


[www.jeffersoninst.org](http://www.jeffersoninst.org)
[www.laender-analysen.de](http://www.laender-analysen.de)
[www.res.ethz.ch](http://www.res.ethz.ch)
[www.boell.ge](http://www.boell.ge)

## THE CAUCASUS IN THE GLOBAL FINANCIAL CRISIS

■ <b>OPINION</b>		
The South Caucasus: Rethinking Development and Democracy		2
By Vartan Oskanian, Yerevan		
■ <b>ANALYSIS</b>		
Armenia: How a Small Country Counters the Global Crisis		5
By Haroutiun Khachatrian, Yerevan		
■ <b>DOCUMENTATION</b>		
IMF Loan for Armenia		8
■ <b>STATISTICS</b>		
Armenian Macroeconomic and Financial Indicators January 2008 – February 2009		10
■ <b>ANALYSIS</b>		
Splendid Isolation? Azerbaijan's Economy Between Crisis Resistance and Debased Performance		12
By Gerald Hübner and Michael Jainzik, Frankfurt am Main		
■ <b>STATISTICS</b>		
Development of Real GDP in Azerbaijan		16
Banking System Structure 2007 – 2008		17
Development of Time Deposits in Azerbaijan		18
■ <b>ANALYSIS</b>		
Georgia's Expansion Halts		20
By Molly Corso, Tbilisi		
■ <b>DOCUMENTATION</b>		
IMF Loan for Georgia		22
■ <b>STATISTICS</b>		
Macroeconomic and Financial Indicators of Armenia, Azerbaijan and Georgia in Comparison, 1992 – 2008		23
■ <b>CHRONICLE</b>		
From 17 April to 19 May 2009		30

## Opinion

# The South Caucasus: Rethinking Development and Democracy

By Vartan Oskanian, Yerevan

## Abstract

Just when formerly communist countries had begun to accept that capitalism brings with it inequalities and harsh competition, the financial meltdown that turned into a global economic crisis pushed the developed world itself to question the premises, excesses and dangers of laissez-faire capitalism. The crisis brought on soul-searching everywhere. The key question to consider here in the Caucasus is whether the crisis is, at its core, solely economic or actually political.

## The International Context

The G20 first tackled the global economic crisis through a summit aimed at developing a unified strategic vision for addressing the problems in the world's real and financial sectors, discouraging the growth of national protectionism through a recommitment to free-trade, tightening banking and financial regulation, and creating aid packages for poorer countries.

This holistic approach offers hope to our new free market economies because we continue to be seriously impacted by the G20 countries' journey from boom to bust and hopefully to boom again. In the Caucasus, we are greatly dependent on Russia, Europe and the US, and we would welcome their efforts to shore up devalued currencies and fallen stock prices, enable competitiveness to prevent a rise in protectionism, strengthen banks and regulate excesses.

But relying on international review and restructuring won't save us in the Caucasus, or in other former east bloc countries. If we had the strong democratic institutions of the G20, we could dare the tough questions and grasp the tough answers about our own development paths. If we had the initiative or the opportunity for a G20 type conclave for our own transitional, dependent, fragile, often unstable countries, we would benefit from strength in numbers and shared experiences. If we had the political courage to sit together, we could look at each other's systems to address our internal crises, to help ameliorate consequences, and to prescribe long-term and even similar solutions.

From development to democratization, this crisis offers the opportunity and imposes the imperative to rethink essential – and erroneous – premises upon which our political and economic evolution has been based. In other words, we could use the crisis, as the G20 has done, to pinpoint the weak points in our individual systems, and in our regional economic system, and to consider taking the risky, responsible steps to eradicate them. In our developing countries, we have fundamental premises

to rethink. After all, we were the subjects of an unprecedented experiment, and two decades later, we have something to say about that experiment.

## Rethinking Development and Democracy

Even before the crisis, in the countries of the former Soviet Union, it was becoming clear that the challenge to our growth is not just economic. Today, in the midst of the crisis, economic problems are not the only threats. It is the other crisis – a crisis of ideology and outlook – that is actually more consequential and that has been brought to the fore because of the stresses of the economic meltdown. There are four fundamental premises to rethink if we are to benefit from this crisis.

First, we who have embarked on new, liberal, free-market development have misunderstood “development” and its ensuing challenges and seen them as merely economic in nature. Development is a political process, not an economic one. It requires political changes in society and an organized process of engaging both elites and public, without threatening one or discouraging the other. Development doesn't mean spending money on infrastructure alone; it means infrastructures that are designed and maintained by a responsive state apparatus with functioning governance systems. Developing into a modern economy requires the provision of fair, transparent public services. Access to the sea, and endless barrels of oil do not add up to a functioning economy. Only political will and a change in political thinking can bring that about. Our countries must develop politically in order to develop economically.

Second, pretense at democratization is dangerous and counterproductive. It distorts the relationship between government and the governed, raising expectations that can't be met, obstructing progress that could be taking place elsewhere in society. There are many prosperous countries in the world which are not democratic, and don't pretend to be. Singapore is one example of a thriving country where democratic rights are largely sus-

pended; the United Arab Emirates is another. If the elites in our countries really only want economic development, then there should not be a show about democratization. Governments who repeat the predictable democratic formulations but don't have sufficient trust in their people to respect the electoral process, or to govern openly, force citizens onto the streets – either episodically as in Armenia, or chronically as it seems in Georgia.

The frustrations born of fake elections persist and draw a wedge between segments of society and between government and society. Such explosions divert energy and resources from all sectors, including the economy. Citizens avoid paying taxes to a government they don't trust; government refuses to loosen the tax burden on rebellious citizens. The alternative, an autocracy – not unlike what Azerbaijan seems to have institutionalized with its recent constitutional amendment removing term limits for the inherited presidency of the current president – is after all, much more predictable, transparent and direct. This may be a cynical conclusion, but it remains an option for some. On the other hand, if the peoples of our countries really want democratization, which I believe is the unquestionable choice, then they must actively, genuinely, patiently, consistently work to make that happen. It will not come with repeated revolutions as in Georgia, or with petulant street protests as in Armenia.

Third, the Soviet-era definition of power continues to distort the modern concept of legitimate authority. World leaders like Mahatma Gandhi and Nelson Mandela had no power but operated from a position of authority. They accomplished things that changed the world. Except for a brief period immediately after independence, our societies have not experienced governments who enjoy the consent of the governed. Hard power, exclusive and brute power, hereditary power, can continue to be exercised, but that will not assure our leaders the authority they require to bring about significant, lasting political or economic change. Economic growth, and change, depends foremost on confidence and trust. The greatest threats to confidence are silence and untruthfulness. In times of economic upheaval, silence leads to speculation, aggravates insecurity and further deteriorates trust. Unfortunately, the leadership in all three countries has chosen either not to talk about the causes and effects of this global challenge, or to talk about it in rosy, general, superficial terms. Even in societies where the government controls the major broadcast media, however, rising unemployment, weakened currencies, decreased investments, falling remittances and inevitable inflation are realities that no amount of “spinning” can mask.

Finally, even before the crisis we could see that our adherence to the wild, textbook capitalism that we adopted as we tore away from communism is not working. We can, and must consider a more modern, compassionate form of public-private partnership that will allow the state to intervene where necessary to support strategically important sectors and enable economic growth, and not just in a time of crisis. Unfortunately, in the absence of unshakable rule of law, public-private has sometimes come to mean using public resources to help private friends. Instead, it must become government offering individuals and businesses a hand up, not a handout. In other words, if certain entities in the private sector sink rather than swim, it must not be because the government has not done its part to create an enabling economic environment. If Armenian or Georgian or Azerbaijani farmers are unable to earn a living, it cannot be because governments in the Caucasus have shirked their responsibility to share costs and risks, while governments in France and the US have not.

### **Bottlenecks to Democratization and Economic Growth**

The fundamental bottleneck that impedes change in all these spheres is the absence of institutions and an across-the-board acceptance of rule of law. Although the developed world has been able to transfer support and assistance, it has not succeeded in transferring strong institutions. All three countries in the South Caucasus lack strong institutions, although the reasons are different in Armenia, Georgia and Azerbaijan.

Economist Milton Friedman, just a decade after the fall of the Soviet Union, explained that if in the early days of independence, his appeal to all the new states was before and above all else, to privatize, a decade later, he had come to the realization that possibly it is rule of law that is more basic. Frances Fukuyama, in his *State Building* refers to this conclusion of Friedman's as an important consideration for governments seeking economic growth and efficiency.

Armenia was the first to privatize on a massive scale, but it did not succeed in equally spreading the rule of law. Thus, the firm, integrated personal networks of power centers in government and in big business are a huge roadblock to the country's development. Regardless of who is the country's political leader, power continues to be shared among the business-government elite. Over three presidents and three administrations, the elites have remained more or less the same – in make-up and in the way they work. Government agencies – from tax and customs to courts – develop policies and

implement programs always looking over their shoulder for direction. In normal times, this prevents public engagement in the reform and perfection of public institutions for fear of stepping on important toes. In times of crisis, this thwarts the will and necessity to act. If the public were willing to go along with massive, radical change in one or another area – in income tax, educational requirements, land ownership – the existence of such an interdependent and reciprocated power network stands in the way of risky, innovative changes since the elite's interests are sure to be affected. Those making the decisions – about monopolies, taxation, personal property, access to services – would be the ones whose personal and political power would be affected. Thus where the presence of strong institutions should have buffered the shock of major but essential change, instead, institutions remain personalized and partisan, and block, rather than enable, change.

In Georgia, the same roadblock exists. There, too, consistent, predictable state institutions are absent, but for another reason. The Rose Revolution tore down old institutions, but did not replace them with new ones. Although reformed government agencies have become more responsive in matters of everyday life, nearly eliminated petty corruption, and provide tangible benefits and visible improvements in infrastructure, at the state level, personal power networks, allegiances and political dependencies have replaced neutral, continuous, independent state institutions. The new government's revolutionary mindset seems to prefer immediate results and change over time-consuming, and often unpredictable

(and uncontrollable) legislative and institutional processes. The ruling team came to power by revolution and when its legitimacy and power are under threat, it continues to promise not gradual, difficult and pervasive evolution, but a second revolution.

In Azerbaijan, the ruling regime appears to have decided that just as it doesn't need a diversified economy, it also doesn't need democratic institutions. Checks and balances, transparency, accountability and predictability are not associated with oil-centric economies, with one or two notable exceptions. According to international indexes, Azerbaijan is not one of them. The hereditary presidency and an entitled government have substituted for the continuity, accountability and even-handed governance that institutions provide. Oil income causes economic growth numbers to rise, but the real picture in Azerbaijan's chemical, aluminum and metallurgical industries demonstrate that the economic institutions are not at all solid. This will become a crucial problem as oil revenues decline within a decade. Until then, oil wealth funds the personal institution of the president, but not the social institutions necessary for a viable state, and especially one in a time of crisis.

Unless the economic crisis and its twin political crisis lead to substantive, public debate on these fundamental issues of political direction and social and economic responsibility, we will veer further from the already-difficult path toward stability, development and democracy, regardless of what the G20 says and does, or how much assistance our friends offer.

*About the author*

Vartan Oskanian, Armenia's Minister of Foreign Affairs from 1998 to April 2008, is the founder and president of the board of the Yerevan-based Civilitas Foundation.

## Analysis

# Armenia: How a Small Country Counters the Global Crisis

By Haroutiun Khachatryan, Yerevan

## Abstract

Armenia, a small country lacking substantial natural resources and a competitive economy, is potentially very vulnerable to the global economic crisis. The first wave, namely the financial storm that began in September, had no effect in Armenia for the simple reason that the Armenian financial system is very small and had little contact with international financial markets. However, beginning in October 2008, the country felt a strong impact.

## Crisis Challenges

At the beginning of the global economic crisis, most experts and officials agreed that the main challenges presented by the crisis for Armenia were external and derived from the crisis' impact on Armenia's major trading partners. Two shocks were seen as especially dangerous, namely, the drop in exports and the failure of the country to attract foreign investment.

Two major components of Armenia's exports are most vulnerable to the crisis. First, Armenia is a major exporter of basic metals, primarily copper and molybdenum. Shrinking demand and/or falling prices in the world market would hit the country hard. The second type of Armenian exports are not always considered to be "exports." This "export" is in fact private transfers of money from Armenians living abroad, mostly migrant workers, who send money to their relatives back to Armenia. The amount of this money is quite large: in 2008 it was more than \$2.1 billion, which is more than half of the domestic retail trade turnover. For specialists, such remittances represent an export of labor. And like other types of exports, revenues flowing back to Armenia depend on the demand for the exported commodity (the labor) and on its price, i.e., the amount of employment and the level of salaries in the countries where these people work. As more than 70 percent of Armenian migrant workers are in Russia, the fate of this type of Armenian "exports" depends, first of all, on the performance of the Russian economy, in particular, the construction industry, where a substantial part of the Armenian migrant workers are employed. In the worst-case scenario, the crisis might force some of the Armenians living abroad to return home, which might cause an even higher rate of unemployment and more burden on the government budget.

Both types of exports suffered as the economic crisis reached Armenia's partners. The price for metals dropped in October-December to half of the level they had been in early 2008, and Armenian mine production fell 7

percent in the first ten months of 2008. As for the second important component of Armenian "exports," private remittances fell 25 percent in January-March 2009. Both factors combined to cause a shortage of foreign currency in the country, forcing the authorities to depreciate the dram, the national currency of Armenia. The Central Bank preferred to avoid a gradual depreciation of the dram (contrary to what was seen in Russia), and sold dollars for a while to avoid mass panic. However, on March 3, 2009, they announced their decision to stop intervening in the market and the dram exchange rate immediately fell from 305 dram/dollar to 360. Since then, the situation in the currency market has been relatively stable, and the Central Bank has had no need to intervene.

The second negative trend, the decrease in foreign investments (especially in the construction sector, which had been growing quickly in recent years) started even before the global crisis reached Armenia. The August Georgia-Russia war created transportation problems for Armenia and raised fears among investors. As a result, investments shrank drastically, and the crisis, which arrived a month later, prevented investment activity from recovering.

