

Russia-Turkey-Iran: Why the Caspian Sea region is not the Bermuda Triangle of business

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Executive summary

- A triple shock - rising geopolitical risks, the deep recession in Russia and tumbling commodity prices – has disrupted the economic performance in the Caspian Sea region over the last years.
- All economies in the region have been affected by declining exports to Russia and falling remittances inflows or tourism income from Russia. Further, all countries are significant commodity exporters, but net energy exporters (Azerbaijan, Kazakhstan, Russia, Turkmenistan, Iran, Uzbekistan) have suffered more.
- Average annual real GDP growth in the region fell from +5.5% in 2010-2013 to +3.9% in 2014-2015 and is forecast at +2.6% in 2016-2017. All currencies in the region depreciated or were devalued sharply in 2014-2015, but have stabilized in 2016.
- The improved business environment, over the past decade, the planned North-South Transport Corridor from Russia via Iran to India and decisive pro-business policies could provide future opportunities for companies in the region.

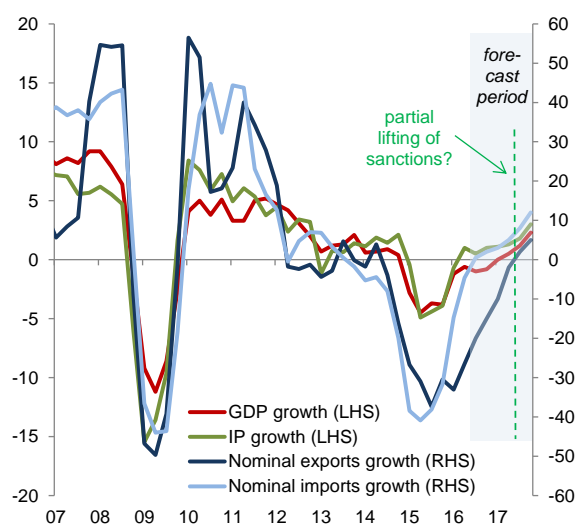
Against the background of rising geopolitical tensions and risks, the protracted crisis in Russia and the general decline in global commodity prices, the Caspian Sea region – comprising the Caucasus (Armenia, Azerbaijan, Georgia), Central Asia (Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, Uzbekistan), Iran, Russia and Turkey – has faced significant economic turbulences over the past years. This analysis works out the varying degrees of impact of these disruptions on the economies. It also provides a view on future opportunities once these disruptions will have faded.

Disruption #1: (Rising) geopolitical risks

Russia/Ukraine

Geopolitical tensions between Russia and the West arose after Russia's annexation of Crimea in March 2014 and over its continued involvement in the conflict in east Ukraine, resulting in economic sanctions and countersanctions that have remained in place to date. The economic fall-out for the Russian economy was exacerbated by sharply

Figure 1: Growth of real GDP, industrial production (IP), nominal exports and imports in Russia (% y/y; quarterly data)



Sources: National Statistics, IHS, Euler Hermes

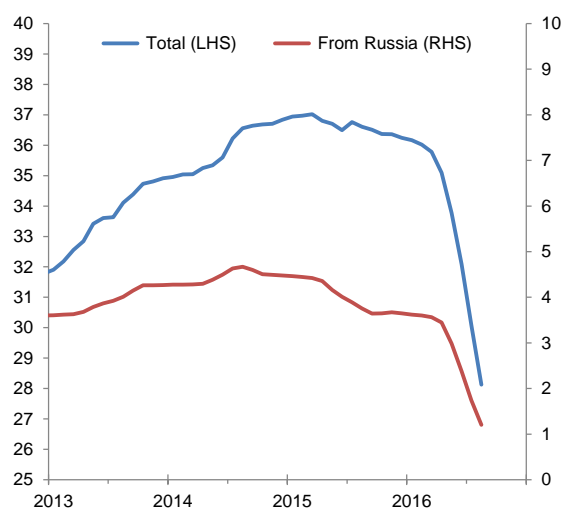
falling global oil prices, which adversely impacted exports and government revenues, and an equally sharp depreciation of the RUB. The country entered a deep recession in 2015, with real GDP contracting by -3.7%, industrial production by -3.4%, nominal exports of goods by a hefty -31% and imports by -37% (see Figure 1).

