GDP 2005–2009




### Figure 2: Growth of Real GDP and Inflation Rate 2005–2009




*Source: State Statistical Committee of the Azerbaijan Republic, Central Bank of the Azerbaijan Republic, International Monetary Fund*

### Table 1: Main Macroeconomic Indicators 2005–2009

| | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|
| Nominal GDP in million AZN | 12,523 | 18,746 | 28,361 | 40,137 | 34,579 |
| Nominal GDP in million USD | 13,245 | 21,027 | 33,090 | 50,172 | 43,111 |
| Real GDP in 2003 prices in million AZN | 9,955 | 13,389 | 16,742 | 18,544 | 20,268 |
| Growth of real GDP | 26.4% | 34.5% | 25.0% | 10.8% | 9.3% |
| Inflation rate | 9.7% | 8.4% | 16.6% | 20.8% | 1.5% |

*Source: State Statistical Committee of the Azerbaijan Republic, Central Bank of the Azerbaijan Republic, International Monetary Fund*

### Table 2: SOFAZ: Development of Assets and Revenues

| Year | Assets (million AZN) | Assets (million USD) | Assets in % of GDP | Revenues (million AZN) | Revenue in % of GDP | Transfers to the state budget (million AZN) |
|---|---|---|---|---|---|---|
| 2007 | 2,088 | 2,456 | 7.4% | 1,790 | 6.3% | 585 |
| 2008 | 9,010 | 11,219 | 22.4% | 11,633 | 29.0% | 3,800 |
| 2009 | 11,967 | 14,900 | 34.6% | 8,177 | 23.6% | 4,915 |
| Q1/2010 | 13,050 | 16,243 | | 2,746 | | 1,225 |

*Source: Financial Statements 2007 and 2008 (audited), 2009 and 2010 unaudited figures of SOFAZ (*http://www.oilfund.az*)*

### Table 3: Development of State Budget 2005–2009 (in million AZN (unless stated otherwise))

| | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|
| GDP | 12,522.5 | 18,746.2 | 28,361.0 | 40,137.2 | 34,578.7 |
| ***Revenues total*** | ***2,055.2*** | ***3,868.8*** | ***6,006.6*** | ***10,762.7*** | ***10,325.9*** |
| of which transfer from SOFAZ | 200.0 | 400.0 | 585.0 | 3,800.0 | 4,915.0 |
| ***Revenues w/o SOFAZ*** | ***1,855.2*** | ***3,468.8*** | ***5,421.6*** | ***6,962.7*** | ***5,410.9*** |
| ***Expenditures total*** | ***2,140.7*** | ***3,790.1*** | ***6,086.2*** | ***10,774.2*** | ***10,567.9*** |
| of which finance of national economy | 444.7 | 1,246.9 | 2,350.0 | 4,958.6 | 4,373.9 |
| of which finance of social and cultural activities | 843.3 | 1,049.7 | 1,670.3 | 2,312.5 | 2,763.0 |
| ***State Budget Balance with SOFAZ transfers*** | ***-0.7%*** | ***0.4%*** | ***-0.3%*** | ***0.0%*** | ***-0.7%*** |
| ***State Budget Balance w/o SOFAZ transfers*** | ***-2.3%*** | ***-1.7%*** | ***-2.3%*** | ***-9.5%*** | ***-14.9%*** |

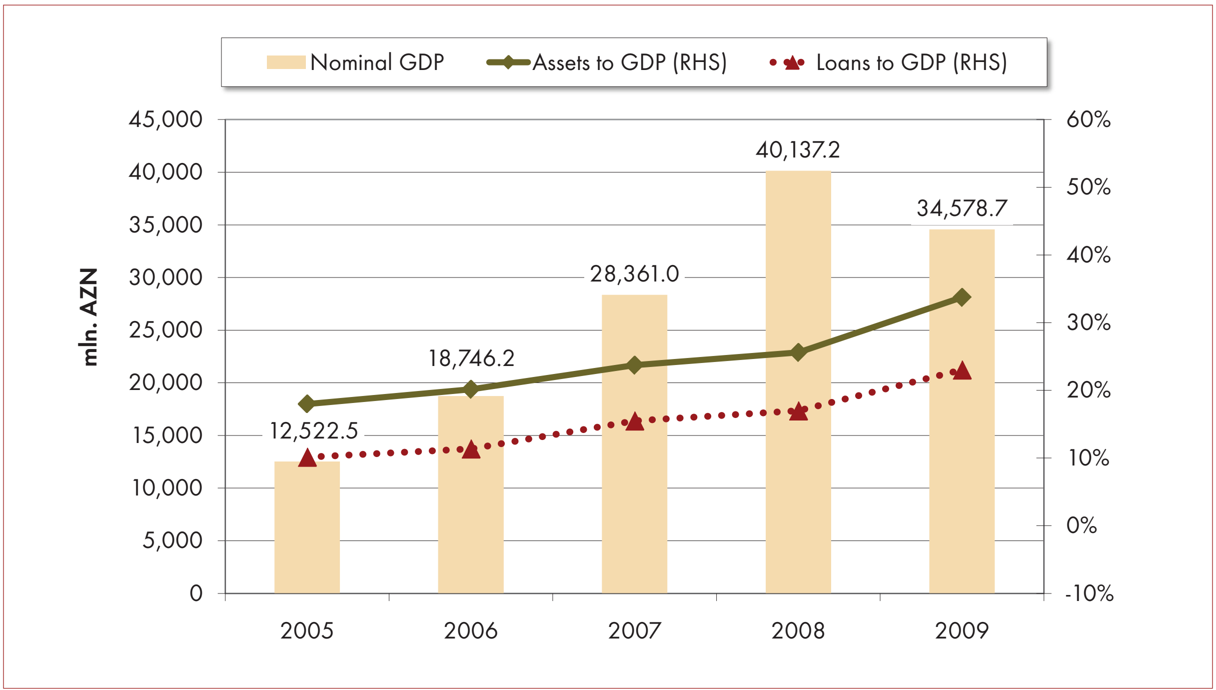
*Source: State Statistical Committee of the Azerbaijan Republic,* http://www.azstat.org/publications/azfigures/2010/en/010.shtml

**Table 4: Nominal GDP Development and Banking Sector Penetration (in million AZN, unless stated otherwise)**

| | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|
| Nominal GDP | 12,523 | 18,746 | 28,361 | 40,137 | 34,579 |
| Nominal GDP in million USD | 13,245 | 21,027 | 33,090 | 50,172 | 43,111 |
| Assets | 2,252 | 3,778 | 6,726 | 10,274 | 11,665 |
| Credits (netto) to Costumers | 1,269 | 2,129 | 4,394 | 6,817 | 7,964 |
| Assets to GDP | 18.0% | 20.2% | 23.7% | 25.6% | 33.7% |
| Loans to GDP | 10.1% | 11.4% | 15.5% | 17.0% | 23.0% |

*Source: State Statistical Committee of the Azerbaijan Republic, Central Bank of the Azerbaijan Republic, International Monetary Fund*

**Figure 3: Nominal GDP Development and Banking Sector Penetration**



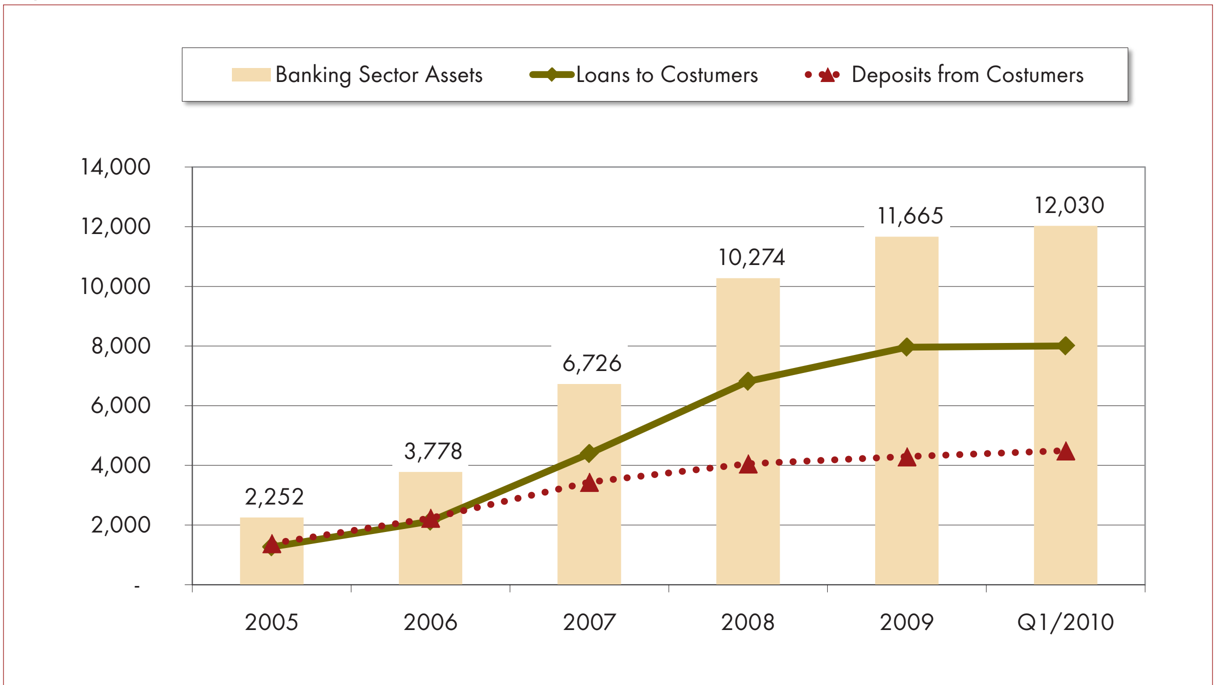

*Source: State Statistical Committee of the Azerbaijan Republic, Central Bank of the Azerbaijan Republic, International Monetary Fund*

