

Analysis of Azeri energy market and its future

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Executive Summary: Azerbaijan is an oil rich country and a transition economy. It is witnessing an increasing foreign direct investment and fast economic growth.

Mismanagement of this process might turn resources from being a blessing into a curse, one that destabilizes the economy, society and the region. *Dutch disease* is analyzed as one way the factors economic development could be disturbed in Azerbaijan. The effects of Dutch disease, as well as, ways to avoid it are explored in this paper. I argue that in order to avoid the so called ‘disease’, government should manage the revenues via funds that are governed in a transparent and efficient manner so that these funds would compensate the economy in case of a fluctuation in the world oil markets, and it would support the economy when the reserves are used up. While managing revenues via funds the income should be allocated to investment in sectors that produce tradable goods for the market, sectors such as agriculture and manufacturing would qualify.

1. An overview of Azerbaijan energy market

Azerbaijan is the fastest growing country among oil-and-gas rich Caspian countries namely Georgia, Kazakhstan, Turkmenistan, and Uzbekistan. This landlocked former Soviet country has invited international oil development since its independence in 1991, and since then there is active oil exploitation and export industry supported by international investment. Although its GDP is increasing sometimes at a rate of 10 percent, Azerbaijan remains to be a transition country with an oligarchic government in rule. Like many resource rich countries with relatively

weak state structures, it risks destabilization; meaning Azerbaijan energy can be a curse as well as a blessing. Good governance of the resources might result in prosperity and stability whereas mismanagement would diminish it to another resource doomed state. In this paper three possible negative effects mismanagement of the large share of oil revenues in Azerbaijan economy will be analyzed. a) Making the country vulnerable to fluctuations in world oil prices, b) risking contraction in development of other sectors of the economy and c) destabilizing social dynamics of the country, and the region.

Energy market is volatile and unpredictable, especially for price taker countries like Azerbaijan. Therefore landlocked countries of Caspian have to manage their resources in such a way that exploration, processing, transportation would be funded as long as there are resources to be extracted. When resources run out, these economies should be ready to smoothly transform into a balanced economy with the help of previously gained oil revenues.

Azeri market, since its independence has been weak and vulnerable to world market price irregularities. Since 2000 Azerbaijan economy is booming due to hydrocarbon industry. According to IMF data Azerbaijan's GDP has jumped 24.3 percent between years 2004 and 2005, and this increase is expected to be 25.6 percent for 2006 and 26.4 for 2007 (Crandall, 2007 & appendix table 1). Azerbaijan stands out as the fastest growing economy in the region in this sense and the country has a long way to go in order to close the GDP per capita gap between other Caspian states this is an optimistic picture of the economy (Azeri GDP per capita is close to 1992 levels -- 3,400 USD according to OECD - Figure 2.)

International oil prices are known to fluctuate around a long term cycle that is generated by capital intensive nature of the business. Once the world market is saturated the prices will start falling before picking up again. Such development would harm the Azeri economy that is largely

dependent on its oil rents and pipeline revenues. Like most former Soviet states, Azerbaijan state structure lacks some Western characteristics. It has an authoritarian regime with concentration of power in first under Heydar Aliyev and as of 2003 his son Ilham Aliyev. The economy lacks a complex free market and is dependent on oil rents to a great extent. According to IMF by 2002 Azeri oil sector provided 89 percent of exports, 29.5 percent of GDP in the country, which accounts for 55 percent of government revenues (Auty, 2006, p. 67).

Dependency of Azeri economy on oil and oil related products has been over 85 percent every year since 2002 (see Table 3).

II. Lack of transparency

Management of oil revenues lies in the government side of the sector for implementing regulations in an efficient and transparent way. Due to increasing interest in its oil fields after 1989, Azerbaijan energy markets has been under the scope of investors for a long time and problems of the market has been very well voiced. Two of the most outspoken are corruption and lack of transparency in management of rents and revenues. Two are closely tied to transparency issue in general. 2007 Corruptions Perception Index prepared by Transparency International indicates Azerbaijan's transparency score is 2.1 over 10, placing the country to 14th rank in the Eastern Europe and Central Asia region consisting of 20 countries (see appendix table 4).

Lack of transparency harms economy in two ways, first in the form of unmonitored transactions in ruling elite might end up in benefiting a small group and secondly by harming trust of international investors in the country markets.

One of the tools for good management that one frequently comes across in the literature is a fund to deal with energy revenues. Azerbaijan has a State Oil Fund of Azerbaijani Republic (SOFAZ) which is established in 1999 in order to govern the collection of oil revenues. Although

this is a good tool to use in terms of management of the revenues, it has one weak point that is the fund is directly accountable to the Azeri President. The President appoints the executive director and the members of the council (Kalyuzhnova, 2006). This fund is managing all aspects of oil revenues from rental fees to pipelines and yet all process by executive ranks has to be approved or instructed by the President. As Yelena Kalyuzhnova indicates in her article this is not a good governance method that also leaves room for unprofessional / arbitrary decisions and lack of legitimacy for the fund. The executive body of the SOFAZ is accountable to the President only. A desirable way would be if the fund gained its legitimacy from the people of Azerbaijan instead of decree of Heydar Aliyev.