Russia's fourfold crises (politics, investor confidence, oil price, currency) are ongoing but the impact is softening as the country has adapted somewhat to the new conditions. The recession has bottomed out in the second half of 2015, however, the economy continued to contract through the first half of 2016 (-0.9% y/y) partly as a result of renewed oil price and RUB weakness. Euler Hermes forecasts full-year GDP to contract by -0.9% in 2016, followed by a modest recovery and +1% growth in 2017. This includes the assumption that economic sanctions may be partially lifted in mid-2017. Industrial production as well as nominal exports and imports should also return to moderate positive growth in 2017 (see Figure 1).

Turkey

Political developments and events since 2015 have led to markedly increased political and policy uncertainty, which is unlikely to fade over the next year. These include (i) ongoing, frequent terror attacks by ISIS and PKK and the intensified Turkish military campaign against both (raising security concerns); (ii) deteriorated relations with Russia after the downing of a Russian military plane in late 2015 (although rapprochement has begun); (iii) the failed military coup in July 2016 and the subsequent purge of almost all non-parliamentary opposition; and (iv) ongoing insurgencies in neighboring Syria (and northern Iraq) and Turkey's increased involvement there.

Figure 2: Foreign visitors arrivals in Turkey (million)



Sources: Ministry of Culture and Tourism, Euler Hermes

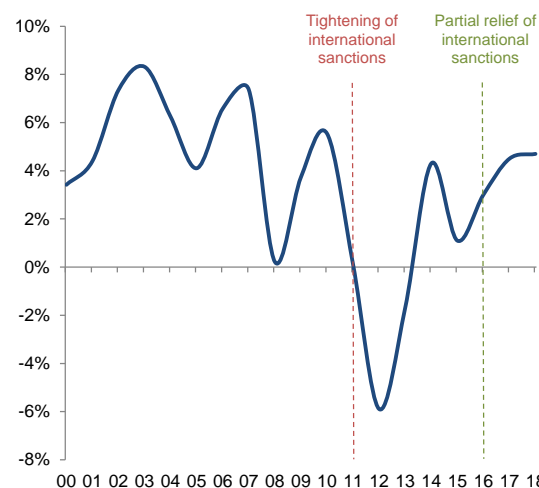
The rising political uncertainties will weigh on Turkey's medium-term economic prospects (e.g. lower growth due to lower foreign and domestic investment; renewed financial market turbulences, perhaps triggering sharp monetary tightening at some point). However, some short-term impact

through fewer tourist arrivals and thus falling tourism revenues has already been noticed as well (see Figure 2). Overall, Euler Hermes has reduced its forecasts for annual real GDP growth to around +3% in 2016-2017 (for more details see also our recent [Country Report Turkey](#)).

Iran

Sharply tightened international sanctions in 2011 led to a two-year recession in 2012-2013. The partial lifting of sanctions in early 2016 will boost growth as oil production is set to climb from 3.3 mn barrels/day in 2015 to 3.9 mn in 2016. Euler Hermes forecasts real GDP growth to pick up to +3% in 2016 and +4.5% in 2017 (see Figure 3).

Figure 3: Real GDP growth in Iran (% y/y)



Sources: IHS, Euler Hermes

However, although sanctions on financial transactions with Iranian banks were repealed, in reality there is still hardly external financing available as western banks remain reluctant doing business with Iran, being wary of infringing remaining U.S. sanctions. Overcoming these would increase the opportunities for a sustained recovery.

Armenia/Azerbaijan

Geopolitical risk remains also on the agenda in the Caucasus region as the currently slumbering but unresolved conflict between Armenia and Azerbaijan over the Nagorno Karabakh enclave may erupt again at any time.