**Table 5: Business Growth of Azerbaijani Banks (in million AZN, unless stated otherwise)**

| | 2005 | 2006 | 2007 | 2008 | 2009 | Q1/2010 |
|---|---|---|---|---|---|---|
| Assets | 2,252 | 3,778 | 6,726 | 10,274 | 11,665 | 12,030 |
| Cash and Cash equivalents | 572 | 943 | 979 | 1,420 | 1,311 | 1,651 |
| Credits (netto) to Costumers | 1,269 | 2,129 | 4,394 | 6,817 | 7,964 | 8,005 |
| Liabilities | 1,864 | 3,175 | 5,628 | 8,569 | 9,660 | 10,035 |
| Deposits from Costumers | 1,381 | 2,233 | 3,438 | 4,055 | 4,293 | 4,493 |
| Liabilities to FS (Dep.+Credits) | 316 | 736 | 1,720 | 3,265 | 4,478 | 4,774 |
| *of which Foreign Liabilities* | *158* | *408* | *972* | *2,049* | *1,932* | *2,234* |
| Caital (Equity) | 388 | 603 | 1,098 | 1,705 | 2,005 | 1,995 |
| Capital Adequacy Ratio | 17.2% | 16.0% | 16.3% | 16.6% | 17.2% | 16.6% |
| Foreign Liabilities in % of Total Liabilities | 8.5% | 12.9% | 17.3% | 23.9% | 20.0% | 22.3% |

*Source: State Statistical Committee of the Azerbaijan Republic, Central Bank of the Azerbaijan Republic, International Monetary Fund*

**Figure 4: Business Growth of Azerbaijani Banks**



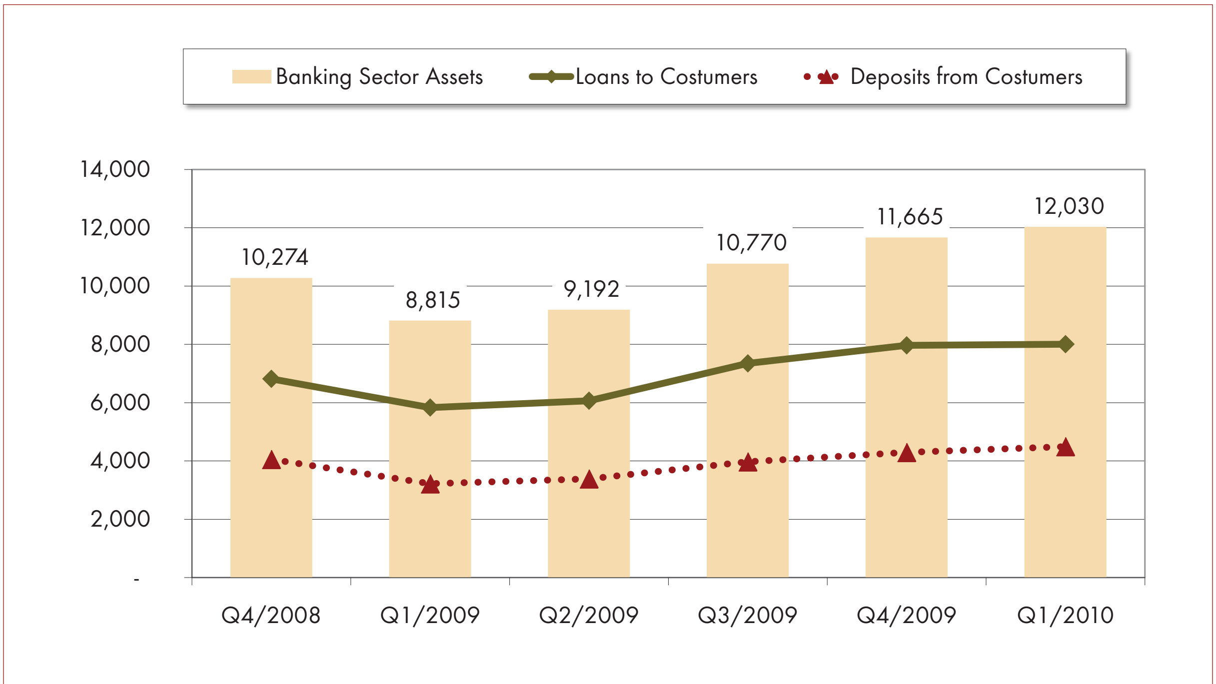

*Source: State Statistical Committee of the Azerbaijan Republic, Central Bank of the Azerbaijan Republic, International Monetary Fund*

## Table 6: Business Growth of Azerbaijani Banks in 2009 (in million AZN, unless stated otherwise)

| | Q4/2008 | Q1/2009 | Q2/2009 | Q3/2009 | Q4/2009 | Q1/2010 |
|---|---|---|---|---|---|---|
| Assets | 10,274 | 8,815 | 9,192 | 10,770 | 11,665 | 12,030 |
| Cash and Cash equivalents | 1,420 | 986 | 941 | 1,106 | 1,311 | 1,651 |
| Credits (netto) to Costumers | 6,817 | 5,833 | 6,066 | 7,346 | 7,964 | 8,005 |
| Liabilities | 8,569 | 7,028 | 7,332 | 8,817 | 9,660 | 10,035 |
| Deposits from Costumers | 4,055 | 3,219 | 3,388 | 3,972 | 4,293 | 4,493 |
| Liabilities to FS (Dep.+Credits) | 3,265 | 2,929 | 3,038 | 3,930 | 4,478 | 4,774 |
| of which Foreign Liabilities | 2,049 | 1,909 | 1,845 | 1,797 | 1,932 | 2,234 |
| Caital (Equity) | 1,705 | 1,787 | 1,860 | 1,952 | 2,005 | 1,995 |
| Capital Adequacy Ratio | 16.6% | 20.3% | 20.2% | 18.1% | 17.2% | 16.6% |
| Foreign Liabilities in % of Total Liabilities | 23.9% | 27.2% | 25.2% | 20.4% | 20.0% | 22.3% |

*Source: State Statistical Committee of the Azerbaijan Republic, Central Bank of the Azerbaijan Republic, International Monetary Fund*

## Figure 7: Business Growth of Azerbaijani Banks in 2009




*Source: State Statistical Committee of the Azerbaijan Republic, Central Bank of the Azerbaijan Republic, International Monetary Fund*

**Macro-economic and Banking Sector Data (in million AZN, unless stated otherwise)**

| | 2005 | 2006 | 2007 | 2008 | 2009 | Q1/2010 |
|---|---|---|---|---|---|---|
| Nominal GDP | 12,523 | 18,746 | 28,361 | 40,137 | 34,579 | n.a. |
| Nominal GDP in million USD | 13,245 | 21,027 | 33,090 | 50,172 | 43,111 | n.a. |
| Real GDP in 2003 prices | 9,955 | 13,389 | 16,742 | 18,544 | 20,268 | |
| Growth of real GDP | 26.4% | 34.5% | 25.0% | 10.8% | 9.3% | 5.4% |
| Consumer Price Index for AZN | 9.7% | 8.4% | 16.6% | 20.8% | 1.5% | 3.8% |
| Consumer Price Index for USD | 3.4% | 3.2% | 2.8% | 3.8% | -0.4% | 3.4% |
| Assets | 2,252 | 3,778 | 6,726 | 10,274 | 11,665 | 12,030 |
| Cash and Cash equivalents | 572 | 943 | 979 | 1,420 | 1,311 | 1,651 |
| Credits (netto) to Costumers | 1,269 | 2,129 | 4,394 | 6,817 | 7,964 | 8,005 |
| Liabilities | 1,864 | 3,175 | 5,628 | 8,569 | 9,660 | 10,035 |
| Deposits from Costumers | 1,381 | 2,233 | 3,438 | 4,055 | 4,293 | 4,493 |
| Liabilities to FS (Dep.+Credits) | 316 | 736 | 1,720 | 3,265 | 4,478 | 4,774 |
| Caital (Equity) | 388 | 603 | 1,098 | 1,705 | 2,005 | 1,995 |
| Capital Adequacy Ratio | 17.2% | 16.0% | 16.3% | 16.6% | 17.2% | 16.6% |
| Foreign Liabilities | 158 | 408 | 972 | 2,049 | 1,932 | 2,234 |
| Foreign Liabilities in million USD | 172 | 469 | 1,157 | 2,561 | 2,415 | 2,792 |
| % of total liabilities | 8.5% | 12.9% | 17.3% | 23.9% | 20.0% | 22.3% |
| overdue amounts | 68 | 78 | 100 | 160 | 304 | 356 |
| gross loan amount | 1,337 | 2,206 | 4,494 | 6,977 | 8,267 | 8,361 |
| overdue amounts/gross loan port | 5.10% | 3.52% | 2.23% | 2.29% | 3.67% | 4.26% |
| Assets to GDP | 18.0% | 20.2% | 23.7% | 25.6% | 33.7% | n.a. |
| Loans to GDP | 10.1% | 11.4% | 15.5% | 17.0% | 23.0% | n.a. |

*Source: State Statistical Committee of the Azerbaijan Republic, Central Bank of the Azerbaijan Republic, International Monetary Fund*

# Georgia: Continued Reverberations of the Crisis

By Revaz Sakevarishvili, Tbilisi


## Abstract

The economic situation in Georgia is continuing to deteriorate. GDP shrunk 3.9% in 2009. Most importantly, foreign investment has dropped off considerably. Foreign loans have replaced this investment, but such assistance is likely to run out by the end of the year. At the same time many domestic projects are on hold due to a lack of capital, foreign remittances are dropping as a result of the on-going international crisis and the Georgian currency is losing value.