## The Impact of the Crisis

The crisis has had a strong impact on the Armenian economy. In 2008, the economy grew 6.8 percent. This seemingly high rate was in fact a sign of trouble, as during the previous seven years, Armenian GDP had grown at rates above 10 percent a year. Meanwhile, in 2009, the situation deteriorated much faster, since in January-March real GDP was 6.1 percent lower than a year earlier. This drop was the first decline in the Armenian economy since 1994, the end of the crisis caused by the USSR's collapse and the war over Nagorno Karabakh. In addition, budget revenues in the first quarter of 2009 fell almost 10 percent against the level of the previous year, whereas the state budget had envisaged 14 per-

cent growth. The government decided to re-schedule its spending plans, moving some of the previously planned expenditures to the fourth quarter, hoping that it would have more money then.

The decline affected almost every sphere of the economy, with industrial output dropping to 90.5 percent of the level of the first quarter of 2008, agricultural production to 94.9 percent, and construction to 78.1 percent. The service sector was the only one to show a slight increase. Foreign trade shrank drastically, with exports comprising just 52.7 percent of the level of a year ago, and imports, 77.8 percent.

In late March, the Central Bank presented its latest forecast for the real GDP, according to which, it will fall by approximately 3 percent year-to-year by the end of 2009, and the most likely value of inflation is 5.9 percent in December.

### The Anti-Crisis Program

The government announced the general outline of its anti-crisis program early on, in November 2008. Prime Minister Tigran Sargsyan presented the National Assembly a plan including measures similar to those adopted by many developed nations, seeking to stimulate consumption while supporting local producers and exports. In particular, the government promised to subsidize or provide loan guarantees to companies having difficulties and even take a stake in some of them. The authorities also pledged to improve conditions for small and medium-sized companies, which create most jobs. No tax cuts were planned (although some measures reducing the tax burden were undertaken later) and the government continues to push ahead with its strategy to improve tax collection and reduce the size of the shadow economy, a program started in May 2008. Finally, the government pledged to meet all its social obligations, including the construction of cheap housing and making mortgages available to a wider range of people.

A major part of the anti-crisis program was infrastructure construction. It included extensive plans to modernize rural roads and build a new international motorway, a project for which the presidents of Armenia and Georgian reached preliminary agreement in October. This road will run from the Georgian port of Batumi to the Armenian-populated Samtskhe-Javakhetia region of Georgia into Armenia and then through Gyumri-Yerevan-Meghri to the Armenian-Iranian border. The government expects to get loans from the Asian Development Bank for these works. A large-scale construction program in the zone of the 1988 earthquake, where several thousand people are still homeless, is part of the gov-

ernment program as well. 70 billion drams (190 million dollars) are planned for this purpose.

The government also announced its decision to create two "Free Economic Zones," one around Zvartnots international airport near Yerevan, and one in Gyumri, the second largest city of Armenia, which was strongly hit by the 1988 earthquake and has been economically depressed since then.

Finally, a distinguishing feature of the anti-crisis plan is its ambition to attract the funds of non-residents, particularly Diaspora Armenians, into the Armenian banking system. This system is relatively small, but the banks are well capitalized, and, as indicated above, did not suffer from the global financial turmoil. Thus, the government hopes to persuade the Diaspora Armenians to use the Armenian banks as a safe haven for their money during the crisis. In addition, the government is going to launch the so-called All-Armenian bank, a special commercial structure (with the government as a major shareholder) aimed at attracting the funds of Diaspora Armenians for investments in Armenia.

### External Assistance

Evidently, the government will need funds from external sources to implement these anti-crisis measures, especially as state budget revenues declined following the economic downturn. The sum needed to close the budget gap and realize the above-mentioned ambitious plans is estimated to be at least 1.5 billion dollars (the official state budget is equivalent to 2.5 billion dollars, however, it is unlikely to be fully collected). The government has already succeeded in getting part of this sum. In March, the IMF approved a \$540 million stand-by arrangement, of which \$239 million was made available immediately. The IMF acknowledged the quality of the anti-crisis program of the Armenian government by providing a loan unprecedented in size, as it equals four times Armenia's quota in the IMF. Second, Russia, Armenia's important economic and political partner, provided initial consent in February for a \$500 million stabilization loan. This loan was expected to arrive in a lump sum in March, however, it has been delayed (reportedly, due to technical reasons) and is now expected to be available in June. The World Bank, in turn, agreed on extending to Armenia four loans totaling \$85 million, including \$35 million in fast-track funds aimed at providing "immediate employment opportunities." This is part of a \$525 million World Bank assistance package for 2009-2012. Finally, the Asian Development Bank has agreed to extend two loans totaling \$47 million for different programs.

Negotiations are under way for additional sources of external funding. In addition, a large inflow of funds is expected from Iran to implement several joint programs in Armenia, including construction of a hydro-power station and a pipeline for pumping oil products from Tebriz to Armenia.

### Anti-Crisis Measures

The Armenian government has so far performed the following major anti-crisis measures to boost business activity and create jobs.

- Simplification of tax, accounting and reporting rules for small and medium-sized businesses. This process started with the adoption of a legislative package last year, but its implementation is controversial.
- Full restoration of operations at five mining companies producing copper and molybdenum. This measure saved 6,000 jobs, which were important especially for the Syunik province (marz) in the south. Due to some recovery in metal prices, their work is nearly profitable; in addition, the government provides assistance to these companies.
- Government subsidies to perspective businesses. So far, more than twenty companies have received some 25 billion drams (\$67 million) in different forms of assistance, such as loans, credit guarantees and share-buying by the government. These companies

are involved in a wide range of activities, including food processing, textiles, software, machine-tool production and others.

- Loan guarantees to developers for completing the construction of buildings that are already 50 percent or more complete. The total sum of guarantees declared on April 13 was 20 billion drams (\$54 million).
- Start of the small and medium-size business crediting program under the World Bank's \$50 million loan.

The results of these measures are not yet evident. In particular, local business is in a very difficult state due to extremely high interest rates, now around 20 percent for credits. Government critics claim it has much to do in improving the business climate in the country.

### Conclusion

Externally, no crisis signs are evident in Armenia. Life in the country has not undergone visible changes. Moreover, recently released statistical data show that retail trade in January-March 2009 increased against the same period of the previous year, despite the decrease in the GDP. The government has not encountered any problems in fulfilling its promises. However, the living standards of the population in Armenia may drop if the world economic crisis persists.

#### *About the author*

Haroutiun Khachatryan is an editor and analyst with Noyan Tapan news agency in Yerevan.

## Documentation

### IMF Loan for Armenia

#### IMF Press Release No. 09/68, of March 6, 2009

The Executive Board of the International Monetary Fund (IMF) today approved a 28-month SDR 368 million (about US\$540 million) Stand-By Arrangement for Armenia to support the country's program to adjust to the deteriorated global outlook, restore confidence in the currency and financial system, and protect the poor. The approval makes the amount equivalent to SDR 161.5 million (about US\$237 million) immediately available and the remainder in nine installments subject to quarterly reviews. The Stand-By Arrangement entails exceptional access to IMF resources, amounting to about 400 percent of Armenia's quota. It was approved under the Fund's fast-track Emergency Financing Mechanism procedures.

The authorities' program is based on a consistent set of measures regarding exchange rate, monetary, financial, and fiscal policies, as well as continued structural reforms.

Key elements include:

- Return to a flexible exchange rate regime. The Central Bank of Armenia (CBA) announced on March 3 that it will no longer intervene in the market, except to smooth extreme volatility, and raised its policy interest rate by 100 basis points. Following the announcement, the dram depreciated about 20 percent, and since then, has broadly remained in that range.
- Strengthening of the financial sector to maintain stability and confidence. Key aspects of the CBA's policy response include liquidity support operations, as needed, and enhanced banking supervision.
- A revision of fiscal priorities to maintain macroeconomic stability, while protecting social outlays and public investment, in light of the expected revenue shortfall. The authorities intend to cut back on non-priority spending while providing an increase in social spending of 0.3 percent of GDP, relative to the budget, to protect the poor through well-targeted social safety nets. Additional external financing will be used to boost public investment.

Armenia's gross external financing requirements are projected at about US\$1.6 billion for 2009, and will remain elevated through 2011, albeit with a slight downward trend. The Stand-By Arrangement will cover a large share of the country's 2009-2011 financing gap. Additional financing will be provided by Armenia's donors and international partners, including the World Bank.

Following the Executive Board discussion on Armenia, Mr. Murillo Portugal, Deputy Managing Director and Acting Chair, said:

"Since the approval of a low-access PRGF arrangement in November 2008, Armenia has been confronted by a variety of major external shocks. Reflecting the sharp deterioration in global economic conditions, private transfers and capital inflows slowed considerably and international commodity prices have dropped severely, affecting mining exports and production. In light of a rapid decline in international reserves and growing financing needs, the authorities have requested additional financial assistance from the Fund.

"With the adverse global developments, real growth is expected to contract in 2009, reflecting the downturn in Russia and other countries in the region. Falling international prices, lower growth, and exchange rate depreciation will help reduce the external current account deficit. Medium-term prospects remain good.

"Sound policies are essential to maintain macroeconomic stability. The recent return to a flexible exchange rate will help cushion the impact of the global downturn and eventual further regional deterioration. An appropriately tight monetary policy is necessary to contain the inflationary pressures stemming from the depreciation and support demand for dram-denominated assets. While potential negative impact of the depreciation on the financial sector seems unlikely, contingency plans are available to help address any such effects. In light of the expected revenue shortfall, fiscal policy will remain prudent, protecting social outlays and public investment by reducing non-priority spending.

"Maintaining the structural reform agenda will contribute to macroeconomic stability and a strengthened business environment. Key elements include the completion of the unfinished tax policy and tax administration reform agenda, and progress on financial sector reforms.

"The Fund is confident that the policy package put in place by the authorities is appropriate and strong," Mr. Portugal said.

*(continued overleaf)*

## Annex

### *Recent Economic Developments*

The global crisis has confronted Armenia with a number of large external shocks. Remittances and capital inflows, which sustained rapid economic growth in recent years, have decelerated markedly. Falling international commodity prices adversely affected mining, a key export sector. GDP growth came to a halt in the fourth quarter, and fell to 6.8 percent for the year as a whole, from over 13 percent in 2007. Following the rapid unwinding of international prices and domestic demand, annual CPI inflation fell to 1 percent in February 2009. With exports being hit by the global downturn and imports growing strongly through October, the external current account deficit rose to an estimated 12½ percent of GDP in 2008.

The rapid and unexpected deterioration of the economic situation had a strong impact on program performance under the PRGF arrangement. Most of the end-December 2008 quantitative performance criteria were missed. The authorities, recognizing the changed circumstances and the large increase in their financing needs, have requested the Stand-By arrangement and also requested the cancellation of the PRGF arrangement.

### *Program Summary*

The authorities' program aims to achieve the necessary external adjustment, restore confidence in the domestic currency and the banking sector, and protect the poor. Their program is based on a consistent set of policies in the exchange rate, monetary, financial, and fiscal areas as well continued structural reforms.

As part of the program, the authorities are returning to a flexible exchange rate regime. In particular, the authorities have indicated that they will no longer intervene in the market, except to smooth extreme volatility. Under a managed float, the authorities would gradually return to their inflation-targeting framework.

Strengthening financial stability will be a key part of the authorities' program. The authorities will implement short-term emergency measures to stabilize the system, while at the same time enacting more structural measures to ensure the soundness of the system going forward. Key aspects to be addressed are liquidity support operations and enhancing banking supervision.

Fiscal priorities will be revised. To partly offset the anticipated revenue shortfall for 2008, the authorities intend to cut back on non-priority spending and introduce some tax policy measures, yielding savings of about 0.8 percent of GDP. Accordingly, the program aims at limiting the deficit, excluding non-programmed externally financed investment projects, to 2.8 percent of GDP compared to a deficit target of 1 percent of GDP in the announced budget.

The IMF supports the protection of social spending embedded in the program. The program accommodates an increase in social spending of 0.3 percent of GDP, relative to the budget, to protect the poor through well-targeted social safety nets. The program also provides room for additional infrastructure and investment spending as foreign financing materializes.