Disruption #2: Spillovers from Russia's recession to the Caspian Sea region

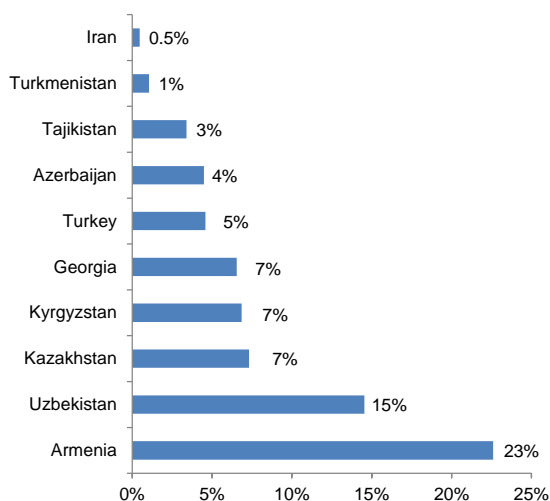
The direct impact of the crisis in Russia on the economies in the Caspian Sea region has come through two main channels: exports of goods to Russia and remittances from Russia.

Disruption of exports to Russia

The direct dependence on the exports of goods to Russia is the highest in Armenia where these accounted for around 23% of total exports in 2013 (the year before Russia's crisis began) followed by Uzbekistan with 15%. Then follow Kazakhstan, Kyrgyzstan and Georgia with each about 7% of its total exports shipped to Russia. The export depen-

dence is relatively limited for Turkey, Azerbaijan, Tajikistan, Turkmenistan and Iran (see Figure 4).

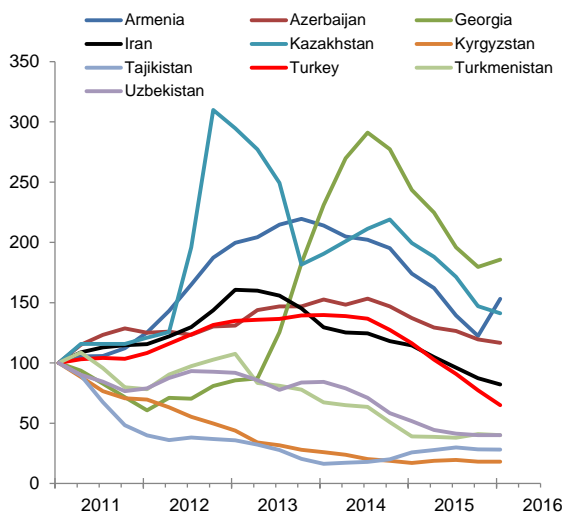
Figure 4: Exports to Russia in % of total exports (2013)



Sources: IMF, Euler Hermes

Figure 5 shows that exports from Central Asia to Russia have already fallen since 2011, except for Kazakhstan, as the Russian economy started to lose momentum and global commodity prices began to decline. Starting mid-2014 when the Russian economic slowdown accelerated in the wake of Western sanctions and falling oil prices, exports from the whole Caspian Sea region to Russia plunged. The sharpest falls were registered in Armenia, Georgia, Kazakhstan and Turkey. The only exception is Tajikistan which has seen modestly rising exports to Russia since 2014 but, as shown above, the level of this country's exports is very low.

Figure 5: Exports to Russia (4 qtrs. moving average, 2011 Q1 = 100)



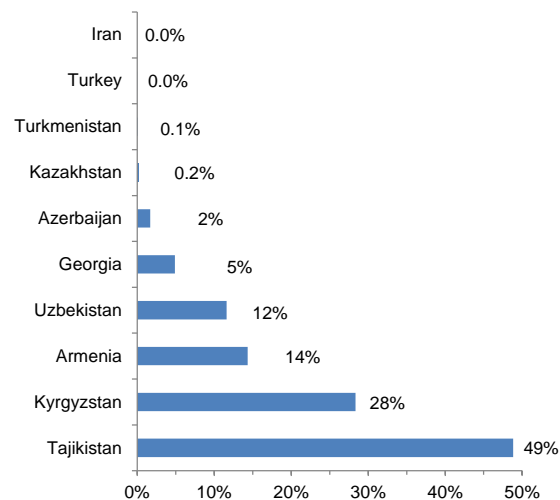
Sources: IMF, Euler Hermes

Disruption of remittances from Russia

Remittances inflows from Russia are particularly important for Tajikistan (amounting to 49% of GDP

in 2013), Kyrgyzstan (28%) and Armenia (14%) – the three smallest economies in the Caspian Sea region with regard to annual GDP – as well as for Uzbekistan (12%). For the other six countries remittances accounted for less than 5% of GDP in 2013 (see Figure 6).