## Georgia's Economy is Shrinking

Few people trust official statistics in Georgia since they are either too optimistic or designed to fit the wishes of the government. But even official statistics cannot hide trends in Georgia during the last few years driven by the 2008 War and the global financial crisis.

According to Georgia's official statistics agency, SakStat, Gross Domestic Product dropped 3.9% in 2009 to 17.9 billion GEL (9.7 billion USD); GDP per capita fell to 4,092 GEL (2,200 USD) (for comparison: in 2008 GDP was 19.7 billion GEL and GDP per capita was 4,353 GEL). The main concern is not just the falling GDP, but the fact that while Georgia is moving toward liberalism and deregulation, the state still makes up the largest share of the economy—public administration comprises 16% of the economy, surpassing industry (15%), trade (14%), transport and communication (12%) and agriculture (10%).

In 2009, when Georgia started spending the 4.5 billion USD mobilized by the Donor Conference in Brussels, the state was the biggest player in economy. As events evolved, state spending was supposed to increase the size of the economy by 4%. The current budget and investment statistics point exactly to that.

## Foreign Investments Are Crucial

In 2009, the government had to cut the state budget twice—first by 500 million GEL and then by 120 million GEL, bringing it down to 7.18 billion GEL overall. As for the 2010 budget, planners determined that is would be 6.76 billion GEL, 440 million GEL less than the 2009 budget. In other words, the budget of Georgia rapidly dropped by more than 1 billion GEL from its previous size. No less important is the fact that in 2010 the state budget has one unique characteristic: every fourth lari to be spent—25% of the budget—comes from foreign loans. The Georgian government is trying to expand the country's GDP through foreign borrowing. It is simple arithmetic: in 2007, at the peak of investment activities, foreign investments in Georgia comprised 2 billion USD. In 2008, this figure fell to 1.56 billion GEL, and in 2009 it dropped even more—to 760 million GEL.

Currently the billions accumulated at the Brussels Conference compensate for the lack of investments. However, though this support continues through the end of this year, there is nothing to replace it.

Due to its small size, Georgia will never become an economy that can survive based on the consumption of its domestic market. On the other hand, Georgia does not have sufficient exportable resources enabling it to take a leading economic position on the global stage. Consequently, foreign investments are critically important for Georgia, since they can ensure its sustainable development.

The significant growth the Georgian economy achieved in 2004—2008 was mainly the result of foreign investments. At that time, they reflected a growing trend: in 2005, 450 million USD were invested into Georgia, in 2006—1.19 billion USD and in 2007, 2.14 billion USD. The 12% increase achieved in 2007, ensuring a high rating for Georgia, was the result of efforts provided by the private businesses which sustained these investments. While current increases are ensured by the big infrastructure projects sponsored by the state, most of these projects are financed from resources obtained through foreign loans. Without new money to replace the funds collected at the donor conference, failure for the Georgian economy is inevitable.

## Few Sources of Local Capital

There are numerous difficulties facing efforts to increase locally generated resources. The crisis is continuing in several market segments. One example is illustrative: The Revenue Service of the Ministry of Finances drew up payment agreements (basically debt restructuring plans) with more than 50 companies in the first five months of 2010, with a total value exceeding 10 million GEL.

According to the Revenue Service, the number of applications from companies is constantly increasing and by mid-June 2010, approximately 600 companies had expressed a desire to restructure their debts. This practice became possible following the amendment made to the Tax Code on 21 December 2009, which promised entrepreneurs with debts greater than 10,000 GEL, the possibility to restructure their debt rather than the need for bankruptcy. Now several companies are applying to the Ministry of Finances each day with a request to use this scheme. Investors are also applying to the state asking it to defer their debt obligations.

### Tax-Free Industrial Zones Not Developing

As many companies are struggling with debt, the government has had little success in launching tax-free industrial zones. In the most recent setback, the presentation of the Poti tax-free industrial zone was delayed. The operator of this industrial zone, "RAK Georgia Holding," did not explain the delay, but it most likely was the result of the overall economic conditions.

Currently, Tbilcement is the only Georgian company operating in the Poti zone. According to the government, 22 Georgian companies should construct new enterprises in the zone. Additionally, the South Korean company LG—a leader in the production of the consumer electronics—is expected to open a plant there.

Overall, of the six planned industrial zones, only the one in Kutaisi is operating, though with shortcomings. The fortune of Kutaisi's second industrial zone, to be constructed by the Chinese company Hungly Industry remains uncertain. The Israeli company Terra—1 has not yet started construction on the Tbilisi zone. Construction should have started in autumn 2009, but definitive plans are not yet in place. The situation is the same with the Rustavi industrial zone. An Estonian business group bought the territory of the former Chimbochko factory for its construction in 2007, though again no actual work has begun. The construction of one more industrial zone was planned in Khelvachauri, but the government of Ajara never found an investor interested in developing it.

### Projects on Hold

The crisis is also visible in projects started and frozen in Tbilisi years ago. The construction of the five star Inter Continental Hotel in Tbilisi has been terminated due to a lack of necessary investment. The construction of the Hyatt is also frozen and the management has not specified a resumption date. It should be finished this year, though the financial crisis halted construction. Additionally, the total cost of the project was cut from 150 million USD to just 70 million USD. All these projects should have been implemented by direct foreign investment, but now there is little hope in this regard.

Official statistics continue to reveal alarming trends. The volume of investments made in the first quarter of 2010 was the smallest in the last five quarters. According to SakStat, in January–March 2010, compared to same period of 2009, the volume of investments made in Georgia fell about 42% and comprised just 76 million USD, while in the first quarter of 2009 this figure reached 130 million USD. If we compare the data from the first quarter of this year with the previous quarter, the decrease is even larger—exceeding 70%. The volume of investments comprised 254 million USD in the fourth quarter of 2009.

### Investment Falls Short of Expectations

Given the relative success of the fourth quarter 2009—254 million USD—the Georgian government expected investments of at least of the same volume this year, ultimately totaling 1 billion USD annually. Unfortunately, actual investment comprised just 7% of what was anticipated in the first quarter of this year.

The countries investing in Georgia have changed radically from previous years. According to the data from the first quarter of 2010, the biggest investor in the country is Turkey, with investments making up 26.8% of the total. Previously, Turkey had invested 30.3 million USD in Georgia, a relatively low figure for this country. According to the volume of investments, the Czech Republic occupies second place with investments of 18.8 million USD, which is 26.1% of the total investments made in the first quarter. Third is Egypt with 18 million USD—23.8%, then comes Japan with 20.7%, followed by a variety of other countries with minor investments. It is obvious that the leaders of the previous years—the United Arab Emirates, Holland, Great Britain, Cyprus, Denmark, China, Kazakhstan and Azerbaijan are no longer active.

The slumping investor interest caused the government to trim back its privatization plan. This plan has been steadily decreasing for several months already. According to the changes made to the 2010 budget, the government cut the privatization plan from 210 to 170 million USD. In the first quarter, income from privatization was 21 million; accordingly it is hard to say that the plan will be implemented when just 10% was carried out in the first quarter. The privatization plan results for 2009 were also terrible: the Ministry of Economy managed to collect just 30 million GEL out of the planned 70 million.

## Size of Remittances Shrinking

The amount of money sent home by Georgian workers abroad has been dropping. The volume of money transfers from abroad fell from 74.4 million USD in April 2010 to 71.1 million USD in May 2010. Clearly, processes taking place in international markets are impacting the domestic situation in Georgia, reflecting the greater integration of Georgia's economic and labor resources in the world economy.

For example, the recent crisis in Greece has had a serious impact on the welfare of a significant part of the Georgian population. Greece is one of the leaders in the list of countries in which the share of Georgian labor migrants is high. This flow had been increasing until recently. There are no statistical data regarding legal or illegal labor migrants traveling to Greece, however, according to informal statistics, the number of Georgian migrants in Greece might be 100,000—150,000.

Thanks to the economic crisis, the condition of the Georgian labor migrants in Greece has become much more difficult. Many enterprises are being closed and people are losing jobs, including many Georgians. Even the salaries of those who continue to work, especially women employed as cleaners or nurses, are falling by as much as 50%.

All these problems are directly reflected in the money flows coming to Georgia from Greece and threatening the financial welfare of many families in Georgia who depend on this income. The money transfers from Greece comprise more than 7% of the total transfers from abroad and rank third behind flows from Russia and the US. Most likely, Greece's position will drop significantly due to its deepening crisis.