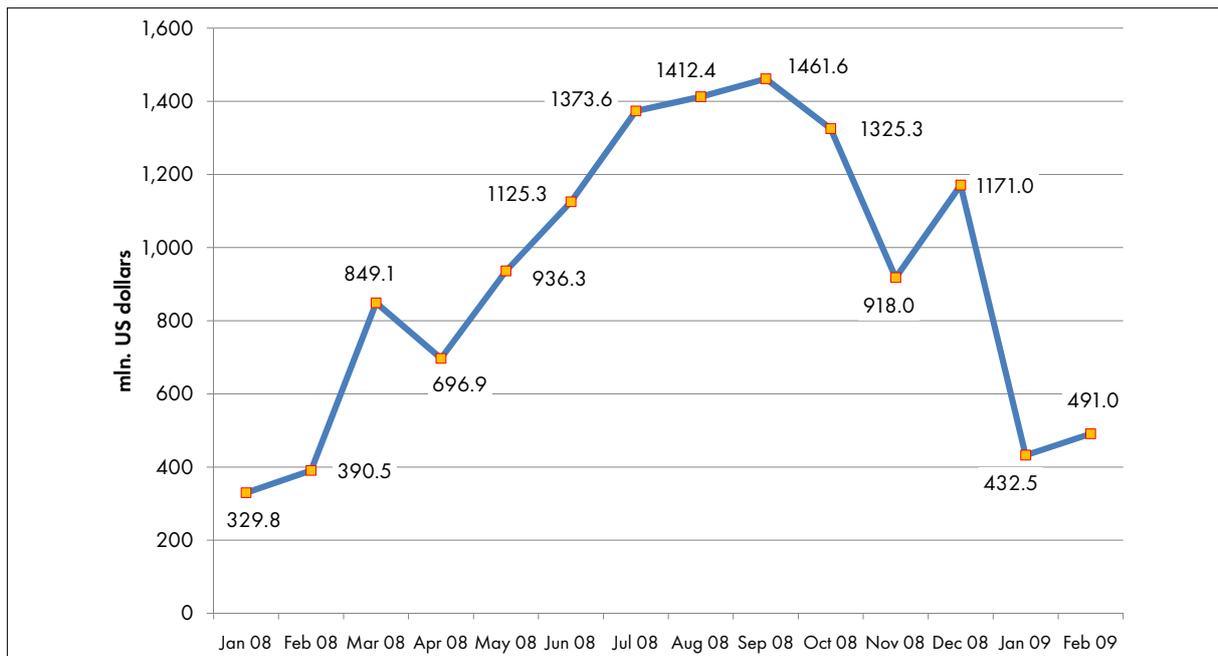
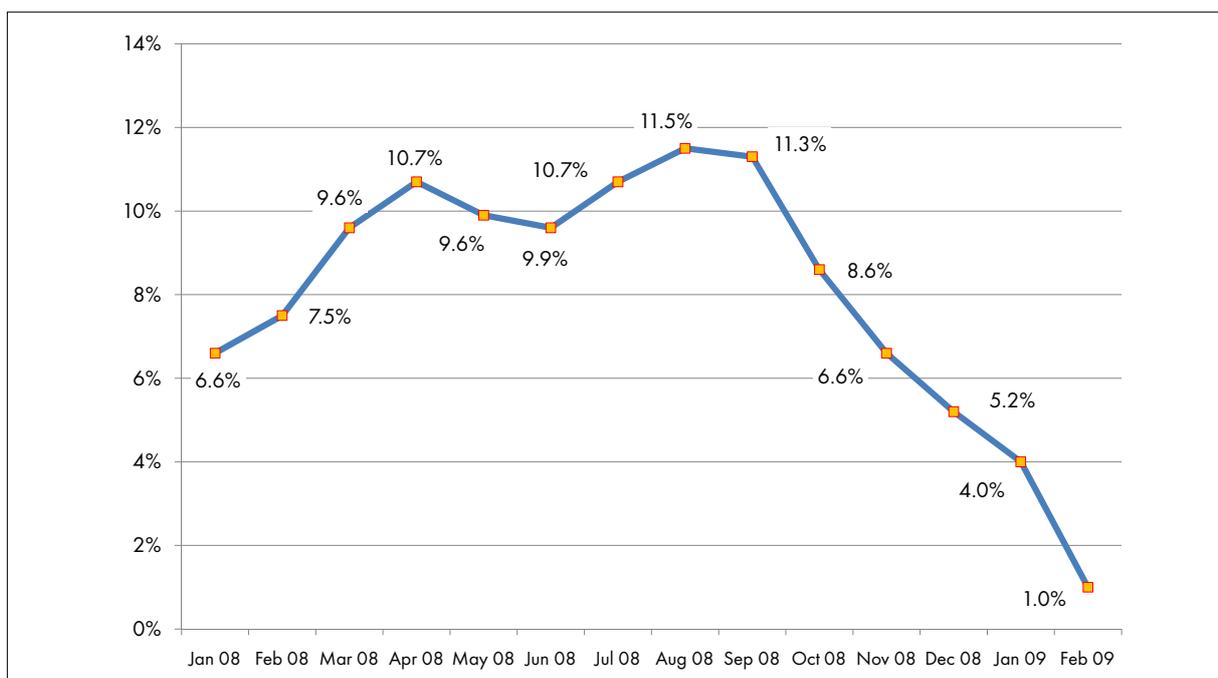
The authorities will continue their wide-ranging structural reform agenda outlined in their Sustainable Development Program. This agenda is aimed at deepening productivity-enhancing structural reforms, and improving governance. A key area will be continued efforts to strengthen the business environment, with a focus on tax administration reforms and the fight against corruption.

Armenia joined the IMF on May 28, 1992; its quota is SDR 92 million (about US\$135.2 million) and its outstanding credit to the IMF (as of end-January 2009) is SDR 87.495 million (US\$128.6 million).

Source: <http://www.imf.org/external/np/sec/pr/2009/pr0968.htm>

**Statistics**

## Armenian Macroeconomic and Financial Indicators January 2008 – February 2009

**Figure 1: Armenia: GDP 2008–2009 (in mln. US dollars at current prices)**

**Figure 2: Armenia: Inflation 2008–2009 (annual change in %)**


Source: <http://www.imf.org/external/country/ARM/rr/index.htm>

Figure 3: Armenia: Exchange Rate January 2008 – February 2009 (Armenian dram per US dollar)

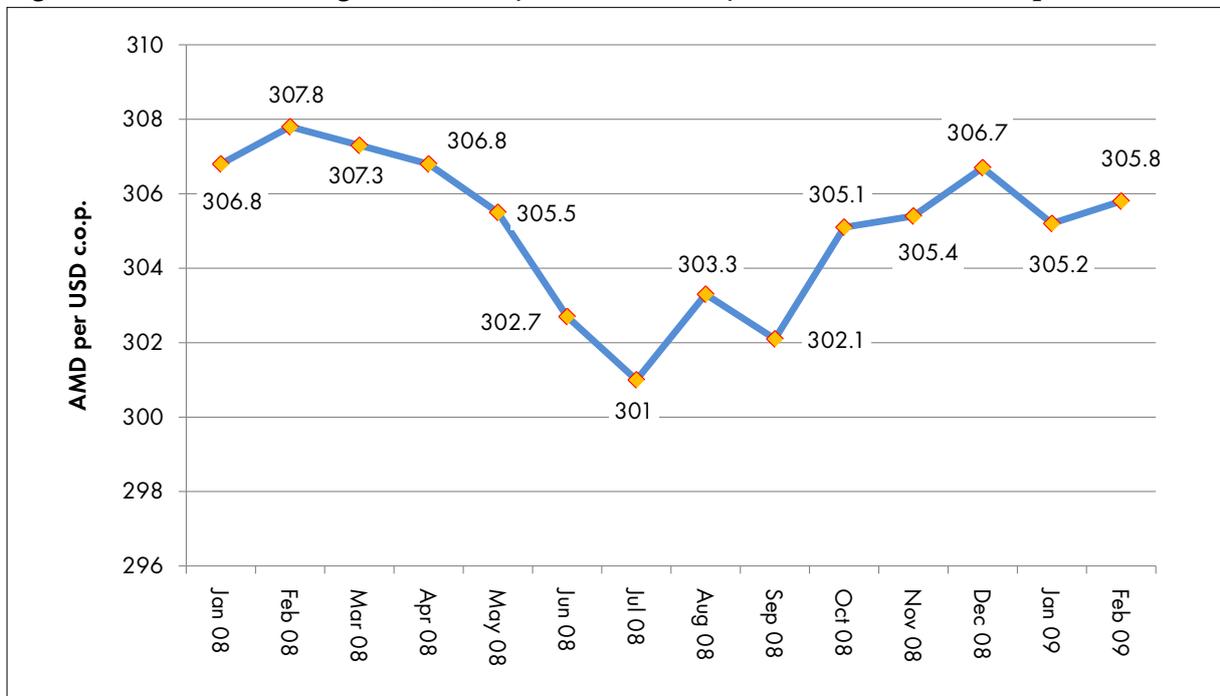
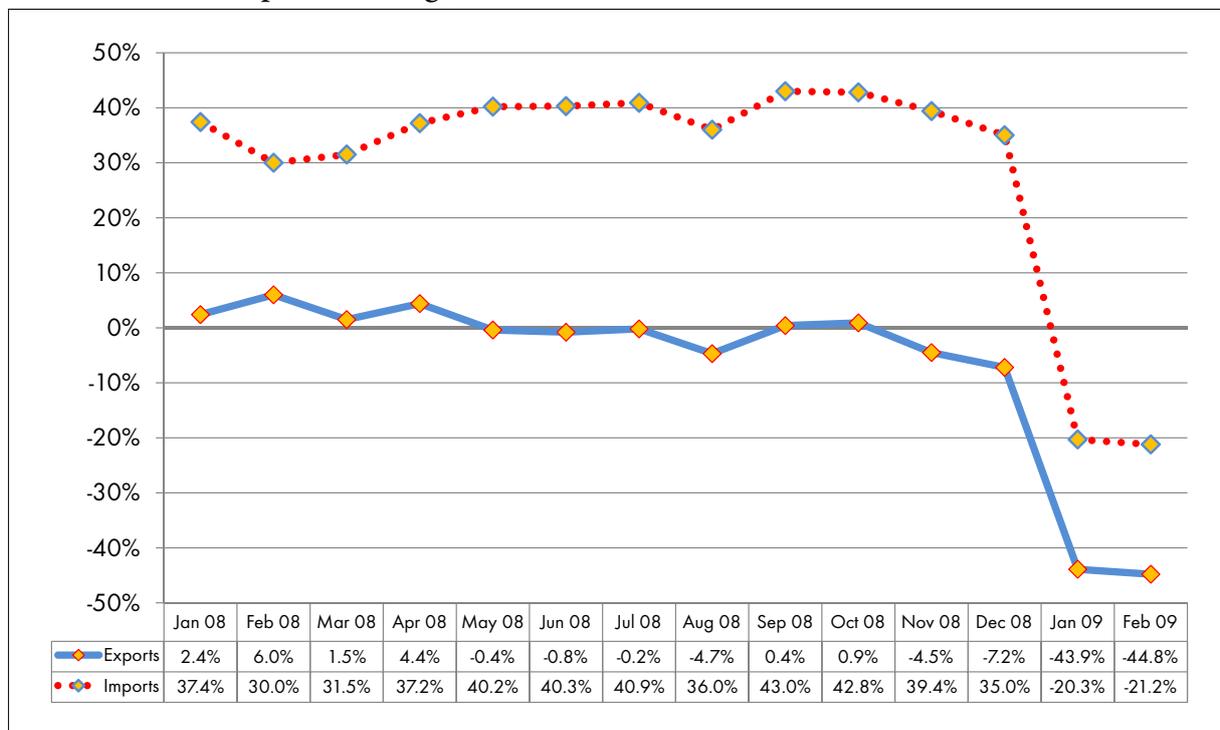


Figure 4: Armenia: Exports and Imports January 2008 – February 2009 (annual cumulative percent change)



Source: <http://www.imf.org/external/country/ARM/rr/index.htm>

Compiled by Daniel Demele

## Analysis

### Splendid Isolation?

## Azerbaijan's Economy Between Crisis Resistance and Debased Performance

By Gerald Hübner and Michael Jainzik, Frankfurt am Main

### Abstract

The global financial and economic crisis reached Azerbaijan with a time lag and – so far – to a much lesser extent than most of its peers in Eastern Europe. Two causes are responsible for this outcome. First, the enormous oil revenues received in recent years led to a certain macroeconomic stability and resulted in a financial cushion, which gives enough leeway for the state to mitigate the short-term impacts of the crisis. Second, the financial sector is still small and only integrated into the global financial architecture in a limited way. It was hence less affected by the crisis than financial sectors in other European transition countries. But the dramatic drop in oil prices shows the vulnerability of the economy due to its weak diversification and high dependency on the extractive industries sector. Thus, the country is facing the challenge to diversify its economy and develop its value chains across sectors. This holds true especially for the small and medium-size enterprise segment of Azerbaijan.

### Introduction

The global financial and economic crisis has so far hit Azerbaijan much less than most of the other CIS countries. In contrast to neighboring Armenia and Georgia, as well as other CIS countries in Europe and Central Asia, the oil-dominated, but relatively small economy of Azerbaijan suffered neither currency devaluation, nor severe drops in economic production (Gross Domestic Product or GDP). Two major economic reasons are responsible for this crisis resilience. First, the financial sector of Azerbaijan is still much less developed than in other CIS countries, such as Russia, Ukraine and Kazakhstan, and its South Caucasus neighbors Armenia and Georgia. Accordingly, it is only poorly integrated into global financial markets, resulting in a limited impact of the crisis on the local banking sector. Secondly, the extractive oil and gas industries dominate the economy of Azerbaijan. Energy exports, among other effects, cause a continuously positive current account balance and a steady inflow of hard currency. The rise in commodity prices for crude oil on the world markets between 2005 and mid-2008 occurred simultaneously with the country's second oil boom, with all-time records in production and export volumes since the start of industrial oil extraction in Azerbaijan at the beginning of the 19<sup>th</sup> century. These circumstances bestowed a windfall profit upon the country over the last three years, leading to robust macroeconomic conditions with strong growth figures and low levels of public debt, both national and international. At the same time the country started to boost public spending and private per capita consumption. Escalating prices – both for daily living as well as

for real estate – appeared as the first signs of economic overheating and indicated that the country was struggling to absorb this sudden wealth.

Since other economic sectors are of limited importance for GDP and negligible for exports, Azerbaijan's macro economic performance is highly dependent on oil price levels. But as the massive oil and gas production is not yet at its peak, the country should still be able to mitigate the current crisis even despite the sudden drop in proceeds from oil exports. Azerbaijan has so far been quite lucky in its circumstances. But it needs to act with caution now and should use its financial resources in a more sustainable way, above all by diversifying the economy. This is of utmost importance because the extractive sector itself does not contribute to massive job creation, thus, the economic well-being of major parts of the population depend on diversified growth.

### The Macroeconomic Situation and the Real Economy

As a result of the break-up of the USSR, the collapse of trade relations, and the military conflict surrounding Nagorno-Karabakh, economic production fell by more than 60 percent between 1989 and 1995. Agriculture accounted for more than 30 percent of GDP in 1995 and industrial production had a share of only 15 percent by this time. It took Azerbaijan one decade to recover (see [Figure 1 on p. 16](#)). Since the completion of the oil and gas pipelines to Turkey in 2005/2006, the exploitation of Azerbaijan's hydrocarbon resources accelerated significantly: Azerbaijan grew by an average annual growth rate of 21 percent in 2004–2008 and brought GDP

from 9 billion USD in 2004 to more than 46 billion USD at the end of 2008 – making it one of the fastest growing economies worldwide. Oil and gas sector production accounted for more than 60 percent of GDP in 2008 (against 38 percent in 2004) as well as 60 percent of state revenues and nearly all export proceeds. Due to this export growth, Azerbaijan showed a current account surplus with a new historic record of 17 billion USD in 2008, a share of more than 40 percent of the GDP.

The unexpected high oil revenues of the last three years replenished the country's strategic reserves to 18 billion USD by the end of 2008. This amount is twice the state's foreign debt. The biggest portion (11 billion USD) of the reserves sits with the State Oil Fund of Azerbaijan (SOFAZ). The fund's assets are partly invested overseas, which helped reduce the upward pressure on the exchange rate. But a considerable portion was also channeled to Azerbaijan for huge infrastructure investments. In line with a fourfold increase in the state budget between 2005 and 2008, these vast expenditures fueled high demand, above all in the construction sector. The governmental expenditures led also to rapid income growth among the population, resulting in growing per capita consumption and in high demand for real estate.