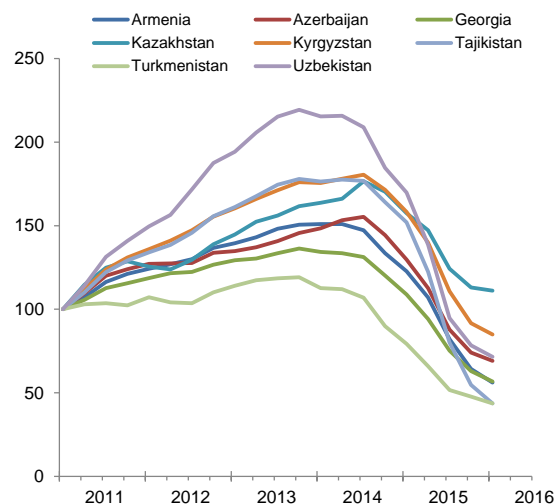
Figure 6: Remittances from Russia in % of GDP (2013)



Sources: Central Bank of Russia, Euler Hermes

Figure 7 shows that remittances from Russia to the three Caucasus countries and the five Central Asian countries have dropped sharply since mid-2014 in the wake of the multiple Russian crises. Until early 2016, there has been no respite in this decline.

Figure 7: Remittances from Russia (4 qtrs. moving average, 2011 Q1 = 100)



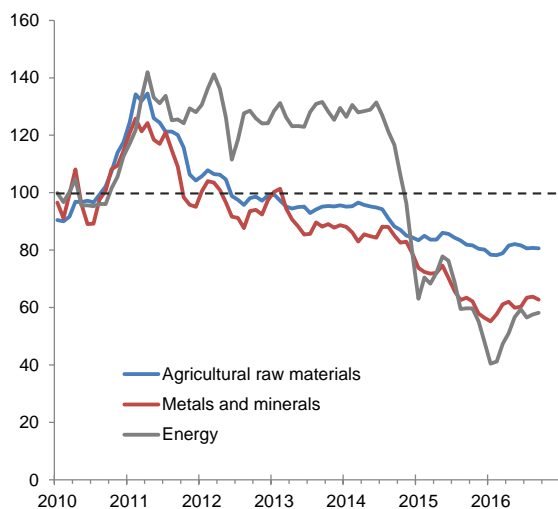
Sources: Central Bank of Russia, Euler Hermes

Disruption #3: Low for longer commodity prices

Commodity prices have continuously fallen since 2011 (see Figure 8). Energy prices initially held up better but then experienced a sharp drop in H2 2014 and again from mid-2015 until Q1 2016. At the time of writing, the price for a barrel of benchmark

Brent oil stood at USD52, still less than half the average in H1 2014 (USD109).

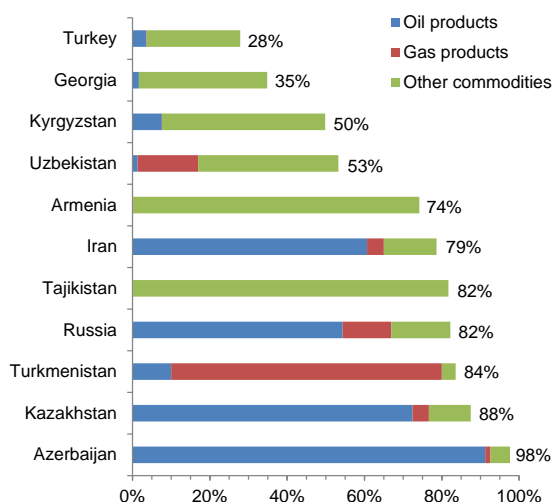
Figure 8: Commodity prices development (2010 = 100)



Sources: World Bank, Euler Hermes

Figure 9 shows that in seven out of the 11 Caspian Sea economies, commodities account for three fourth or more of total exports; in two countries the share is about half; and in the other two it is about one third. Overall, this suggests that for most economies in the region the adverse effects of falling commodity prices have been larger than the negative impact of Russia's recession.