## Georgian Currency Weakening

This series of negative external and internal events has inevitably weakened the value of the Georgian currency. The lari has declined steadily from the beginning of the year to the middle of June, depreciating 10% against the dollar during the last five months. The Monetary Policy Committee increased the interest rate from 5% to 6.25% in the middle of June. The 5% rate had been in effect since 25 November 2009; before that, starting in July 2008 it had been steadily decreasing and gradually was reduced to 5% from 12%. Now, the 5% rate that had been in effect for 6.5 months has started to rise significantly. The Monetary Policy Committee made the abovementioned decision at an extraordinary meeting held earlier than planned. The Committee members acted in order to prevent high levels of inflation. In May 2010 the annual inflation indicator was 4%. Committee members feared that inflation would jump to 6% unless they took action.

In June, the annual increase of the money aggregate M3 exceeded 40%. The government says that the increase of the money supply resulted from the fiscal stimulus of the economy, on one hand, and the flow of credits into the economy, increased from the beginning of this year, on the other. Much of this spending resulted from political efforts prior to the elections. The risks of inflation rise when the increase in the money mass starts to outpace economic growth.

According to the preliminary data, the commodity trade deficit deepened in May, like in March and April, which was the result of domestic demand. The deepening trade deficit, lower-than-expected capital inflows in the first part of the year and the appreciation of the dollar on the world market caused the depreciation of the Georgian lari against the dollar.

Taking into consideration the factors mentioned above and in order to keep inflation within the targeted level in the midterm period, the Monetary Policy Committee of the World Bank decided to adopt a stricter policy toward Georgia. This decision is yet another indicator of the worsening economic situation in the country.

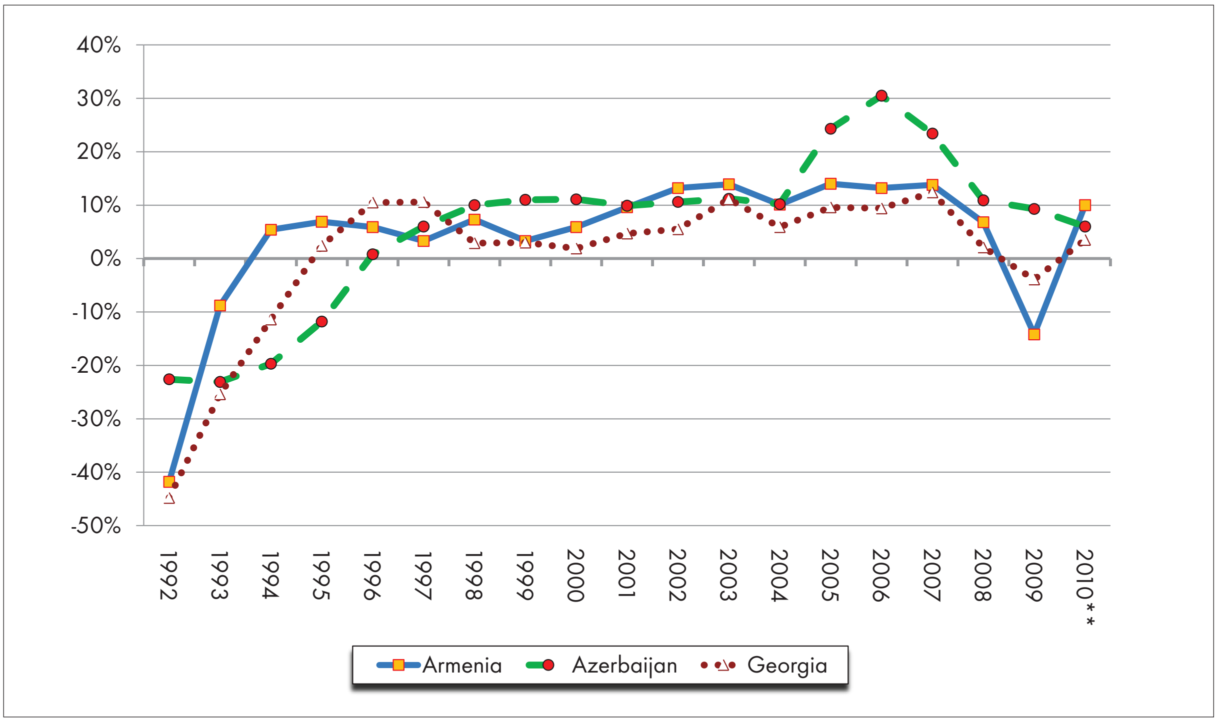
*About the Author*

Revaz Sakevarishvili is a director of the Econometer analytical center, author & anchor of Capital TV show on Imedi TV, and economics analyst of Radio Free Europe/Radio Liberty.

## Statistics

# Macroeconomic and Financial Indicators of Armenia, Azerbaijan and Georgia in Comparison, 1992–2010

### Figure 1: Real GDP Growth Rates for Armenia, Azerbaijan and Georgia 1992–2010 (in %)




| | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|---|---|---|---|---|
| Armenia | -41.8% | -14.0% | 5.4% | 6.9% | 5.9% | 3.3% | 7.3% | 3.3% | 5.9% | 9.6% |
| Azerbaijan | -22.6% | -23.1% | -19.7% | -11.8% | 0.8% | 6.0% | 10.0% | 11.0% | 11.1% | 9.9% |
| Georgia | -44.8% | -25.4% | -11.4% | 2.4% | 10.6% | 10.6% | 2.9% | 3.0% | 1.9% | 4.7% |

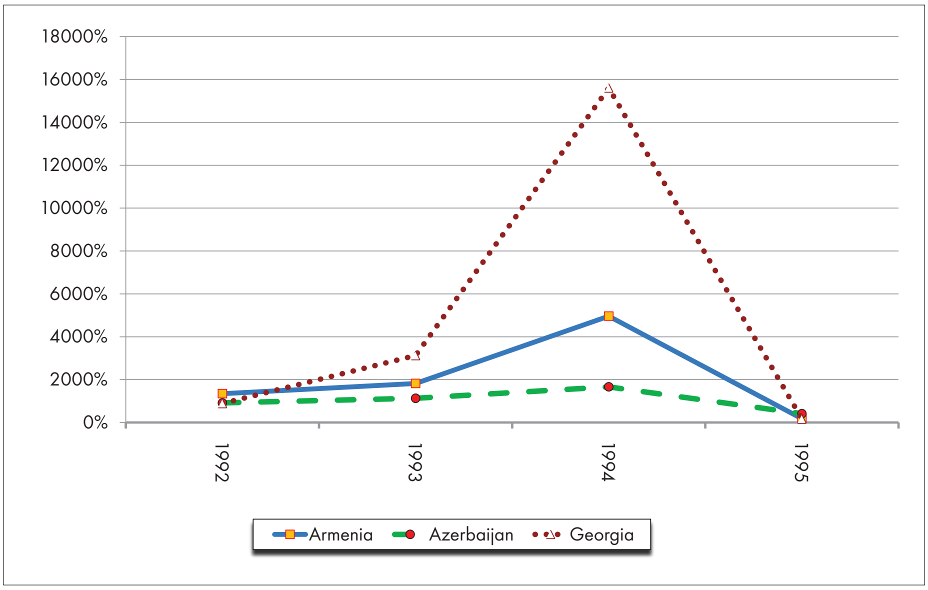
| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010** |
|---|---|---|---|---|---|---|---|---|---|
| Armenia | 13.2% | 13.9% | 10.1% | 14.0% | 13.2% | 13.8% | 6.8% | -14.2% | 10.0% |
| Azerbaijan | 10.6% | 11.2% | 10.2% | 24.3% | 30.5% | 23.4% | 10.9% | 9.3% | 6.0% |
| Georgia | 5.5% | 11.1% | 5.9% | 9.6% | 9.4% | 12.4% | 2.1% | -3.9% | 3.5% |

*** = forecast as of May 2010*

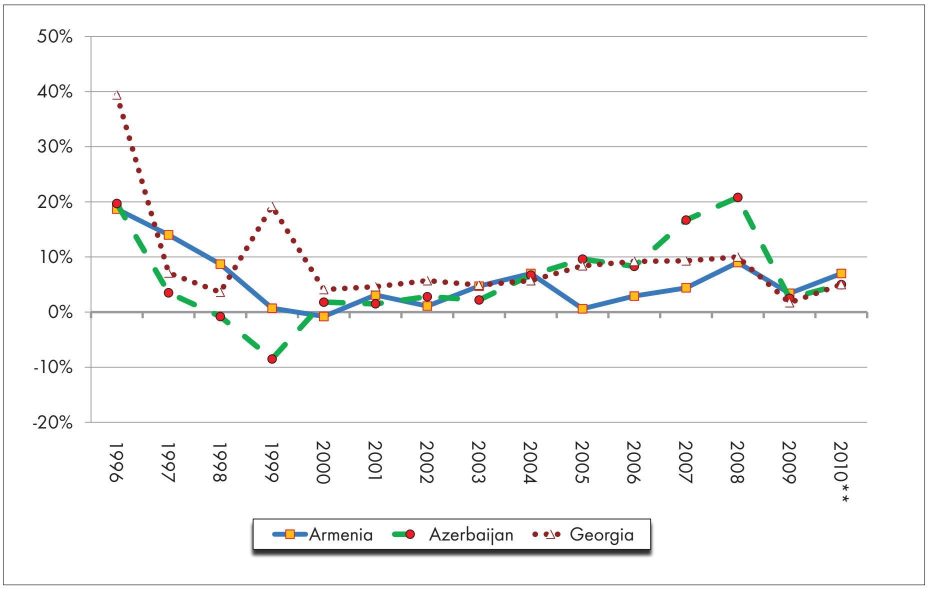
*Source: EBRD Economic Analyses and Forecasts* http://www.ebrd.com/pages/research/analysis/forecasts.shtml