Due to increased spending, inflation grew by 55 percent between 2005 and 2008, with a peak rate of 21 percent in 2008. At the same time, the Azerbaijani manat (Manat or AZN) appreciated against the US Dollar by roughly 20 percent in nominal terms due to a high influx of foreign currency, which increased demand for the Manat. This combination led, and leads, to an unfavorable environment for productive sectors outside the oil and gas industry. Such real appreciation makes locally-produced goods and services price-wise less competitive with foreign products. This phenomenon – leading to lower exports and higher imports – is termed “Dutch Disease” and has been in full swing in Azerbaijan.

Local industry is coming under increasing pressure. The steel, aluminum, and chemical sectors have suffered from falling prices on the world markets since mid-2008, on one hand, and low productivity and the appreciated Manat, on the other. As a consequence, the big state-owned enterprises in these sectors cut back production or even suspended activities and sent employees home for unpaid leave since the beginning of 2009. Despite the highly visible monetary impact of the extractive industries, they only contribute to slightly more than one percent of countrywide employment. In comparison, the agricultural sector has a share of only 6 percent of GDP, but provides livelihoods to just under half of all house-

holds. Azerbaijan had an average per capita income of 5,400 USD in 2008, therefore statistically it is considered an upper middle-income country. Despite this fact, 20 percent of the population still live in poverty, which continues to be one of the challenges for the country.

The direct impact of the current crisis, with reduced oil prices, already is apparent for Azerbaijan. Real GDP growth is expected to slow to just below 3 percent p.a. in 2009, whereas public investment – on the basis of large transfers of the SOFAZ – will become the single largest source of GDP growth. The current account surplus is also expected to contract significantly, from 17 billion USD to just 1.2 billion USD in 2009.

In 2008, the government took formal steps to improve the non-oil business environment, resulting in Azerbaijan being one of the top performers in the last Doing Business Report, issued by the World Bank. However, reality looks different on the ground. Informal monopolies, import protection and pervasive corruption are unresolved issues, which also hamper Azerbaijan's accession to the World Trade Organization.

In order to increase income for the broader population, Azerbaijan needs to develop a more diversified economy with competitive industrial production, a well established segment of small and medium-sized enterprises (SME) and a strong financial sector. SMEs are usually active in a variety of fields across the economy, are labor-intensive and hence contribute significantly to job creation. A strong and sound financial sector can provide reliable long term and local currency refinancing to the real economy.

### **The Financial Sector in Azerbaijan: Small Banks, Small Business**

Azerbaijan's banking sector is still characterized by its post-Soviet heritage and the country's overall resistance to reforms that create competitive markets and industries. As in other CIS countries, Azerbaijan's market-oriented banking system developed after the country gained independence following the collapse of the USSR in 1991. The 1990s were characterized by poor banking regulations and supervision, which made room for a vast number of weak financial institutions to develop that mainly acted as small “pocket banks” for related enterprises or individuals. In parallel, hyperinflation (1,800 percent in 1994) wiped out much of the population's savings and destroyed their faith in banks and local currency.

Between 1994 and 2004, the number of banks fell from 210 to 44, mainly due to closures and some mergers as the Central Bank of Azerbaijan Republic (CBAR or Central Bank) introduced more stringent regulations,

such as minimum capital requirements. There have been no cases of sector-shaking bankruptcy among the major financial institutions in the country. Today the banking sector consists of 46 banks, including one state-controlled bank (International Bank of Azerbaijan / IBA) that holds some 40 percent of banking assets. The sector is concentrated at the top: six banks control around 70 percent of the system's assets – all of them with local majority shareholders. The other 40 banks account for the remaining market share. Of these, only seven banks have foreign majority owners with 10 percent of banking assets. This is the lowest share of foreign ownership among its peers in the region (see [Figure 2 on p. 17](#)). There are only two “Western-owned” banks in Azerbaijan, the Turkish Yapi Credi Bank (formerly Koc Bank) which belongs to Italy's UniCredito group. The second is AccessBank, a dedicated microfinance bank founded and owned by international financial institutions (World Bank Group's IFC, EBRD, the German Development Bank KfW, Black Sea Trade and Development Bank, and Access Holding). Whereas the first mainly serves Turkish companies and Turkish-Azeri business in Baku, the second mainly serves small entrepreneurs and poor households throughout the country. No major European banking group with a desire to expand in Eastern Europe, such as Austria's Raiffeisen, France's Société General or Hungary's OTP, have entered the Azerbaijani market despite acknowledged or attributed interest. Thus, a modernization shock for the sector through the entry of efficient foreign mainstream banks is yet to come.

Nevertheless, the banking system grew very rapidly over the last few years, though it started from a small basis, and it is still less developed than in other CIS countries. Banking sector assets, as well as the total loan portfolio, tripled in two years and amounted to 10.273 billion AZN (12.842 billion USD) and 7.017 billion AZN respectively. With total assets lower than those of the Savings Bank of the Northern German city of Bremen (“Sparkasse Bremen”) the sector is vanishingly small in absolute figures. (Bremen has approximately 650,000 inhabitants and more than this one bank.) But even in comparison to its own economy, the Azerbaijani banking sector is still small. The financial intermediation ratio – a common indicator of sector development – measured by the ratio of total banking assets to GDP, stood at 27 percent at year end 2008. This is a very low ratio compared with 80 percent in Ukraine or 180 percent in the Euro Area, but it is similar to Georgia and Armenia. This means that the banking sector's economic function – collecting money from savers and allocating it efficiently to investing companies and households – is far from being

as effective as in more developed economies, and, thus, the low performance of the banking sector forms one of the crucial bottlenecks for the future economic development of the country.

And, still, the financial sector is practically equivalent to the country's banking sector. Insurance companies or the stock exchange are negligible.

The main field of activity of the banking sector is lending to the local economy. The share of credits to households and business amounted to 66.2 percent of total bank assets at the end of March 2009, while the remaining part is attributed to cash (5.2 percent), correspondent accounts (6 percent), credits to the financial sector (5 percent) and investments and other assets (17.6 percent). The main source of refinancing comes from household and corporate deposits, which amounted to 36.5 percent of total liabilities and equity. Credits from the local financial sector amounted to 11.6 percent. Foreign borrowing remained small with a share of 21.6 percent of total liabilities and is only slightly higher than the banks' equity, which is 20.3 percent. This means that the absolute liabilities of Azerbaijani banks to international creditors were only 2.4 billion USD. As international financial markets continue to dry up, this figure is likely to come down over the course of the year.

Despite these limited foreign liabilities, the banking sector is not insulated from the crisis. According to the CBAR, sector assets dropped by 1.4 million AZN or 15 percent since the beginning of the year. The loan portfolio in the sector deteriorated at the same time from 2.2 percent of loans which are delinquent by more than 90 days, to 3.1 percent, or in absolute figures from 160 million AZN to 196 million AZN. Banks reduced or stopped lending to households and enterprises, which resulted first in stagnation towards the end of 2008 and in a sharp decline of crediting by one billion Manat from 7 billion AZN to 6 billion AZN since January 2009. This amount of 1 billion Manat corresponds exactly to withdrawals of US-Dollar deposits from the corporate sector over the course of the first quarter of 2009. The authors believe that indeed a more restrictive crediting policy of the banks drove its business clients to withdraw savings in order to keep their businesses going. Such an overall tighter liquidity situation for the corporate sector can be an early indicator for real economy problems not yet visible. A look at the savings behavior of private households indicates that corporate savings behavior is likely to be driven by real economic motives, not by distrust in the banks (see [Figure 3 on p. 18](#)).

Household term-deposits even grew slightly during the same period, indicating a continued confidence in

the sector. However, people converted one third of their savings from Manat term-deposits into US-Dollar term-deposits (see Figure 4 and Table 4 on p. 19). This indicates a certain distrust in the stability of the local currency (but not distrust in the banks). Indeed, during recent months there were on-going rumors that Azerbaijan could follow other CIS countries and devalue its currency against the US-Dollar and/or the Euro. Although Azerbaijan's stable trade balance and current account surplus is not delivering a good macroeconomic reason for currency devaluation, such public expectations might ultimately nevertheless cause the currency's value to drop. During the first four months of 2009, the Central Bank spent 1.2 billion USD, or approximately 20 percent of its reserves, to buy Manat and keep the local currency stable.

In the third quarter of 2008, as the liquidity and funding situation for Azerbaijani banks tightened, the Central Bank stepped in. According to the Central Bank, it provided stabilization measures worth more than 500 million AZN. These measures included:

- A steady decrease of regulatory reserve requirements on deposits (funds to be deposited by the commercial banks with the Central Bank) from 12 percent to 0.5 percent since July 2008. This change caused an influx of more than 400 million AZN worth of liquid funds into the system;
- Abolishment of the 5 percent obligatory reserve on foreign borrowing in October 2008, yielding a further 100 million AZN of liquidity;
- A steady decrease in the key Central Bank refinancing interest rate for local banks from 12 percent to 3 percent since July 2008;
- A three-year tax holiday on the profit tax, as long as shareholders reinvest the profit as authorized capital (equity) into the banks. This will also help to

strengthen the capitalization of banks. Since the beginning of 2009, bank equity increased by almost 100 million AZN or to 20 percent of total assets (from 16.6 percent at year end);

- Set-up of an emergency facility for liquidity support for commercial banks. In November 2008 the Central Bank provided UniBank, then the country's third biggest bank in terms of assets, with short-term refinancing of 50 million AZN to overcome its tight liquidity situation due to restricted availability of international funding.

All in all, in comparison to most of the other CIS countries the situation in the local banking sector in Azerbaijan is not yet too critical. The Central Bank acted in a reasonable manner in order to prevent signs of crisis from spreading. Nevertheless, it would be naive not to expect longer-term negative effects for the development of the banking sector. A slow-down of economic growth in Azerbaijan will most likely lead to a further increase of delinquent loans (both from households and from enterprises) in the portfolio of the banks, resulting in higher provisions and/or higher write-offs, and, thus, reducing the banks' profit and potentially their equity position.

As long as international capital markets remain parched, Azerbaijani banks will not be able to tap external resources in order to meet domestic demand for credit. Thus, the already low financial intermediation in Azerbaijan may be further reduced. Such a decline in crediting the real sector – particularly the business sector – would be a narrowed bottleneck for the development of the non-oil economy. Such development would constrain the country's long-term economic perspectives. Oil does not always form a solid basis for development as the recent crisis indicates.

#### *About the authors*

Both authors, Gerald Hübner and Michael Jainzik, work at KfW Entwicklungsbank, the German development bank. Gerald Hübner is project manager for private and financial sector development in Eastern Europe and Michael Jainzik is a senior sector economist at KfW's competence center for sustainable economic development.

This article expresses the opinions of the authors and does not necessarily represent the position of KfW.

**Statistics**

## Development of Real GDP in Azerbaijan

Figure 1: Development of Real GDP in Azerbaijan (1989=100%)  
(for comparison: Armenia, Georgia, all Transition Countries)

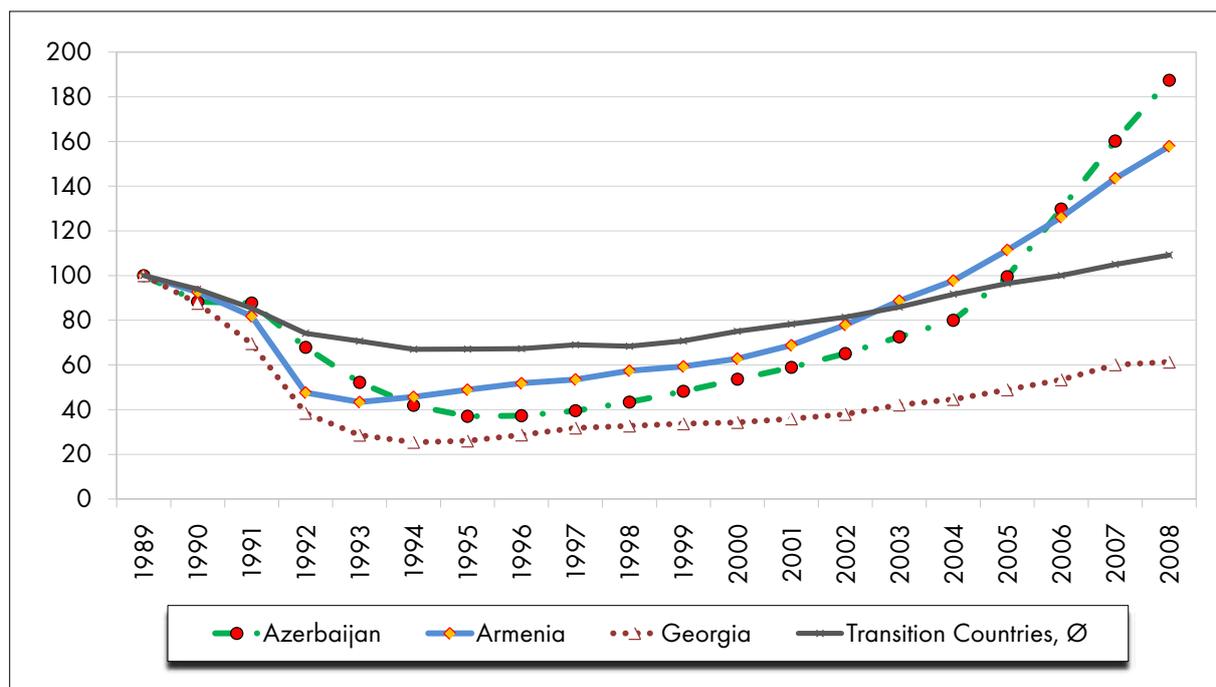


Table 1: Development of Real GDP in Azerbaijan (1989=100%)  
(for comparison: Armenia, Georgia, all Transition Countries)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Azerbaijan	100.00	88.30	87.70	67.90	52.20	41.90	37.00	37.30	39.50	43.40
Armenia	100.00	92.60	81.80	47.60	43.40	45.70	48.90	51.80	53.50	57.40
Georgia	100.00	87.60	69.60	38.40	28.60	25.40	26.00	28.70	31.80	32.70
Transition Countries, Ø	100.00	93.90	85.36	74.17	70.69	67.01	67.08	67.28	69.03	68.41

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Azerbaijan	48.20	53.60	58.90	65.10	72.60	80.00	99.50	129.80	160.20	187.40
Armenia	59.30	62.80	68.80	77.90	88.70	97.70	111.40	126.10	143.50	157.80
Georgia	33.70	34.30	35.90	37.90	42.10	44.60	48.90	53.40	60.10	61.30
Transition Countries, Ø	70.80	75.05	78.28	81.33	85.97	91.64	96.50	100.00	105.00	109.20