Figure 9: Share of commodities in % of total exports (2014)



Sources: Unctadstat, Euler Hermes

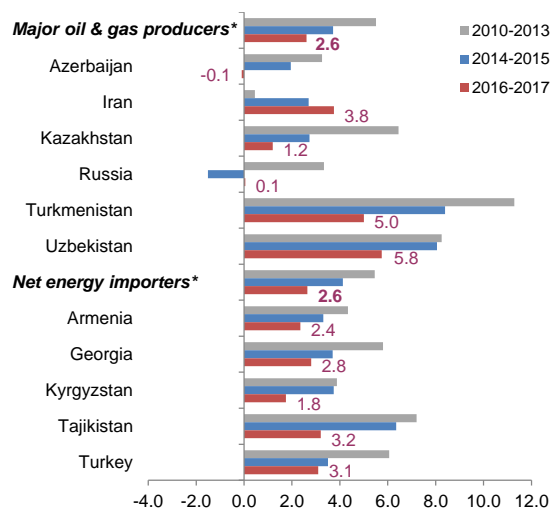
Azerbaijan, Kazakhstan, Turkmenistan, Russia, Iran and Uzbekistan can be identified as major oil and/or gas producers and are net energy exporters. The other countries predominantly export non-hydrocarbon commodities and are net energy importers.

Impact #1: Sharp growth slowdown

In all countries in the Caspian Sea region, except for Iran, average annual real GDP growth declined

in 2014-2015 as compared to 2010-2013. Thereby, the average deceleration in the group of major oil and gas producing countries (from +5.5% in 2010-2013 to +3.7% in 2014-2015) was stronger than in the group of net energy importers (from +5.5% to +4.1%) since oil and gas prices have dropped more markedly since 2014 than other commodity prices. Moreover, commodity exporters that are net energy importers at the same time have also benefited from lower oil and gas prices. In 2016-2017, Euler Hermes expects a further slowdown of growth to an average +2.6% in the region.

Figure 10: Real GDP growth (%; average of periods)



* Average of sub-group of countries.

Sources: National statistics, IMF, Euler Hermes

Impact #2: Substantial currency depreciation/devaluation

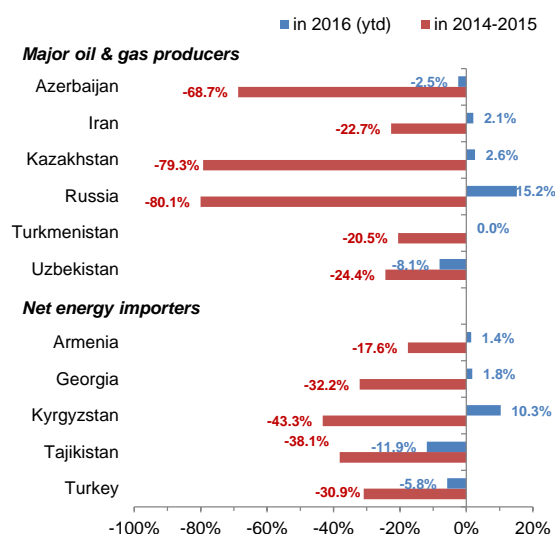
As a consequence of the sharp depreciation of the Russian RUB in 2014-2015, the Caucasian and Central Asian countries' currencies, most of them then (quasi-)pegged to the USD, appreciated sharply against the RUB and their economies lost competitiveness, irrespective of their degree of trade relations with Russia, as they all have a similar production and export structure as Russia. As a result, the monetary authorities devalued their currencies or let them depreciate. Major oil and gas producers experienced, on average, stronger exchange rate corrections over 2014-2015, with the Kazakh KZT (-79%) and Azerbaijani AZN (-69%) seeing the largest drops, similar to the -80% decline of the RUB (see Figure 11).

The Kazakh central bank devalued the KZT twice against the USD – first by -17% in February 2014 and then by -30% in August 2015 when it also moved from the peg to a managed floating regime. The KZT has remained volatile thereafter but regained some ground in 2016, in line with the RUB. Similarly, the Central Bank of Azerbaijan devalued the AZN in February 2015 and again in December when it also shifted from a pegged to a floating exchange rate regime, and introduced capital controls in January 2016 (see Figure 12).