**Figure 2: Consumer Prices Inflation 1992–2009 Armenia, Azerbaijan, Georgia (annual average, percentage change)**

**1992–1995**




**1996–2009**

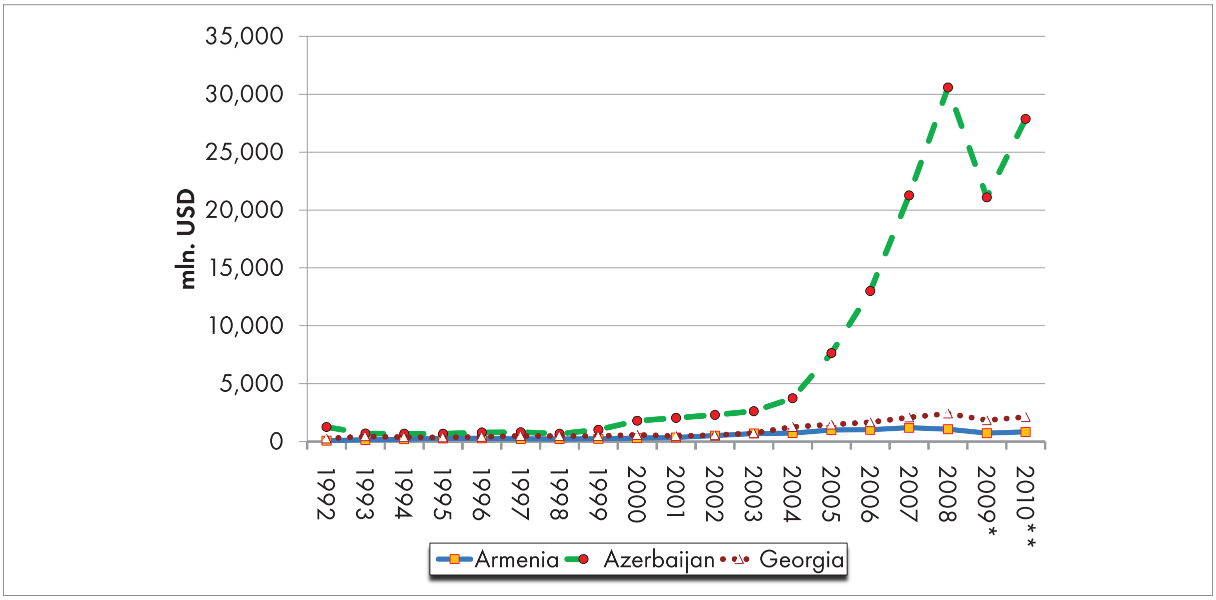



| | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|---|---|---|---|---|
| Armenia | 1346.0% | 1822.0% | 4962.0% | 175.8% | 18.7% | 14.0% | 8.7% | 0.7% | -0.8% | 3.1% |
| Azerbaijan | 912.0% | 1129.0% | 1664.0% | 489.9% | 19.7% | 3.5% | -0.8% | -8.5% | 1.8% | 1.5% |
| Georgia | 887.4% | 3125.4% | 15606.5% | 162.7% | 39.4% | 7.1% | 3.6% | 19.2% | 4.1% | 4.6% |

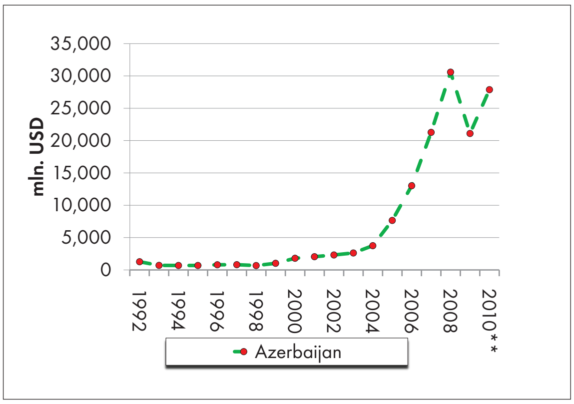
| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010** |
|---|---|---|---|---|---|---|---|---|---|
| Armenia | 1.1% | 4.7% | 7.0% | 0.6% | 2.9% | 4.4% | 9.0% | 3.4% | 7.0% |
| Azerbaijan | 2.8% | 2.2% | 6.7% | 9.6% | 8.3% | 16.7% | 20.8% | 2.5% | 5.0% |
| Georgia | 5.7% | 4.9% | 5.7% | 8.4% | 9.2% | 9.3% | 10.0% | 1.7% | 5.0% |

*** forecast as of May 2010; source: EBRD Economic Analyses and Forecasts* http://www.ebrd.com/pages/research/analysis/forecasts.shtml

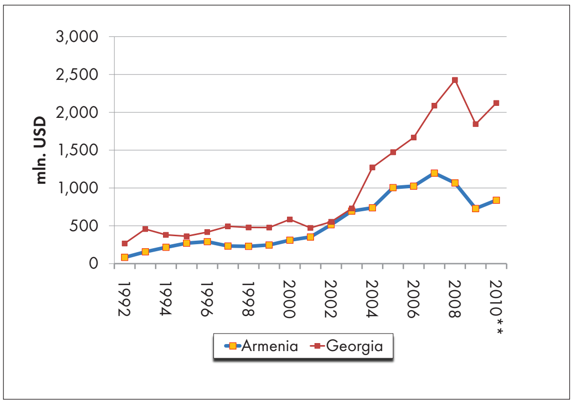
**Figure 3: Merchandise Export 1992–2009 Armenia, Azerbaijan, Georgia (mln. US dollars)**




**Merchandise Export 1992–2009 Azerbaijan (mln. US dollars)**




**Merchandise Export 1992–2009 Armenia and Georgia (mln. US dollars)**

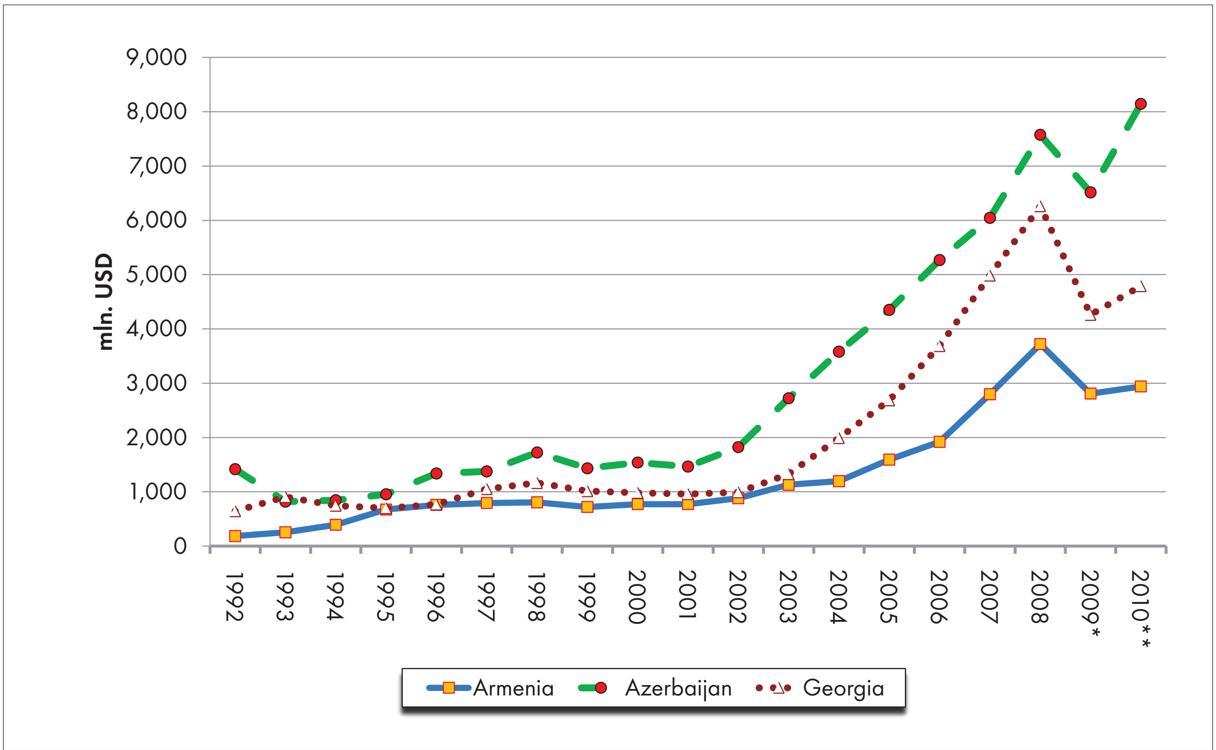



| | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|---|---|---|---|---|
| Armenia | 82.9 | 156.2 | 215.4 | 270.9 | 290.4 | 233.6 | 228.9 | 247.3 | 309.9 | 353.1 |
| Azerbaijan | 1263 | 697 | 682 | 680 | 789 | 808.3 | 677.8 | 1025.2 | 1799 | 2046 |
| Georgia | 266.6 | 457 | 380.7 | 362.6 | 417 | 493.5 | 478.3 | 477 | 584 | 473 |

| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009* | 2010** |
|---|---|---|---|---|---|---|---|---|---|
| Armenia | 513.8 | 696.1 | 738.3 | 936.9 | 1025 | 1197 | 1066 | 729 | 838 |
| Azerbaijan | 2305 | 2625 | 3743 | 7649 | 13014 | 21269 | 30586 | 21097 | 27874 |
| Georgia | 553 | 730 | 1272 | 1472 | 1667 | 2088 | 2428 | 1844 | 2124 |