Source: EBRD Economic statistics and forecasts 2009, <http://www.ebrd.com/country/sector/econo/stats/index.htm>

## Banking System Structure 2007 – 2008

Figure 2: Banking System Structure 2007–2008 Ukraine, Azerbaijan, Georgia, Armenia, Moldova

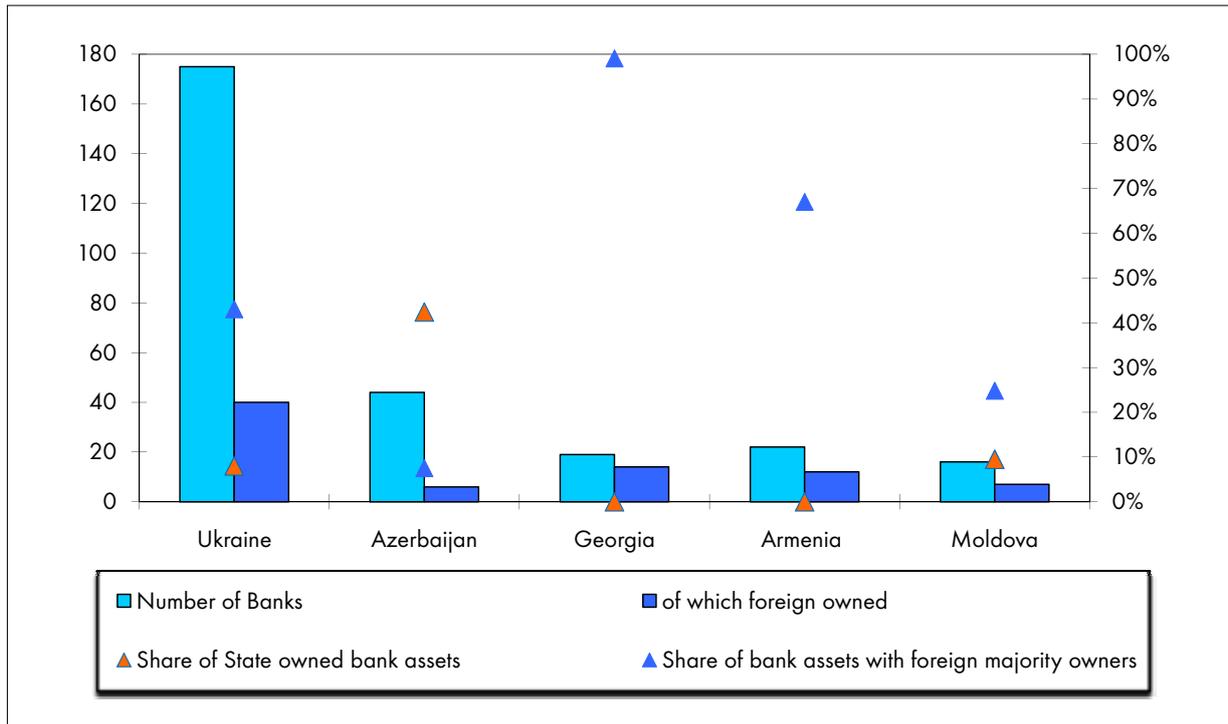


Table 2: Banking System Structure 2007–2008 Ukraine, Azerbaijan, Georgia, Armenia, Moldova

	Number of Banks	of which foreign owned	Share of State owned bank assets	Share of bank assets with foreign majority owners
Ukraine	175	40	8%	43%
Azerbaijan	44	6	42%	8%
Georgia	19	14	0%	99%
Armenia	22	12	0%	67%
Moldova	16	7	10%	25%

## Development of Time Deposits in Azerbaijan

Figure 3: Development of deposits and savings in Azerbaijan, Mar. 2007 – Mar. 2009  
(in million manat)

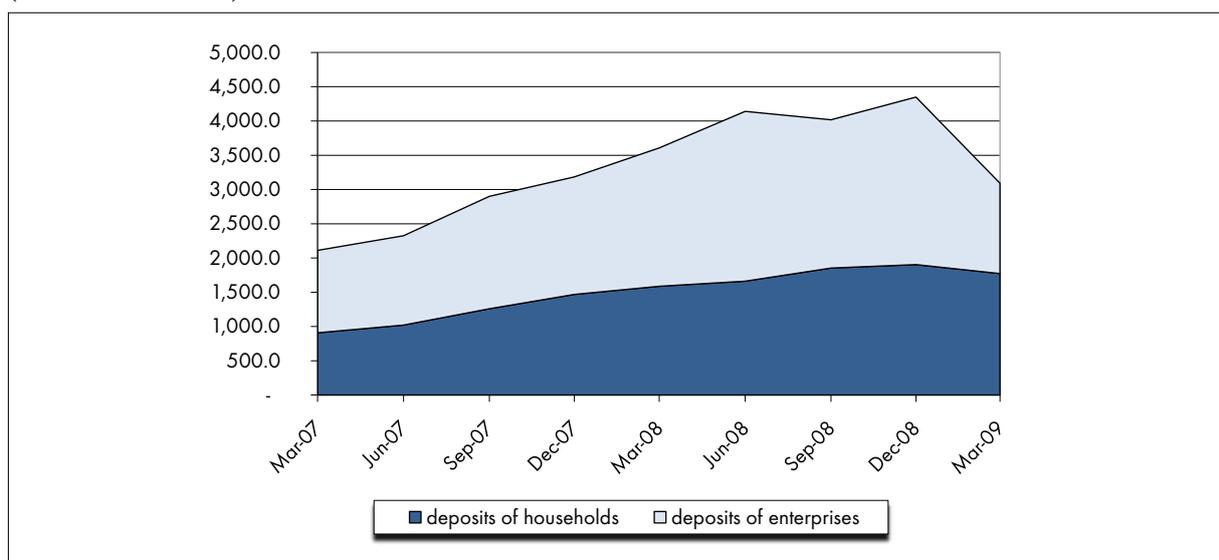


Table 3: Development of deposits and savings in Azerbaijan, Mar. 2007 – Mar. 2009  
(in million manat)

Year, end of month	Total deposits	deposits of households	deposits of enterprises	Households				Enterprises			
				in manat		in foreign currency		in manat		in foreign currency	
				demand deposits	time deposits	demand deposits	time deposits	demand deposits	time deposits	demand deposits	time deposits
Mar. 07	2,111.4	908.4	1,202.9	92.1	197.5	107.1	511.7	452.3	118.1	388.5	244.0
Jun. 07	2,324.9	1,020.8	1,304.1	110.4	267.4	98.2	544.8	458.7	183.9	308.7	352.8
Sep. 07	2,900.1	1,259.2	1,640.8	154.4	349.3	128.3	627.2	585.6	280.1	311.0	464.1
Dec. 07	3,183.7	1,468.4	1,715.3	209.1	467.3	127.3	664.7	730.1	281.6	143.4	560.2
Mar. 08	3,606.7	1,587.2	2,019.6	197.2	532.0	119.8	738.2	670.8	293.8	72.6	982.4
Jun. 08	4,143.2	1,661.6	2,478.6	229.7	612.6	120.9	698.4	694.3	202.8	393.5	1,188.0
Sep. 08	4,017.5	1,853.2	2,164.3	321.6	701.7	128.2	701.7	665.4	193.5	115.5	1,189.9
Dec. 08	4,348.0	1,903.7	2,444.9	325.9	709.7	140.5	727.6	673.4	226.3	68.5	1,476.7
Mar. 09	3,091.1	1,772.8	1,318.4	197.4	464.5	135.2	975.7	586.8	188.1	279.3	264.2

Source: Statistical Bulletin No.3 (109), 3/2009 of the National Bank of the Republic of Azerbaijan

Figure 4: Development of Time Deposits of Households in foreign currency and manat (in million manat)

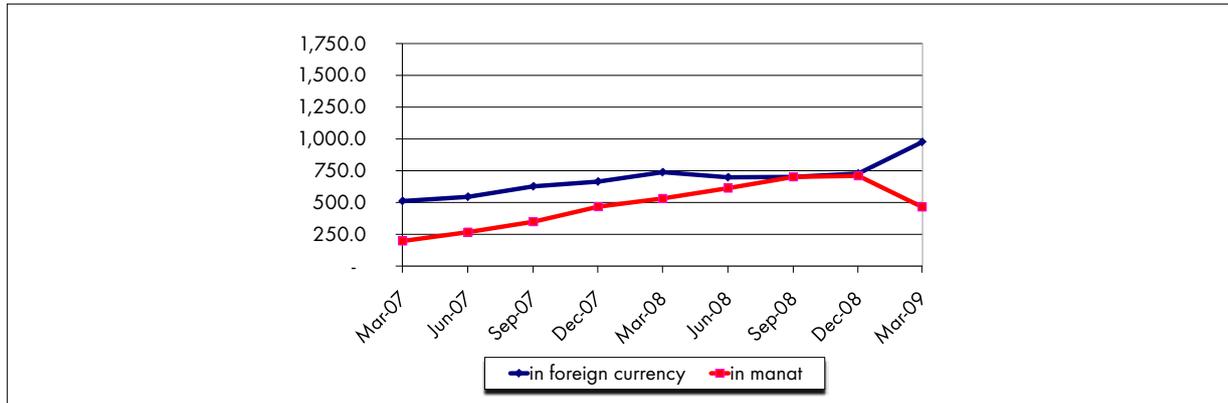


Figure 5: Development of Time Deposits of Enterprises in foreign currency and manat (in million manat)

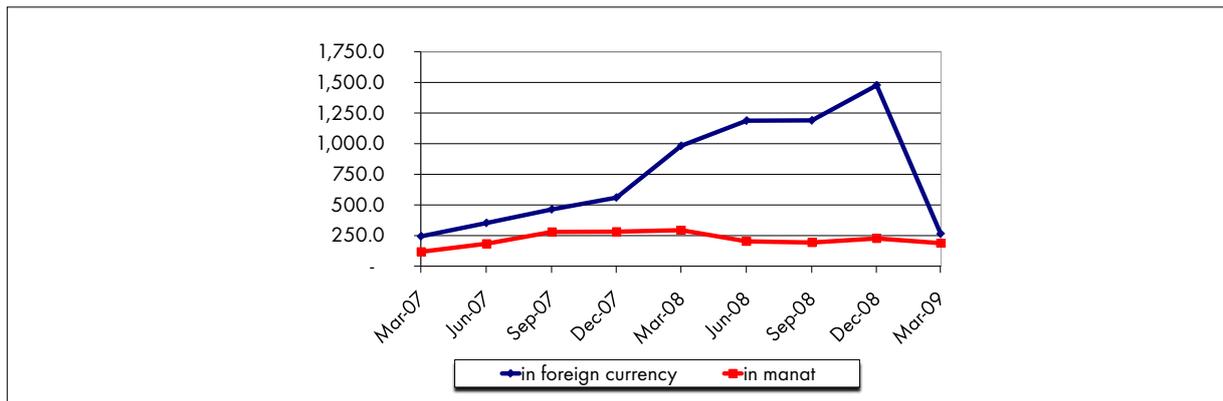


Table 4: Development of Deposits and Savings in Azerbaijan, March 2007 – March 2009 (in million manat)

Year, end of month	Total Deposits	Households				Enterprises			
		in manat		in foreign currency		in manat		in foreign currency	
		demand deposits	time deposits	demand deposits	time deposits	demand deposits	time deposits	demand deposits	time deposits
Mar. 2007	2,111.4	92.1	197.5	107.1	511.7	452.3	118.1	388.5	244.0
June 2007	2,324.9	110.4	267.4	98.2	544.8	458.7	183.9	308.7	352.8
Sep. 2007	2,900.1	154.4	349.3	128.3	627.2	585.6	280.1	311.0	464.1
Dec. 2007	3,183.7	209.1	467.3	127.3	664.7	730.1	281.6	143.4	560.2
Mar. 2008	3,606.7	197.2	532.0	119.8	738.2	670.8	293.8	72.6	982.4
June 2008	4,143.2	229.7	612.6	120.9	698.4	694.3	202.8	393.5	1,188.0
Sep. 2008	4,017.5	321.6	701.7	128.2	701.7	665.4	193.5	115.5	1,189.9
Dec. 2008	4,348.0	325.9	709.7	140.5	727.6	673.4	226.3	68.5	1,476.7
Mar. 2009	3,091.1	197.4	464.5	135.2	975.7	586.8	188.1	279.3	264.2

Source: Statistical Bulletin No.3 (109), 3/2009 of the National Bank of the Republic of Azerbaijan

## Analysis

### Georgia's Expansion Halts

By Molly Corso, Tbilisi

#### Abstract

While Georgia has been affected by the global crisis, early estimates gave the government reason to hope the country would be able to escape the worst of the financial downturn due to large foreign aid inflows and international support for the banking sector. However, local economists and global observers like the International Monetary Fund (IMF) are now predicting zero growth in 2009 and a more protracted recovery period than originally expected.

#### The End of the Boom

With double digit growth rates and rocketing foreign direct investment inflows, the Georgian economy was a post-Soviet success story until the boom deflated during the third quarter of 2008. According to government data, the country's real gross domestic product (GDP) – which is growth rate adjusted for inflation and price changes – increased by 45 percent since 2004. Georgia's boom was based on several underlying factors, including aggressive economic reforms, high levels of foreign direct investment (FDI) and an expanding banking sector.

Under President Mikheil Saakashvili, the Georgian government has put an emphasis on streamlining business regulation and laws. Most significantly, it simplified the tax code and overhauled the customs code. The business community and foreign investors have praised the government's campaign to end the rampant corruption that stifled business under former President Eduard Shevardnadze. Banks and the financial sector have also flourished since the Rose Revolution; major investment in the sector, as well as Georgia's improved international credit rating, helped usher in the country's short-lived "boom" from the end of 2006 through 2008.

During the height of the economy's growth, FDI quarterly inflows averaged a half a billion dollars and the government projected over \$2 billion in foreign investments in 2008. According to data from the department of statistics, the economy received just shy of \$1.3 billion last year. The government had bet on continued growth in 2008 to finance ambitious employment and spending schemes put into place by former Prime Minister Lado Gurgenedze in January 2008. However, growth abruptly slowed following the dual shocks of a short, disastrous war with Russia and the global recession.