Meanwhile, most countries in the region have moved to some sort of managed floating. Figure 13

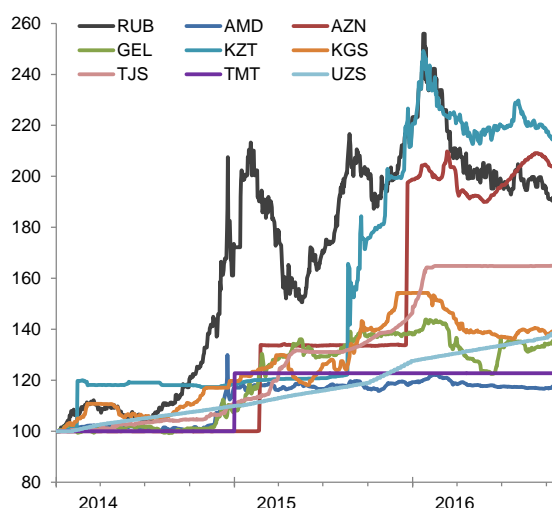
gives an overview of the currently applied exchange rate regimes. Note that only the Russian RUB and the Turkish TRY are fully convertible.

Figure 11: Exchange rate change vs. USD (%)



Sources: IHS, Euler Hermes

Figure 12: Exchange rates vs. USD (1 January 2014 = 100)



Sources: IHS, Euler Hermes

Figure 13: Currency regimes

Country	Currency Code	Exchange rate regime	Convertibility
Armenia	AMD	Floating	No
Azerbaijan	AZN	Managed floating / stabilized	No
Georgia	GEL	Floating	No
Iran	IRR	Tightly controlled	No
Kazakhstan	KZT	Managed floating	No
Kyrgyzstan	KGS	Managed floating	No
Russia	RUB	Managed floating	Yes
Tajikistan	TJS	Managed floating	No
Turkey	TRY	Managed floating	Yes
Turkmenistan	TMT	Conventional peg	No
Uzbekistan	UZS	Crawl-like arrangement	No

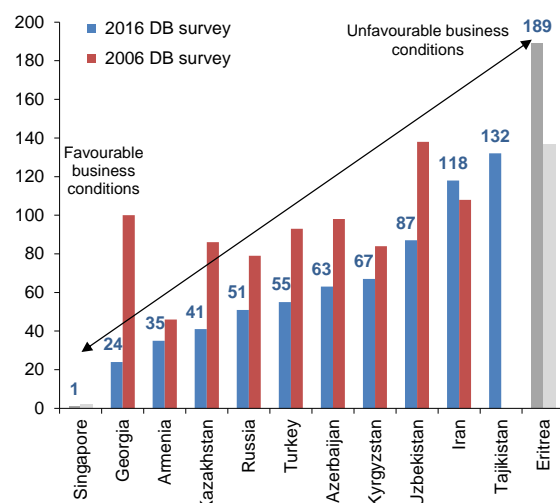
Sources: IMF, Euler Hermes

Opportunity #1: Improved business environment

The World Bank's annual "Doing Business" surveys suggest an improved perception of the overall business conditions for all countries in the Caspian Sea region over the past decade, except for Iran (note: Turkmenistan is not included in the surveys, Tajikistan was not included in the 2006 survey). And most countries are now ranked above the global average (see Figure 14). This should help to increase investor confidence and provides an opportunity to attract more foreign direct investment, especially when the impact of the disruptions as described above is fading.

However, not all is perfect as yet, and the devil often lies in the detail. The rule of law is still weak across the region and resolving insolvencies, for example, remains difficult (see Figure 15).

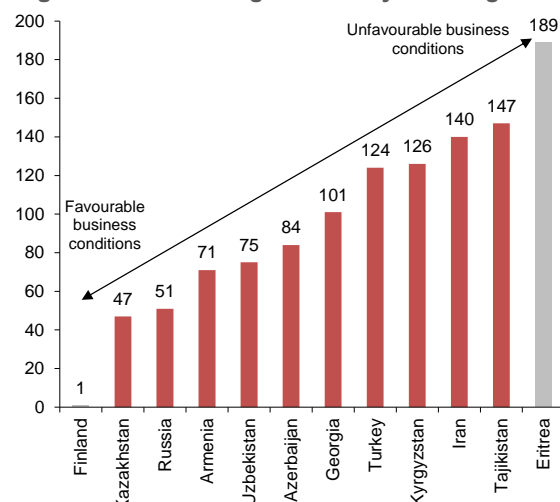
Figure 14: Overall business conditions ranking, 2016 vs. 2006



NB: Criteria for business conditions ranking include ease of starting a business, dealing with construction permits, getting electricity, restricting property, securing credit, protecting investors, paying taxes, trading across borders, enforcing contracts, resolving insolvency.