** = preliminary data, ** = projection; sources: EBRD (until 2007), IMF (from 2008)*

**Figure 4: Merchandise Import 1992–2009 Armenia, Azerbaijan, Georgia (mln. US dollars)**

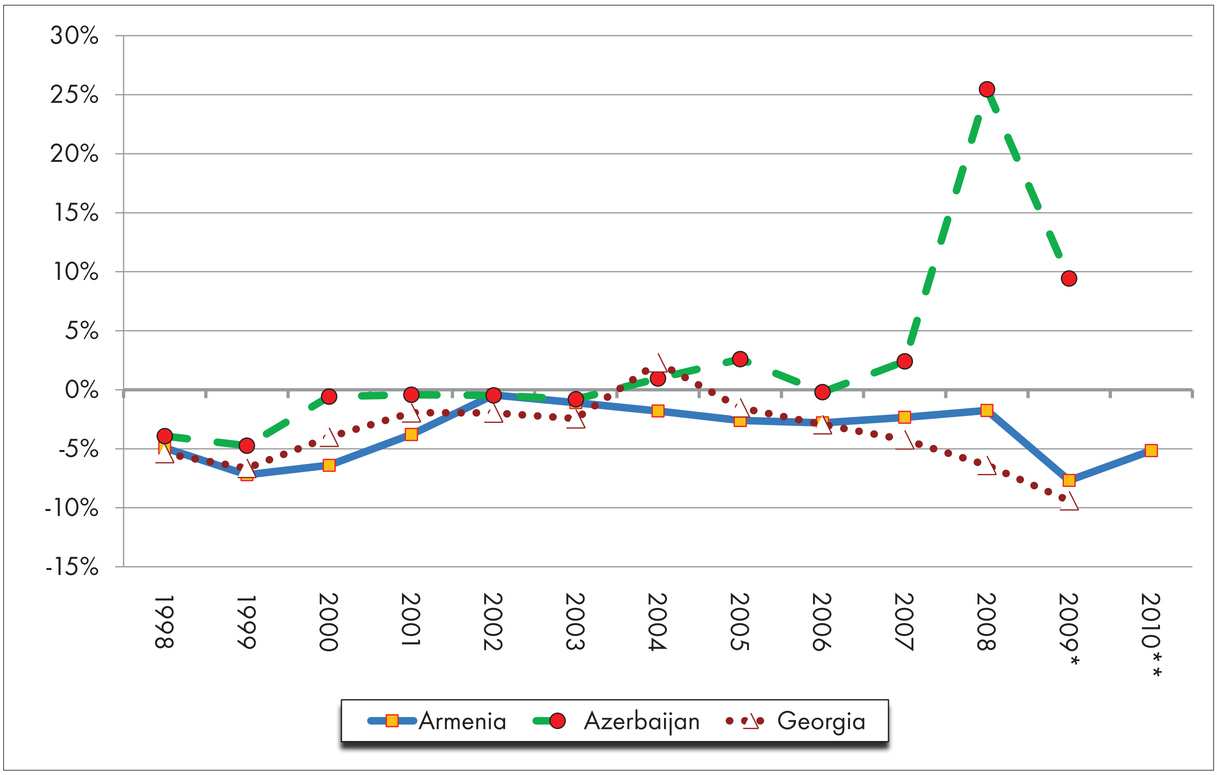



| | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|---|---|---|---|---|
| Armenia | 185.3 | 254.2 | 393.6 | 673.9 | 759.6 | 793.1 | 806.3 | 721.4 | 773.4 | 773.3 |
| Azerbaijan | 1417 | 819 | 845 | 955 | 1338 | 1375.2 | 1723.9 | 1433.4 | 1539 | 1465 |
| Georgia | 644.5 | 905.3 | 745.7 | 700.1 | 767.9 | 1052.4 | 1163.7 | 1013 | 982 | 959 |

| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009* | 2010** |
|---|---|---|---|---|---|---|---|---|---|
| Armenia | 882.5 | 1130.2 | 1196.3 | 1921 | 2194 | 2797 | 3720 | 2809 | 2940 |
| Azerbaijan | 1823 | 2722.7 | 3581 | 4350 | 5269 | 6045 | 7575 | 6514 | 8144 |
| Georgia | 992 | 1328 | 1991 | 2686 | 3686 | 4984 | 6261 | 4260 | 4789 |

** = preliminary data, ** = projection; sources: EBRD (until 2007), IMF (from 2008)*

**Figure 5: General Government Balances 1998–2010 Armenia, Azerbaijan, Georgia (percent of GDP)**



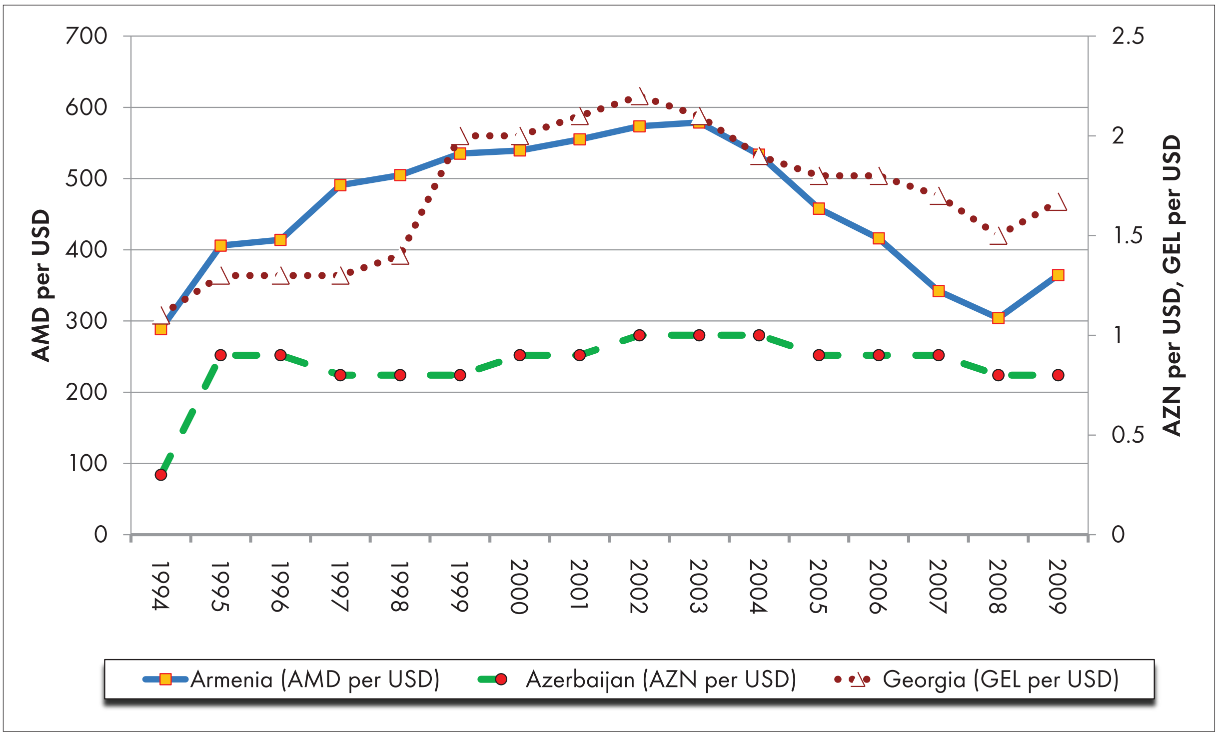

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|---|---|---|
| Armenia | -4.9% | -7.2% | -6.4% | -3.8% | -0.4% | -1.1% | -1.8% | -2.6% | -2.8% |
| Azerbaijan | -3.9% | -4.7% | -0.6% | -0.4% | -0.5% | -0.8% | 1.0% | 2.6% | -0.2% |
| Georgia | -5.4% | -6.7% | -4.0% | -1.9% | -2.0% | -2.5% | 2.3% | -1.5% | -3.0% |

| | 2007 | 2008 | 2009* | 2010** |
|---|---|---|---|---|
| Armenia | -2.3% | -1.8% | -7.7% | -5.2% |
| Azerbaijan | 2.4% | 25.5% | 9.4% | na |
| Georgia | -4.2% | -6.4% | -9.4% | na |

** = estimate, ** = projection*

*Source: EBRD Economic Analyses and Forecasts* http://www.ebrd.com/pages/research/analysis/forecasts.shtml

**Figure 6: Foreign Exchange Rate 1994–2009 Armenia, Azerbaijan, Georgia (annual average, in dram, manat and lari per US dollar, respectively)**




| | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|---|---|---|
| Armenia (AMD per USD) | 288.7 | 405.9 | 414 | 490.8 | 504.9 | 535.1 | 539.5 | 555.1 |
| Azerbaijan (AZN per USD) | 0.3 | 0.9 | 0.9 | 0.8 | 0.8 | 0.8 | 0.9 | 0.9 |
| Georgia (GEL per USD) | 1.1 | 1.3 | 1.3 | 1.3 | 1.4 | 2 | 2 | 2.1 |

| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|---|---|---|
| Armenia (AMD per USD) | 573.4 | 578.8 | 533.5 | 457.8 | 416 | 342.1 | 304.1 | 364.60 |
| Azerbaijan (AZN per USD) | 1 | 1 | 1 | 0.9 | 0.9 | 0.9 | 0.8 | 0.8 |
| Georgia (GEL per USD) | 2.2 | 2.1 | 1.9 | 1.8 | 1.8 | 1.7 | 1.5 | 1.67 |