#### Georgia's Double Whammy – and Surprise Silver Lining

The Georgian economy was grappling with the affects of the August 2008 war with Russia when the bottom dropped out of the world economy in October. Faced with plum-

meting foreign direct investments and banks struggling to shore up liquidity, the Georgian government depended on massive foreign aid packages to protect its currency reserves – which were tapped to uphold the lari during the war and post-war period – and provide the banks with enough funds to ease public concerns and bolster trust.

A \$750 million stand-by loan from the International Monetary Fund (IMF) in early September was followed by a \$4.5 billion foreign aid pledge by major international donors in Brussels in October, days before the global economy slid into recession. The banking sector also received additional financing from the International Financial Corporation, the European Bank for Reconstruction and Development and the Asian Development Bank, as well as other international financial institutions.

The timing of the Brussels Donors Conference was fortunate: there is little doubt that the pledged foreign aid – which the Georgian government believes will cushion the sharp fall in investments – has played a vital role in buffering the Georgian economy from some of the affects of the global crisis over the past several months. According to the Georgian government, funds pledged during the donors' conference have already started to come in; the total amount is slated to arrive over a three-year period.

#### Gloomy Prognosis for 2009

On May 10, the IMF issued a report stating that economies in the Caucasus region, including Georgia, Armenia and Azerbaijan, will likely be more adversely affected by the crisis as it continues to develop in the west and impede trade demand, as well as access to international credit. Initial prognoses by both international observers – like the IMF – and the Georgian government projected a sharp slowdown in economic growth through 2009, estimating less than 3 percent growth this year. Now, the IMF believes there might be zero growth in the region and the recovery could be protracted, depending on the policies put in place locally and globally to offset the recession.

Unlike western economies, Georgia has no real exposure to the "toxic" debts that are wreaking havoc in more

developed countries. The risks facing Georgia are second-tier economic shock waves: the contraction of the global economy due to the recession and lower demands and the lack of financing available from international credit markets.

In the local economy, there are also signs that the recession is deeper and more entrenched than the government has previously indicated. Local and international economists are looking at three main indicators – investment inflows, trade, and tax revenues – to gauge the impact of the global financial crisis on the Georgian economy.

### Currency Inflows: the Lifeline of the Georgian Economy

The Georgian government has relied on increasingly large currency inflows to finance the country's growth since the Rose Revolution. According to government data, foreign direct investments have surged over the past three years, topping at over \$700 million during the third quarter of 2007 alone. Initial government estimates for 2008 placed foreign investment at over \$2 billion; in reality, the country received just over \$1 billion in FDI last year. The Prime Minister's Office forecasts even less for 2009.

Remittances from overseas have also decreased over the past several months as Georgians working abroad are unable to earn enough money to support their families at home. According to IMF data, remittances to Georgia made up less than 10 percent of the country's total GDP. While that is less than in neighboring Armenia, it represents an important source of income and buying power for many Georgian households. According to a recent EBRD study on remittances in Azerbaijan, Georgia and Moldova, half a million people receive remittances in each country, although source countries vary greatly. The study found that while the individual sums were not large, more than 80 percent of recipients use the money for basic needs like food, housing, clothing and medicine.

Local economists maintain remittance levels dropped about 25 percent in March. During a presentation on April 1, Prime Minister Nika Gilauri downplayed any real impact from remittance reduction. However the May IMF report notes that as the Russian and global economies continue to contract, adversely affecting currency rates, migrant workers will have fewer opportunities to send money home. That will reduce the buying power of Georgian households, and represent fewer inflows into the national budget from sales and taxes.

According to Gilauri, the government is calculat-

ing that the combined impact of the anticipated donor inflows and the IMF stand-by agreement, coupled with the limited amount of foreign direct aid still coming into the country, the Georgian budget will not face any real shortages.

The concern, however, remains that the decrease in foreign currency inflows – which the government used to offset the country's trade deficit – could create problems for the economy.

### Trade: Imports Down, Exports Contracting

One weakness of the Georgian economy is its large trade deficit. Prior to the August 2008 war and the global recession, the deficit ballooned as imports reached over \$7 billion – nearly two times the number of exports. While there have been significant reductions on both sides of the equation, economists note that the 30 percent drop in imports is a serious indicator of the lack of local demand – a sign of how the recession is affecting the Georgian market.

Anecdotal evidence supports this; Georgian businesspeople complain about the lack of sales. However, according to government data, tax revenues have been impressive – despite a 5 percent cut in personal income tax, revenues were just over 320 million lari in March. That is a 41 million lari drop from last year.

Financial revenue collection has also been robust: the Prime Minister's office reports that it was 573.2 million lari in March – up from 499.5 million lari in March of 2008. However local economists believe tax revenues did not meet the government's April expectations.

### Conclusion

The Georgian economy has fared well under the first wave of shocks from the global financial crisis. However, international observers like the IMF believe the economy will suffer more in future months as the recession deepens in the region. Georgia is not at risk of any fallout from "toxic" debts; bigger threats lie in the secondary affects of the recession, including less trade and demand on the international market and extremely limited access to international credit.

To date, the Georgian government has worked hard to present a picture of an economy still performing strongly despite the pressures of the global crisis and the August war with Russia. However, there are an increasing number of indicators that the Georgian economy is more adversely affected than was forecast last year.

#### *About the author*

Molly Corso is a freelance journalist based in Tbilisi, Georgia. She also works as the editor of *Investor.ge*, an English-language business magazine.

## Documentation

### IMF Loan for Georgia

#### IMF Press Release No. 09/3, of March 24, 2009

The Executive Board of the International Monetary Fund (IMF) on March 23 completed the second review of Georgia's performance under an 18-month Stand-By Arrangement totaling SDR 477.1 million (about US\$705.3 million). The completion of the review allows for the immediate disbursement of an amount equivalent to SDR 126.2 million (about US\$186.6 million).

The Arrangement was approved in September 2008 (see Press Release No. 08/208) to support the Georgian authorities' macroeconomic policies, rebuild gross international reserves, and bolster investor confidence.

The Executive Board also concluded the 2009 Article IV consultation with Georgia. Details of the findings will be published in a Public Information Notice in due course.

After the Executive Board's discussion on March 23, 2009, Mr. Takatoshi Kato, Deputy Managing Director and Acting Chair, said:

"Economic and financial conditions have become more challenging since the last program review, as Georgia feels the effects of the global crisis. Sharp declines in trade and workers' remittances, weak commodity prices, and recessions and currency depreciations in major trading partners are threatening domestic confidence and adversely affecting foreign direct investment inflows, and growth prospects. The authorities plan to mitigate the impact of the economic slowdown through a donor-financed fiscal stimulus and a reorientation of expenditures.

"With the aim of aligning public spending with available official external financing, the authorities have reduced the 2009 fiscal deficit target. To ensure that public spending has the maximum impact on the population at large and to alleviate pressures on the poorest, expenditures will be reoriented in favor of essential productivity-enhancing infrastructure investment and targeted social support measures. A reform of expenditure management is also being planned.

"The authorities are encouraged to use all the instruments of monetary policy, including the interest rate and reserve requirements, as part of their adjustment strategy. In this regard, the planned improvements in the central bank's liquidity framework are timely, and should help enhance the effectiveness of interest rate policy.

"Foreign exchange auctions have been introduced, an important step toward exchange rate flexibility and the preservation of external stability. This will also help the authorities to protect, and ultimately to rebuild, international reserves.

"Against the background of a deterioration in banks' loan portfolios and the impact of a sharp contraction in credit on bank profitability, strong supervisory vigilance over the banking system will be crucial. In that vein, the Financial Supervisory Agency is strengthening provisioning based on bank-by-bank assessments, and will stress-test banks with technical assistance from the Fund. The authorities are encouraged to consider measures to bolster depositor confidence and deal with possible systemic risks.

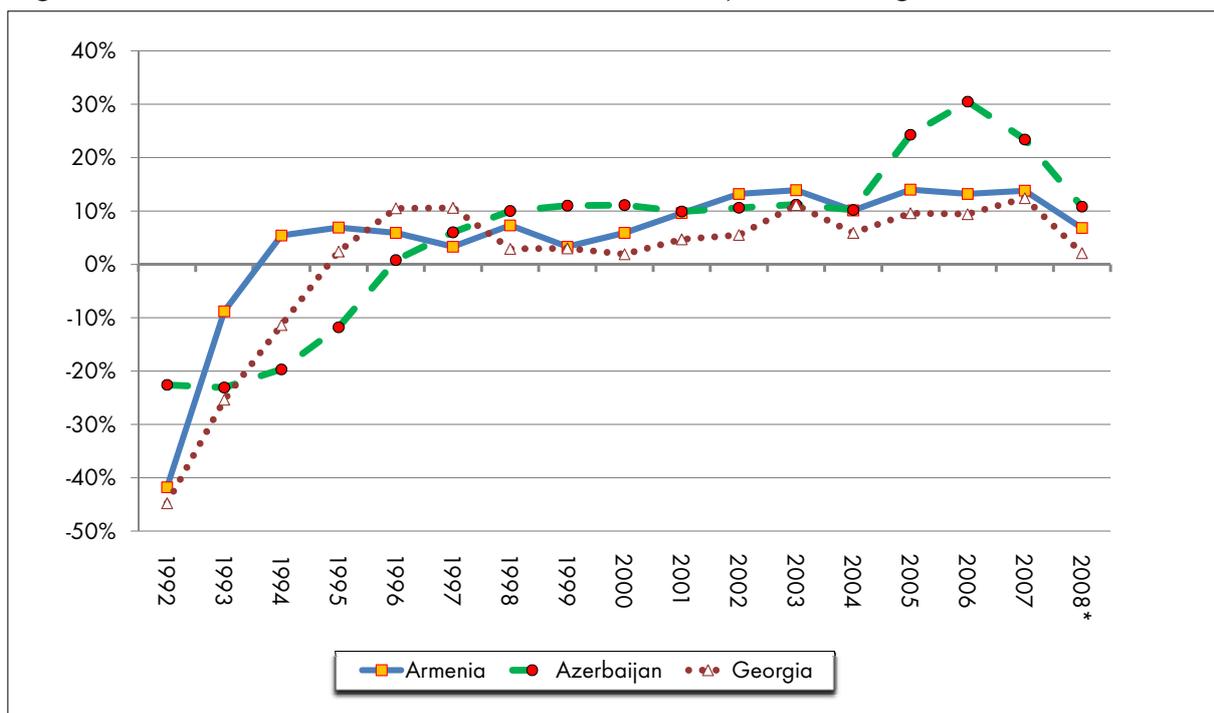
"Georgia's economic policies are being crafted not only in response to the immediate crisis, but also with a view to supporting sustained economic growth over the medium term. The authorities are encouraged to build on their strong track record of reforms and their commitment to fiscal prudence and low inflation. Special focus should be placed on improving Georgia's competitiveness, notably by enhancing the environment for private investment in the tradable sector, and thus helping to reduce the current account deficit and raise employment," Mr. Kato said.

Source: <http://www.imf.org/external/np/sec/pr/2009/pr0983.htm>

Statistics

## Macroeconomic and Financial Indicators of Armenia, Azerbaijan and Georgia in Comparison, 1992 – 2008

Figure 1: Real GDP Growth Rates for Armenia, Azerbaijan and Georgia 1992–2008 (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%

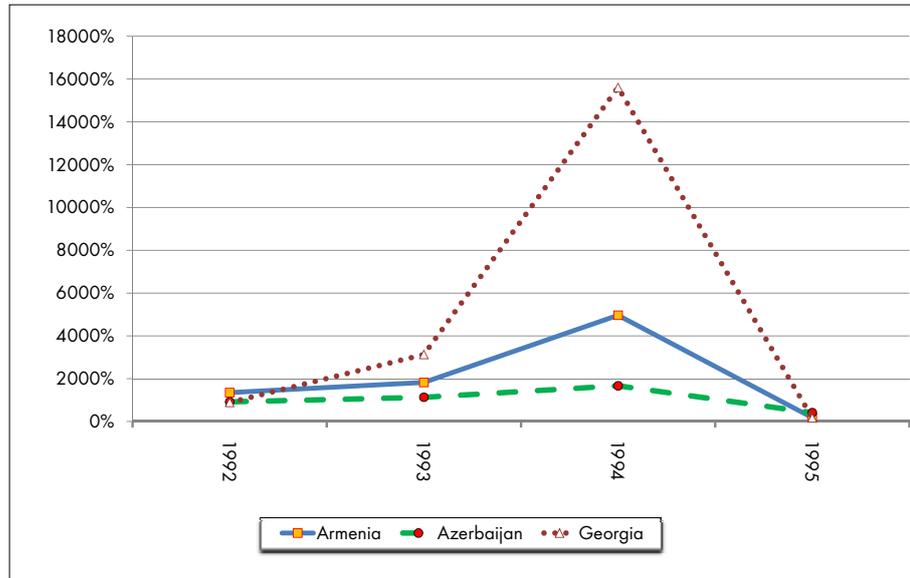
	2001	2002	2003	2004	2005	2006	2007	2008*
Armenia	9.6%	13.2%	13.9%	10.1%	14.0%	13.2%	13.8%	6.8%
Azerbaijan	9.9%	10.6%	11.2%	10.2%	24.3%	30.5%	23.4%	10.8%
Georgia	4.7%	5.5%	11.1%	5.9%	9.6%	9.4%	12.4%	2.1%

\* = estimated

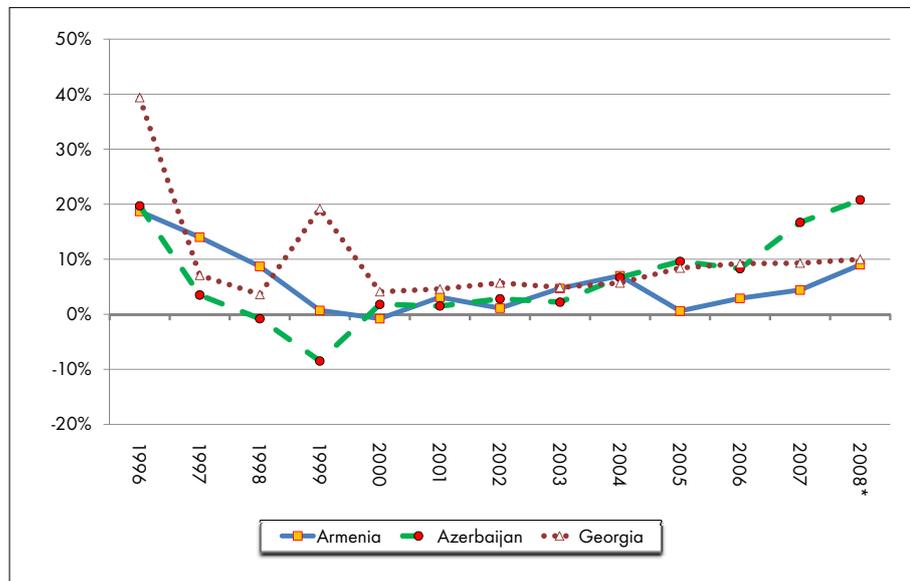
Source: <http://ebrd.com/country/sector/econo/stats/sei.xls>