Sources: World Bank "Doing Business" surveys 2016 (189 countries) and 2006 (155 countries), Euler Hermes

Figure 15: "Resolving insolvency" ranking 2016



Sources: World Bank "Doing Business" survey 2016 (189 countries), Euler Hermes

Opportunity #2: From Russia to Iran, a diagonal worth rediscovering

Since the partial lifting of international sanctions against Iran in early 2016, business and trade relations between Russia and Iran have rebounded. Trade between the two countries was up by +71% in the first five months of 2016, with Russian exports accounting for most of it.

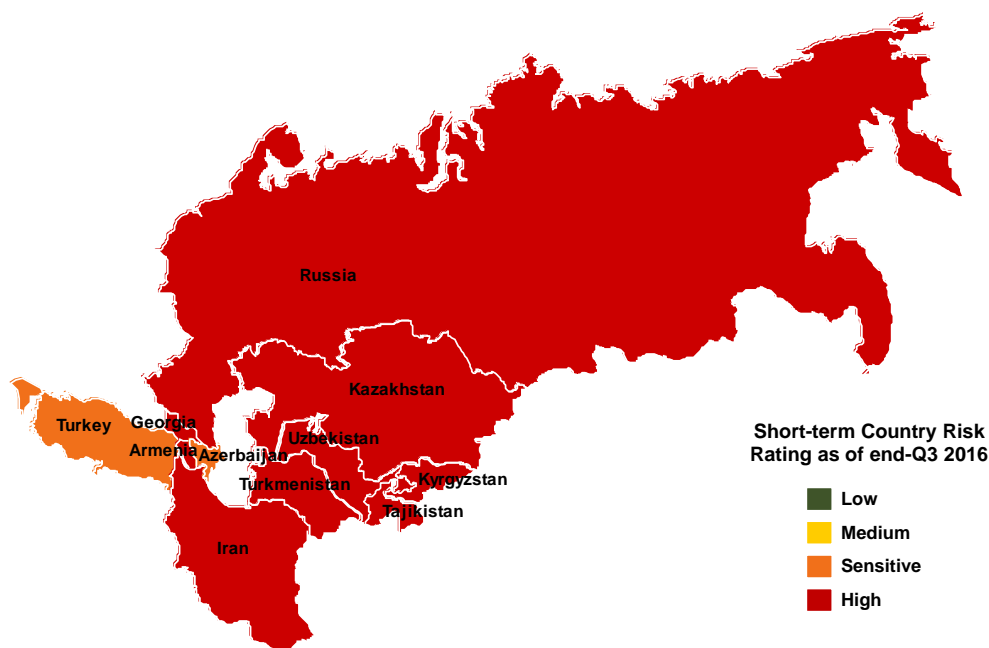
Talk about the so-called North-South Transport Corridor running between Russia and India via Iran, which is intended to reduce freight costs and increase trade along the route, has also resumed. This project would provide considerable investment and other opportunities in the region, notably in Iran and Azerbaijan (which lies between Russia and Iran), including

- Consolidation of the two countries' transport (railway) infrastructure;
- Russian investment in Azerbaijan's and Iran's energy sector (tackling the problem of aging oil fields);

- Resolving issues and strengthening cooperation in the Caspian Sea (e.g. joint investment);
- Benefits for Azerbaijan from rebound in Russia-Iran trade;
- Facilitate rebound in Russia-Azerbaijan trade (Russia needs agricultural products; Azerbaijan needs fertilizers and agricultural machinery).

However, substantial progress on the North-South Transport Corridor project is likely to take years. Nonetheless, foreign investors should be prepared – prepared to invest and to deal with still high country risk (see Figure 16).

Figure 16: Euler Hermes' Country Risk Map for the Caspian Sea Region



Source: Euler Hermes

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