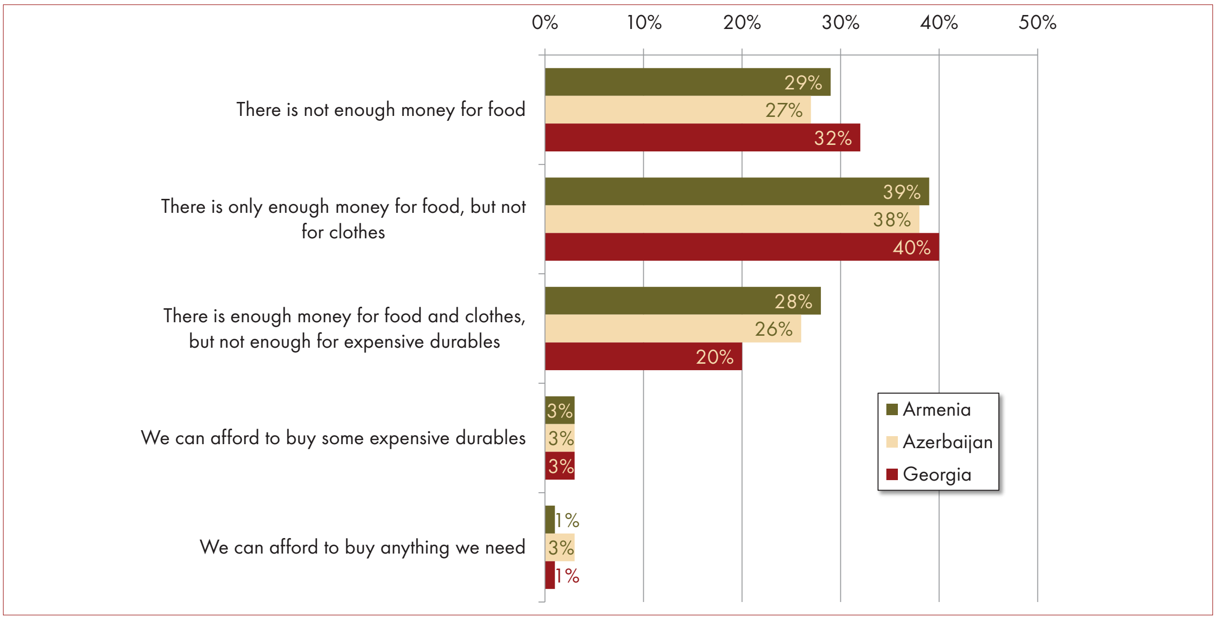
*Sources: 1994–2008: EBRD Country Assessments,* http://ebrd.com/pages/research/analysis/forecasts.shtml; *2009: for Armenia: Central Bank of Armenia,* http://www.cba.am/cms/CBA_SITE/currencyJSP/currencyQueryTable.jsp?__locale=hy; *for Azerbaijan: Central Bank of Azerbaijan Republic,* http://www.cbar.az/other/azn-rates; *for Georgia: International Monetary Fund, IMF Country Report No. 10/83,* http://www.imf.org/external/pubs/ft/scr/2010/cr1083.pdf

*Compiled by Daniel Demele, Andreas Heinrich, Ksenia Pacheco, Heiko Pleines, and Matthias Neumann*

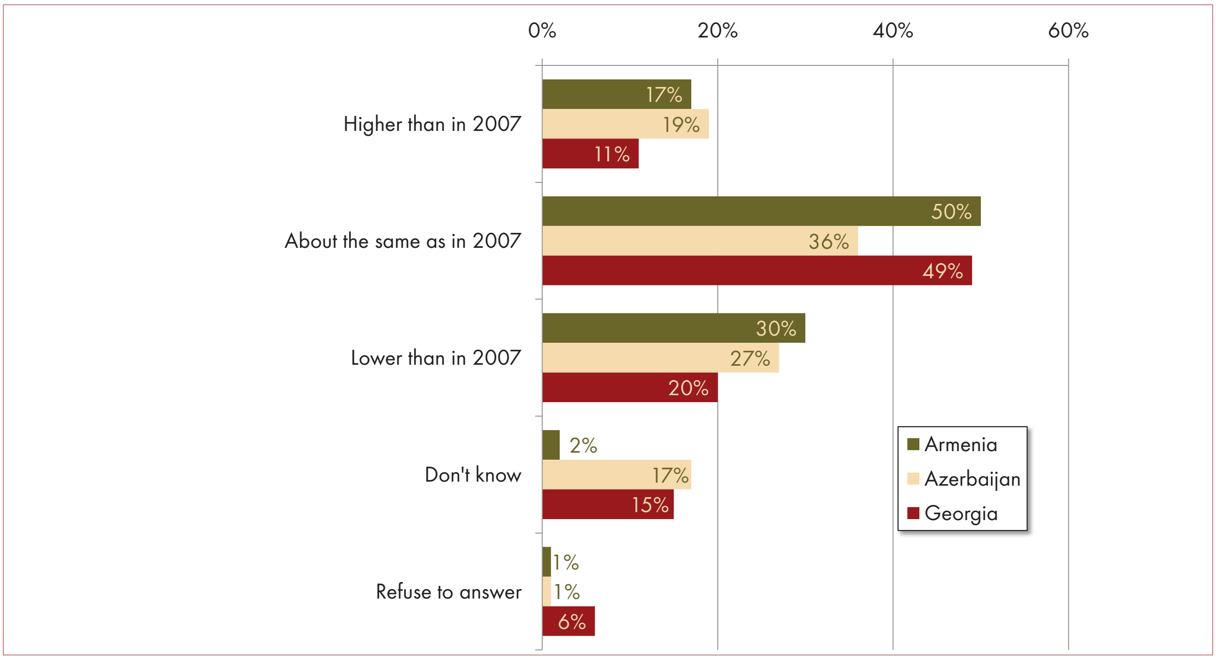
## Opinion Poll

# Crisis Assessment by the Population of the Three South Caucasus Countries

### Which of the following statements best describes the current economic situation of your household?

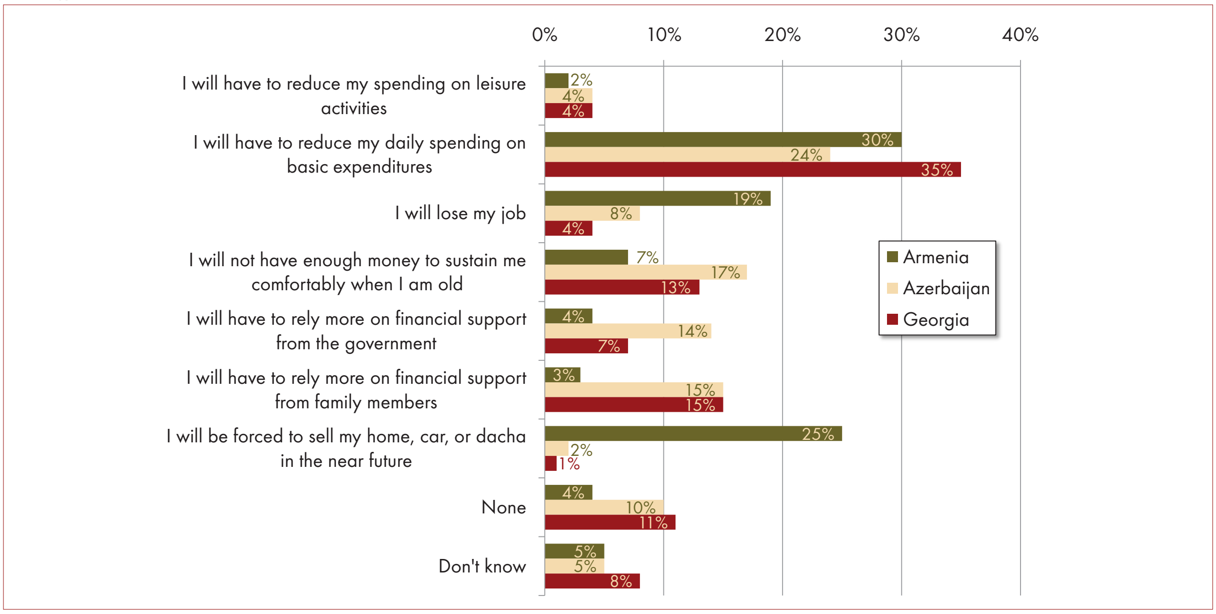



### Excluding income from sales of property or vehicles, compared to 2007, was your household's income in 2008…

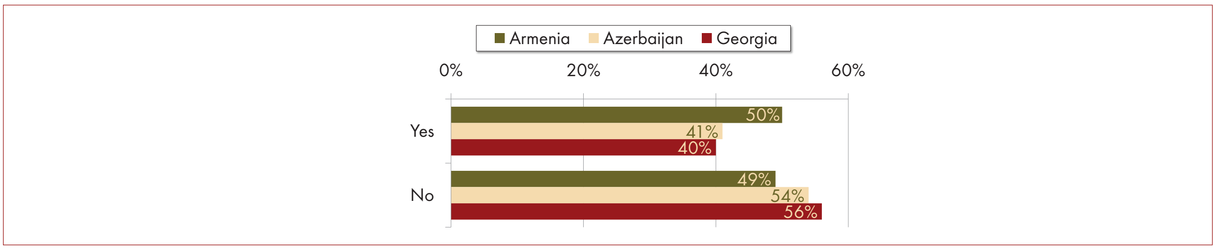



*Source: Caucasus Research Resource Centers' Caucasus Barometer survey (2009). For more information on the Caucasus Barometer, visit CRRC's webpage (*http://www.crrccenters.org/caucasusbarometer/*).*