Figure 2: Consumer Prices Inflation 1992–2008 Armenia, Azerbaijan, Georgia  
(annual average, percentage change)

1992–1995



1996–2008

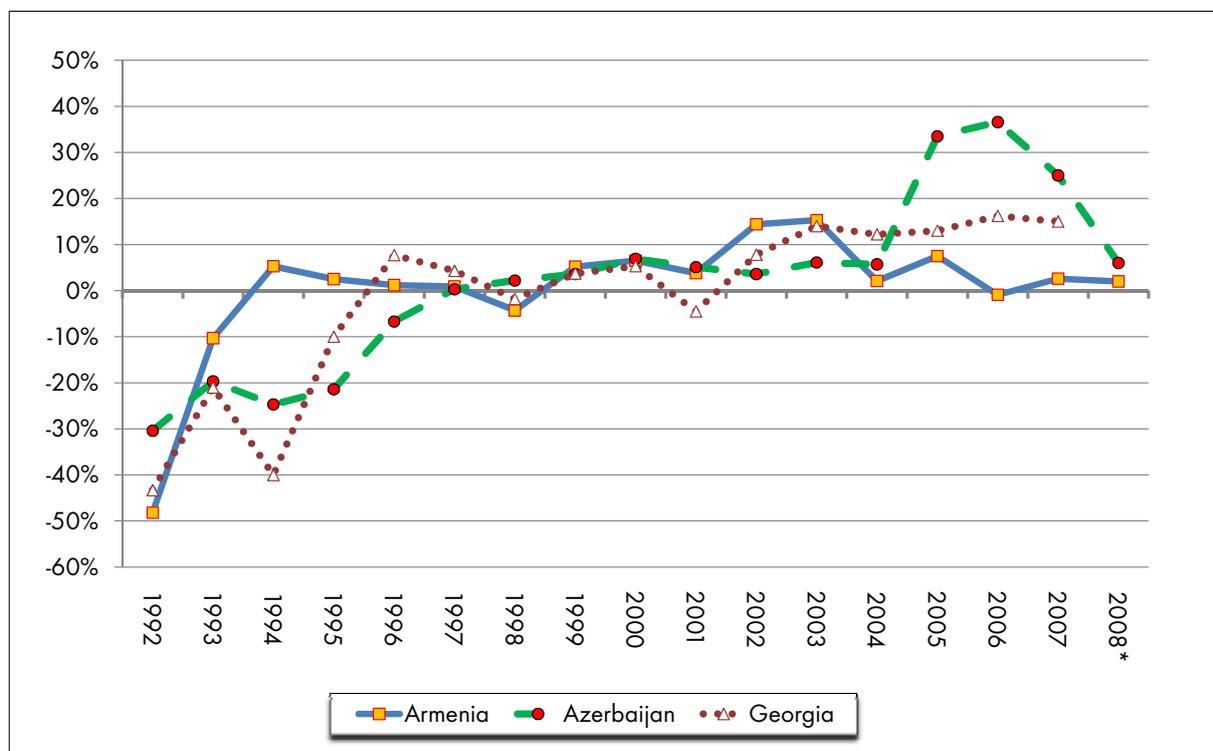


	1992	1993	1994	1995	1996	1997	1998	1999	2000
Armenia	1346.0%	1822.0%	4962.0%	175.8%	18.7%	14.0%	8.7%	0.7%	-0.8%
Azerbaijan	912.0%	1129.0%	1664.0%	489.9%	19.7%	3.5%	-0.8%	-8.5%	1.8%
Georgia	887.4%	3125.4%	15606.5%	162.7%	39.4%	7.1%	3.6%	19.2%	4.1%

	2001	2002	2003	2004	2005	2006	2007	2008*
Armenia	3.1%	1.1%	4.7%	7.0%	0.6%	2.9%	4.4%	9.0%
Azerbaijan	1.5%	2.8%	2.2%	6.7%	9.6%	8.3%	16.7%	20.8%
Georgia	4.6%	5.7%	4.9%	5.7%	8.4%	9.2%	9.3%	10.0%

\* = estimated; source: <http://ebrd.com/country/sector/econo/stats/sei.xls>

Figure 3: Industrial Gross Output 1992–2008 Armenia, Azerbaijan, Georgia (percentage change in real terms)



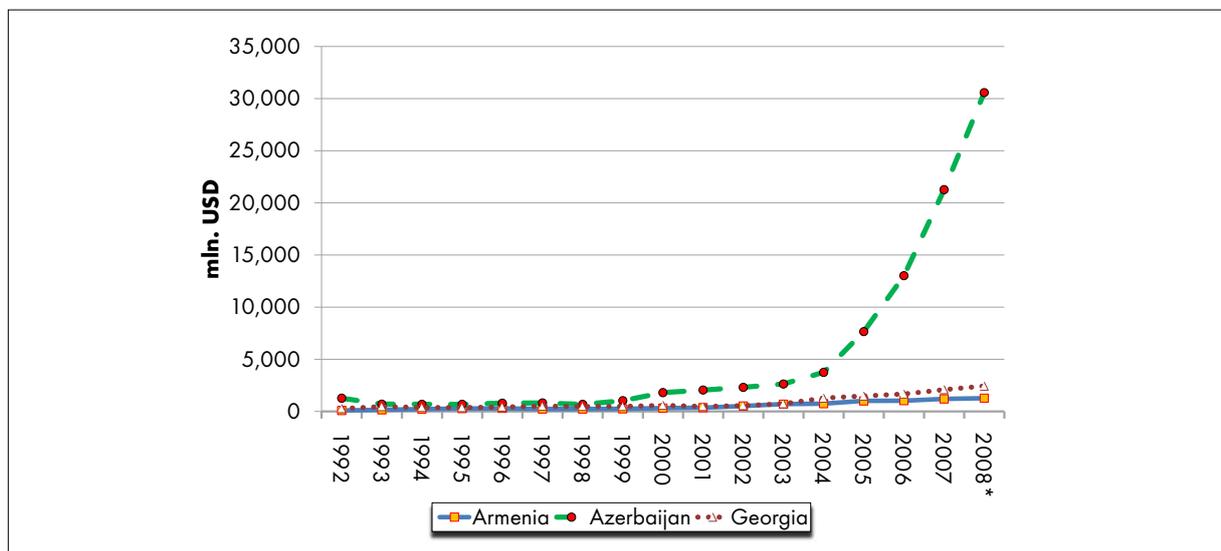
	1992	1993	1994	1995	1996	1997	1998	1999	2000
Armenia	-48.2%	-10.3%	5.3%	2.3%	1.2%	0.9%	-4.3%	5.2%	6.5%
Azerbaijan	-30.4%	-19.7%	-24.7%	-21.4%	-6.7%	0.3%	2.2%	3.6%	6.9%
Georgia	-43.3%	-21.0%	-40.0%	-10.0%	7.7%	4.3%	-1.8%	3.7%	5.3%

	2001	2002	2003	2004	2005	2006	2007	2008*
Armenia	3.8%	14.4%	15.3%	2.1%	7.5%	-0.9%	2.6%	2.0%
Azerbaijan	5.1%	3.6%	6.1%	5.7%	33.5%	36.6%	25.0%	6.0%
Georgia	-4.5%	7.8%	14.0%	12.2%	13.0%	16.2%	15.0%	na

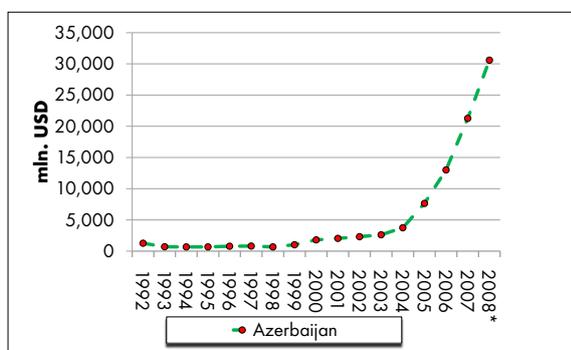
\* = estimated

Source: <http://ebrd.com/country/sector/econo/stats/sei.xls>

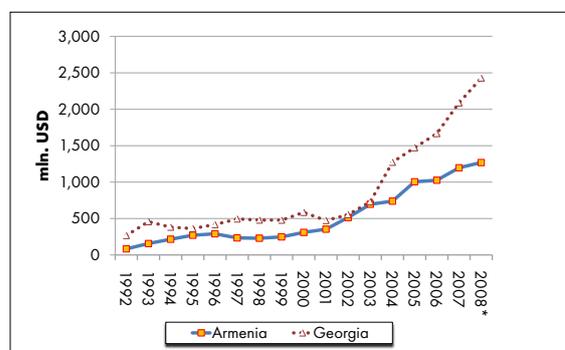
Figure 4: Merchandise Export 1992–2008 Armenia, Azerbaijan, Georgia (mln. US dollars)



Merchandise Export 1992–2008 Azerbaijan (mln. US dollars)



Merchandise Export 1992–2008 Armenia and Georgia (mln. US dollars)

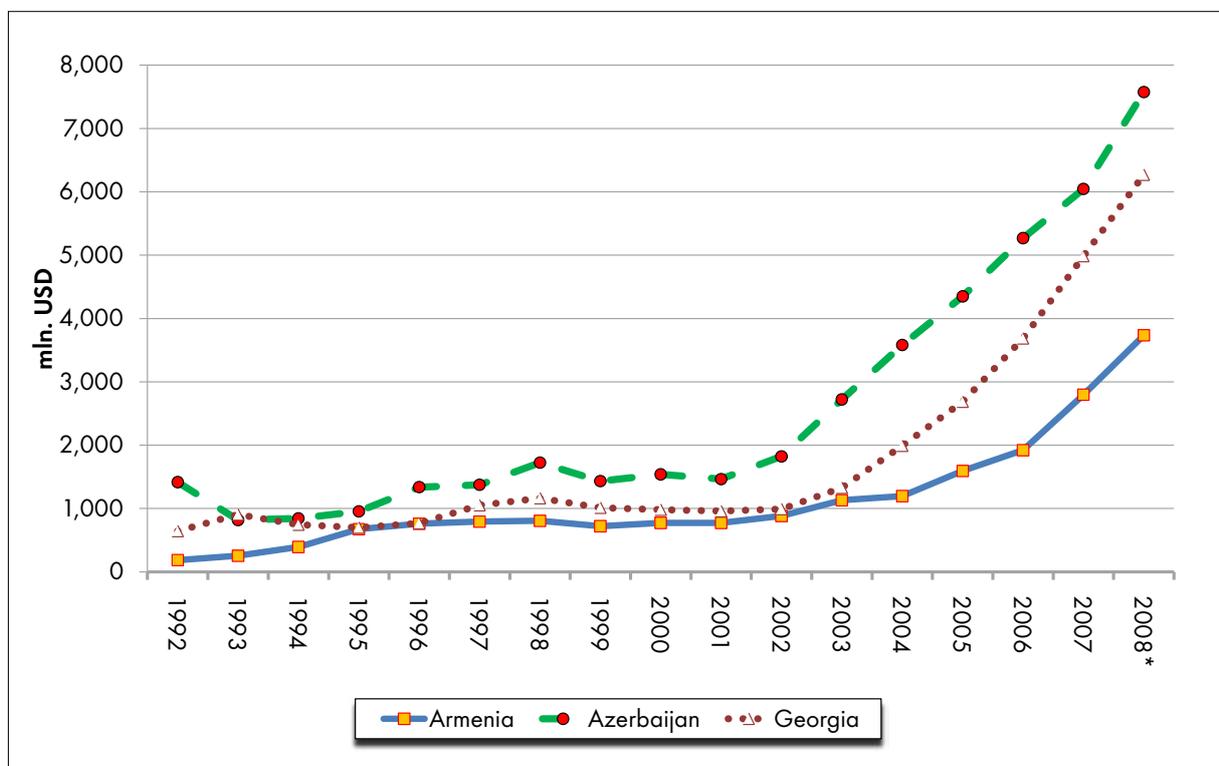


	1992	1993	1994	1995	1996	1997	1998	1999	2000
Armenia	82.9	156.2	215.4	270.9	290.4	233.6	228.9	247.3	309.9
Azerbaijan	1263	697	682	680	789	808.3	677.8	1025.2	1799
Georgia	266.6	457	380.7	362.6	417	493.5	478.3	477	584

	2001	2002	2003	2004	2005	2006	2007	2008*
Armenia	353.1	513.8	696.1	738.3	936.9	1025	1197	1269
Azerbaijan	2046	2305	2625	3743	7649	13014	21269	30584.8
Georgia	473	553	730	1272	1472	1667	2088.3	2428

\* = estimated; source: <http://ebrd.com/country/sector/econo/stats/sei.xls>

Figure 5: Merchandise Import 1992–2008 Armenia, Azerbaijan, Georgia (mln. US dollars)

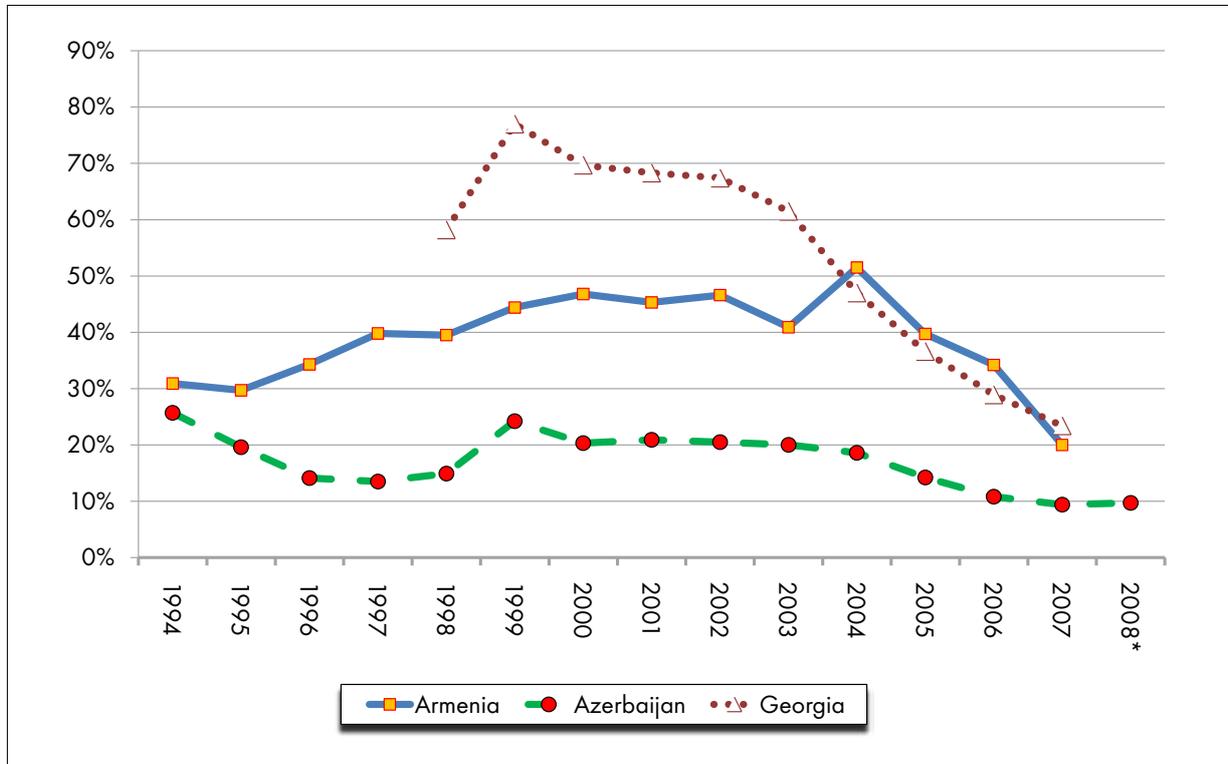


	1992	1993	1994	1995	1996	1997	1998	1999	2000
Armenia	185.3	254.2	393.6	673.9	759.6	793.1	806.3	721.4	773.4
Azerbaijan	1417	819	845	955	1338	1375.2	1723.9	1433.4	1539
Georgia	644.5	905.3	745.7	700.1	767.9	1052.4	1163.7	1013	982

	2001	2002	2003	2004	2005	2006	2007	2008*
Armenia	773.3	882.5	1130.2	1196.3	1921	2194	2797	3735
Azerbaijan	1465	1823	2722.7	3581	4350	5269	6045	7574
Georgia	959	992	1328	1991	2686	3686	4984	6268

\* = estimated

Source: <http://ebrd.com/country/sector/econo/stats/sei.xls>

**Figure 6: General Government Debt 1992–2008 Armenia, Azerbaijan, Georgia (percent of GDP)**


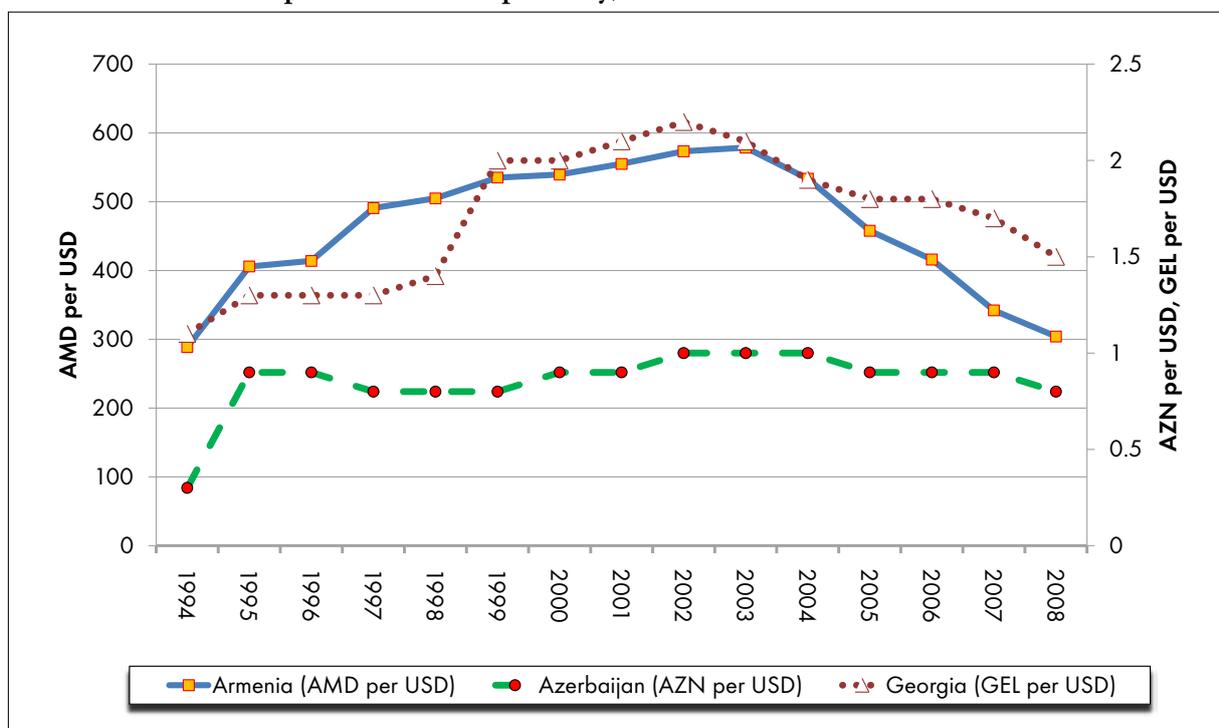
	1992	1993	1994	1995	1996	1997	1998	1999	2000
Armenia	na	na	30.9%	29.7%	34.3%	39.8%	39.5%	44.4%	46.8%
Azerbaijan	na	na	25.7%	19.6%	14.1%	13.5%	14.9%	24.2%	20.3%
Georgia	na	na	na	na	na	na	58.2%	77.0%	69.7%

	2001	2002	2003	2004	2005	2006	2007	2008*
Armenia	45.3%	46.6%	40.9%	51.5%	39.7%	34.2%	20.0%	na
Azerbaijan	20.9%	20.5%	20.0%	18.6%	14.2%	10.8%	9.4%	9.7%
Georgia	68.3%	67.4%	61.5%	47.0%	36.6%	28.9%	23.4%	na

\* = estimated

Source: <http://ebrd.com/country/sector/econo/stats/sei.xls>

Figure 6: Foreign Exchange Rate 1994–2008 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*
Armenia (AMD per USD)	573.4	578.8	533.5	457.8	416	342.1	304.1
Azerbaijan (AZN per USD)	1	1	1	0.9	0.9	0.9	0.8
Georgia (GEL per USD)	2.2	2.1	1.9	1.8	1.8	1.7	1.5

\* = estimated

Source: <http://ebrd.com/country/sector/econo/stats/sei.xls>

## Chronicle

### From 17 April to 19 May 2009

17 April 2009	Azerbaijani President Ilham Aliyev and Russian President Dmitry Medvedev met in Moscow to discuss energy exports and the Nagorno-Karabakh conflict
18 April 2009	Russian President Dmitry Medvedev warns Russia will closely watch planned NATO military exercises in Georgia
21 April 2009	The opposition in Georgia launches a “town of cells” by setting up mock prison cells in front of the Georgian Parliament on Tbilisi’s Rustaveli Avenue
21 April 2009	Kazakhstan refuses to take part in NATO military exercises in Georgia in a show of support for Russia
22 April 2009	The EU Monitoring Mission in Georgia (EUMM) announced that EU and OSCE monitors would facilitate a meeting of the Georgian and South Ossetian sides, as well as representatives from the Russian forces, at the Ergneti village between the Georgian and South Ossetian checkpoints
22 April 2009	Azerbaijan and the United Arab Emirates (UAE) sign a protocol on bilateral cooperation in transport
23 April 2009	Turkey and Armenia agree on a road map to normalize their relations
26 April 2009	Patriarch of the Georgian Orthodox Church Ilia II calls on politicians to pray together on a day of nationwide prayer for repentance on April 28
27 April 2009	Georgia denies the presence of Chechen militants on its territory in response to Russia’s accusations
28 April 2009	The EU Monitoring Mission in Georgia (EUMM) says it is satisfied that the Georgian authorities are in compliance with commitments to create a restricted armament zone near the borders with Abkhazia and South Ossetia
30 April 2009	Russian President Dmitry Medvedev signs border cooperation agreements which give Russia control over the Abkhaz and South Ossetian borders with Abkhaz leader Sergey Bagapsh and South Ossetian leader Eduard Kokoity at a ceremony in the Kremlin in Moscow
30 April 2009	At least 13 people are killed during a shooting at Azerbaijan’s State Oil Academy in Baku
30 April 2009	Armenian Prime Minister Tigran Sarkisian says that Armenia’s largest chemical plant Nairit will resume operations
30 April 2009	Russia accuses Georgia and Azerbaijan of not taking effective measures to curtail transfer of funds to the North Caucasus resistance
5 May 2009	Georgian government officials suggest a mutiny at the Mukhrovani military base outside Tbilisi was funded by Russia to undermine NATO military exercises and foment a rebellion against Georgian President Mikhail Saakashvili
5 May 2009	Armenia, along with Kazakhstan, Serbia and Moldova, pulls out of NATO military exercises in Georgia
5 May 2009	Campaign for mayoral election officially starts in Yerevan
5 May 2009	Belarus President Alexander Lukashenko declares that Belarus and Azerbaijan need enhanced cooperation at a meeting with Azerbaijani First Deputy Prime Minister Yagub Eyyubov
6 May 2009	NATO begins war games in Georgia involving over 1,000 soldiers from more than a dozen NATO member states and partner nations
8 May 2009	EU leaders approve the Eastern Partnership initiative aimed at increasing ties between the EU and six Eastern neighbors (Azerbaijan, Armenia, Belarus, Georgia, Moldova, Ukraine) at a EU summit in Prague

*(continued overleaf)*

8 May 2009	The EU and four partner countries (Azerbaijan, Georgia, Turkey and Egypt) sign a joint declaration at an energy summit in Prague to support the realization of a Southern energy corridor aimed at decreasing Europe's dependency on Russian supplies
11 May 2009	Georgian President Mikhail Saakashvili meets four opposition leaders for talks
13 May 2009	Turkish Prime Minister Recep Tayyip Erdogan meets with Azerbaijani President Ilham Aliyev in Baku
14 May 2009	Abkhaz leader Sergey Bagapsh meets Russian Prime Minister Vladimir Putin in Sochi
14 May 2009	Russia rejects the Greek OSCE chairmanship's proposal of keeping OSCE monitors with right of free movement across the border with South Ossetia
14 May 2009	Iran starts gas supplies to Armenia
15 May 2009	Abkhaz Businessman Beslan Butba says he may run as a presidential candidate in Abkhazia
16 May 2009	Abkhaz official says Abkhazia will not take part in the Geneva talks claiming that the United Nations has not sent a key document in time
17 May 2009	EU Special Representative for the South Caucasus Peter Semneby meets opposition leaders in Tbilisi
18 May 2009	Russia walks out of Geneva talks pending clarification of the Abkhaz position over taking part in the talks
18 May 2009	Russian State Duma Speaker Boris Gryzlov visits Sukhumi in Abkhazia
19 May 2009	The Geneva talks are resumed after Russia, Abkhazia and South Ossetia finally join the fifth round of talks
19 May 2009	EU Special Representative for the South Caucasus Peter Semneby meets with Azerbaijani President Ilham Aliyev in Baku to discuss EU-Azerbaijan cooperation

## About the Caucasus Analytical Digest

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

The Caucasus Analytical Digest (CAD) is a monthly internet publication jointly produced by the Heinrich Böll Foundation in Tbilisi ([www.boell.ge](http://www.boell.ge)), the Research Centre for East European Studies at the University of Bremen ([www.forschungsstelle.uni-bremen.de](http://www.forschungsstelle.uni-bremen.de)), the Jefferson Institute in Washington, DC ([www.jeffersoninst.org](http://www.jeffersoninst.org)) and the Center for Security Studies (CSS) at ETH Zurich ([www.css.ethz.ch](http://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 and partial funding from the Jefferson Institute.

To subscribe or unsubscribe to the Caucasus Analytical Digest, please visit our web page at [www.res.ethz.ch/analysis/cad](http://www.res.ethz.ch/analysis/cad)

### Heinrich Böll Foundation

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.

### Center for Security Studies (CSS) at ETH Zurich

The Center for Security Studies (CSS) at the Swiss Federal Institute of Technology (ETH Zurich) is a Swiss academic center of competence that specializes in research, teaching, and information services in the fields of international and Swiss security studies. The CSS also acts as a consultant to various political bodies and the general public.

### Research Centre for East European Studies at the University of Bremen

Founded in 1982, the Research Centre for East European Studies (Forschungsstelle Osteuropa) at the University of Bremen is dedicated to socialist and post-socialist cultural and societal developments in the countries of Central and Eastern Europe. One of the core missions of the institute is the dissemination of academic knowledge to the interested public. This includes regular e-mail services with nearly 20,000 subscribers in politics, economics and the media.

### Jefferson Institute

The Jefferson Institute is an independent trans-Atlantic research and education institute. We are inspired by Thomas Jefferson's challenge to pursue truth, wherever it may lead, and his vision of foreign policy at its best: to prevail through ideas and commerce. Our mission is simple. We inform decision with alternative solutions.

Any opinions expressed in Caucasus Analytical Digest are exclusively those of the authors.

Reprint possible with permission by the editors.

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

Layout: Cengiz Kibaroglu, Matthias Neumann

ISSN 1867 9323 © 2009 by Heinrich Böll Stiftung, Forschungsstelle Osteuropa, Bremen and Center for Security Studies, Zürich

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](mailto:fsopr@uni-bremen.de) • Internet: [www.res.ethz.ch/analysis/cad](http://www.res.ethz.ch/analysis/cad)