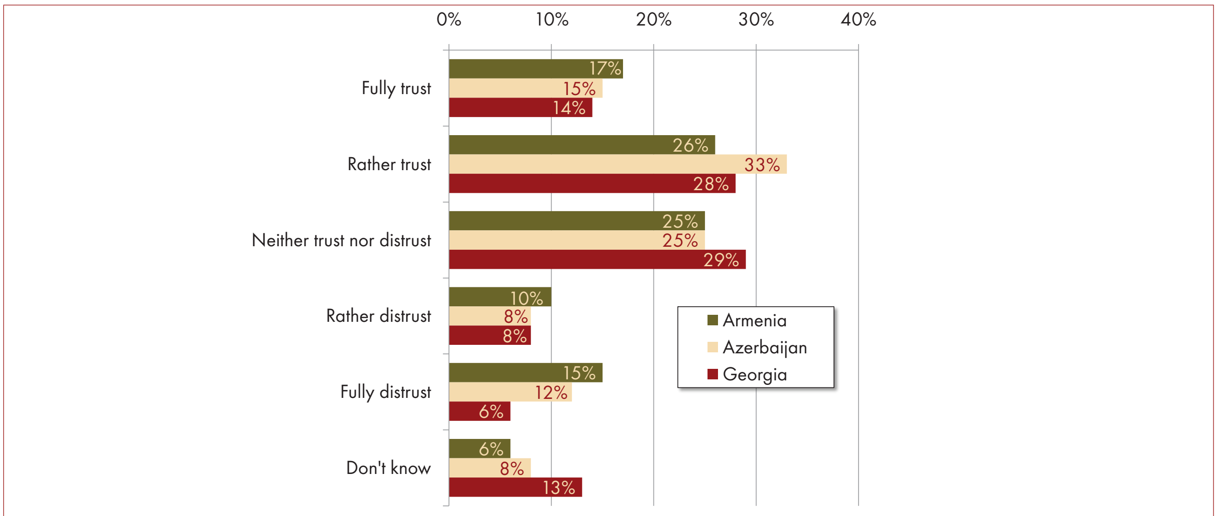
## Which of the following issues would you say is the biggest concern (not expectation) for you at this point in time?




## Does your household currently have any debts?




## How much do you trust the banks?




*Source: Caucasus Research Resource Centers' Caucasus Barometer survey (2009). For more information on the Caucasus Barometer, visit CRRC's webpage (*http://www.crrccenters.org/caucasusbarometer/*).*

## Chronicle

# From 19 May to 28 June 2010

| | |
|---|---|
| 19 May 2010 | The International Monetary Fund (IMF) says that the Armenian economy is recovering faster than expected from the global recession |
| 20 May 2010 | The European Parliament adopts a non-binding resolution on the South Caucasus calling for a greater EU involvement in the region |
| 22 May 2010 | Swedish Foreign Minister Carl Bildt visits Georgia |
| 22 May 2010 | Georgian Deputy Foreign Minister Nino Kalandadze says that Iran-Georgian relations are entering a "new stage" and that Tbilisi hopes that they will further deepen |
| 22 May 2010 | A new political party "Iron" is established in South Ossetia |
| 30 May 2010 | Local municipal elections are held in Georgia |
| 30 May 2010 | The Georgian port of Batumi renames a street in the city after the late Polish President Lech Kaczynski |
| 2 June 2010 | The Central Election Commission in Georgia announces a victory for the ruling party United National Movement in the municipal elections |
| 3 June 2010 | The Georgian police says that it has detained members of an international cartel engaged in cocaine trafficking from Latin America into Turkey via Georgia |
| 4 June 2010 | Ukrainian President Victor Yanukovych says that the recognition of Abkhazia and South Ossetia is "a violation of international laws and norms" |
| 11 June 2010 | Ukrainian President Victor Yanukovych meets with Georgian Foreign Minister Grigol Vashadze in Kiev |
| 11 June 2010 | Russian Foreign Minister Sergey Lavrov says that Russia's decision to recognize the independence of Abkhazia and South Ossetia is irreversible |
| 17 June 2010 | US President Barack Obama promises in a letter to Azerbaijan that the US support for the peaceful resolution of the Nagorno Karabakh conflict is a top priority |
| 17 June 2010 | The European Union and Georgia sign a visa facilitation agreement in Brussels |
| 17 June 2010 | Russian President Dmitry Medvedev meets with the presidents of Armenia and Azerbaijan on the sidelines of the St. Petersburg economic forum to discuss the Nagorno Karabakh conflict |
| 17 June 2010 | The Armenian leadership of the disputed region of Nagorno-Karabakh says that it is skeptical about the meeting between the Azerbaijani and Armenian presidents and their chances to find a solution to the conflict |
| 17 June 2010 | International organizations criticize a new law in Armenia that they say will allow the Armenian government to retain its control of media broadcasting |
| 18 June 2010 | The head of the World Bank in Armenia Aristomene Varoudakis urges the Armenian government to take action against the country's large shadow economy |
| 21 June 2010 | Clashes between Armenian and Azerbaijan forces continue around the region of Nagorno Karabakh |
| 21 June 2010 | Georgian opposition representatives propose to constitutionally bar Georgian President Mikheil Saakashvili from becoming Prime Minister after his term expires |
| 22 June 2010 | Armenian President Serzh Sarkisian meets with German Chancellor Angela Merkel during an official visit in Berlin and discusses bilateral relations, the Nagorno Karabakh conflict and the Armenian-Turkish rapprochement |
| 23 June 2010 | Iranian Ambassador to Armenia Seyed Ali Saghaeyan says that Tehran is strongly opposed to any U.S. involvement in a multinational peacekeeping force that would be deployed in Nagorno Karabakh in the event of an Armenian-Azerbaijani peace agreement |
| 24 June 2010 | The breakaway region of Abkhazia temporarily suspends its participation in the Geneva international talks |
| 24 June 2010 | Prime Minister of the breakaway region of Abkhazia Sergey Shamba says that the possible abolition of the post of European Union Special Representative for the South Caucasus would reduce contacts between Abkhazia and the EU |
| 24 June 2010 | Armenian President Serzh Sarkisian and Defense Minister Seyran Ohanian visit Nagorno-Karabakh |
| 24 June 2010 | International and local human rights groups urge the Council of Europe to take concrete measures to improve the human rights situation in Azerbaijan |
| 25 June 2010 | The statue of Soviet dictator Joseph Stalin is removed from the central square in his hometown of Gori in Georgia |
| 25 June 2010 | The Georgian company Silk Road Group says that US businessman Donald Trump is planning to invest in Georgia |
| 26 June 2010 | Armenian Foreign Minister Edward Nalbandian claims that the international community holds Azerbaijan responsible for the latest upsurge in ceasefire violations around Nagorno Karabakh |
| 28 June 2010 | Georgian Foreign Minister Grigol Vashadze is stripped of his Russian citizenship after he had requested the Russian authorities to renounce it in November 2009 |

## About the Caucasus Analytical Digest

Editors: Iris Kempe, Matthias Neumann, Robert Orttung, Jeronim Perović, Lili Di Puppo

The Caucasus Analytical Digest (CAD) is a monthly internet publication jointly produced by the Heinrich Böll Foundation in Tbilisi (www.boell.ge), the Research Centre for East European Studies at the University of Bremen (www.forschungsstelle.uni-bremen.de), the Resource Security Institute in Washington, DC (resourcesecurityinstitute.org/) and the Center for Security Studies (CSS) at ETH Zurich (www.css.ethz.ch) with support from the German Association for East European Studies (DGO). The Caucasus Analytical Digest analyzes the political, economic, and social situation in the three South Caucasus states of Armenia, Azerbaijan and Georgia within the context of international and security dimensions of this region's development. CAD is supported by a grant from the Heinrich Boell Foundation.

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The Heinrich Böll Foundation, affiliated with the Green Party of Germany, is a legally independent political foundation. The regional office for the South Caucasus was opened in 2003. Its main objective is to contribute to the forming of free, fair and tolerant societies in the region. The Foundation supports and facilitates cooperation of individuals and organizations throughout the region who, based on the principle values of human rights, search for the change of undemocratic and intolerant attitudes in societies and politics, for the transformation of ethno-political and territorial conflicts into the direction of fair and non-violent solutions and for the sustainable development of people and communities. The Foundation encourages critical public debate to make processes of decision-making democratic and transparent.

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### Resource Security Institute

The Resource Security Institute (RSI) is a non-profit organization devoted to improving understanding about global energy security, particularly as it relates to Eurasia. We do this through collaborating on the publication of electronic newsletters, articles, books and public presentations.


Editors: Lili Di Puppo, Iris Kempe, Matthias Neumann, Robert Orttung, Jeronim Perović
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Research Centre for East European Studies • Publications Department • Klagenfurter Str. 3 • 28359 Bremen •Germany
Phone: +49 421-218-69600 • Telefax: +49 421-218-69607 • e-mail: fsopr@uni-bremen.de • Internet: www.res.ethz.ch/analysis/cad