III. Avoiding Dutch disease

Another issue comes to front after the corruption and transparency is the so called Dutch disease effect. Dutch disease is the name for the negative effects of an inadequately managed natural resource boom (Rosenberg and Saavalainen, 1998, p. 4), which could make the gains from regional cooperation and trade with the rest of the world minimal (Kalyuzhnova, 2002.) Another more comprehensive explanation of Dutch disease is offered by Kutan and Wyzan: “oil-exporting countries have periodically experienced significant increases in their national wealth due to higher oil prices, resource discoveries, or technological progress in the energy sector. The booming demand caused by greater wealth leads to shift of an economy's productive resources from the tradable goods sector to the non-tradable goods sector. Such shrinkage of the tradables sector was named the Dutch disease, referring to the supposedly adverse effects on Dutch manufacturing of that country's natural gas discoveries in the 1960s.” (Kutan & Wyzan, 2005, p.1)

The most significant symptom of Dutch disease is lack of diversification, and lack of investment in sectors other than the booming one. This not only increases vulnerability against fluctuations as mentioned before, but it also decreases the sustainability of growth. Governments and international corporations have the tendency to invest more in the money making sector, oil in this case, however natural resources are limited and once they are exploited all that investment would be useless. Therefore diversification and public spending of the resources is crucial in flourishing economic markets.

An IMF working paper dated 2004 summarizes two major issues that governments of resource rich countries face: a) the finite nature of these resources, that is how much oil income to spend on the present generation and how much to save for future generations and b) how to adjust government spending to protect domestic economy from the sharp and unpredictable variations in oil prices and revenue (Fasano, 200, p.3) A good example in dealing with these questions would be Kazakhstan. The country is rich in both oil and gas resources. Although it is found to be having symptoms of Dutch disease itself, it has some successful implementations in using the revenues. The country has a fund called Kazakh Oil Fund (NFRK). NFRK invests in liquid foreign equities and has a long term investment function. According to President Nazarbayev the resources allocated in NFRK will be spent for future generations and for containing economic recession. Nine largest oil companies are subject to transfer based on the reference price, in way that when targets are exceeded surplus is transferred to NFRK when market prices are below reference prices, the Fund transfers revenue to the government. The Fund has accumulated extra payments to the budget in first 5 years of its existence, and now has reserves that exceed 8 billion USD. (Kalyuzhnova, 2007, p.600-603)

Another example from the Kazakhstan market is the pension fund example. Prime Minister Tokayev announced that the revenue from the sale of 5 percent stake in Tengizchevroil consortium was transferred to the generation fund from which Kazakhstan funded pension scheme. In this case U.S. 's Chevron is funding the elderly of Kazakhstan (Kalyuzhnova, 2002, p.79). This way of using the funds is helpful but still not enough because foreign investment will be withdrawn from the country once the resources are not profitable or once they run out. Therefore another suggestion is to invest in wealth generating assets so that even though the country runs out of resources the annual income would not be disturbed. According to Auty such investment should be made in a capital development fund abroad so that it would not be absorbed in domestic markets (p. 64). Auty's solution economically makes sense and it would solve the transparency problem in the eyes of new investors as well. It would also diminish the risk of a sudden oil price change in the market. However it is problematic in the sense that Azerbaijan, formerly a part of Soviet Union policies would not consent to this option. It might lack support from public as well because it is seen as outflow of resources to a fund that would not immediately be benefiting the public.

IV. Transparency: a social perspective

Academic literature is full of articles linking energy resource abundance with conflicts within the state (Amuzegar 1982; Sachs J. D, & Warner A. M. 2001; Karl 1997). It is true that Azerbaijan risks destabilization, due to the unemployment, corruption and lack of access to resources. However a survey carried out in the form of interviews with Azerbaijani citizens in 2004 points out that the possibility of such destabilization is less likely at the societal level with

existing psyche. When Azerbaijanis were asked about their concerns, 94 percent pointed to the issue of Nagorno Karabakh as their concern about the country, unemployment came second with 89 percent of respondents indicating this issue. Access to resources such as gas, electricity and water came later in the list. (O’Lear and Gray, 2004). Moreover when respondents were asked to rank first three of these concerns, issue of Nagorno Karabakh ranked first in every settlement type be it a village, small city or a large city. All segments of the society pay more attention to this 10 year land dispute than material well being, unemployment or corruption. Therefore despite all the scenarios about the social risks a country faces due to fast growing, unequal distribution of revenues and resources; we see that political issue such as Nagorno Karabakh diminish the chances of a political destabilization in Azerbaijan because citizens of Azerbaijan are bounded around one national suffering. This might be one of the factors diminishing the chances of destabilization that would be expected of a country such as Azerbaijan.

V. International aspect

Good governance of energy markets in Azerbaijan is not only significant for domestic balances but for regional balances in Eurasia. It would keep Azerbaijan free from Russian influence. Azerbaijan’s self sufficiency in energy protected it against Russia’s influence in other former Soviet Republics by offering cheap energy supplies. Azerbaijan is not on a transit route for Russian oil exports; therefore it was free from the clashes that we witnessed in Ukraine or Belarus. However Azerbaijan is as landlocked as other Caspian states in terms of energy transfer. Its supporter U.S. does not favor cooperation with Iran and as long as the conflict with Armenia is not solved the country does not have many options. One successful project with the support of U.S. is Baku-Tbilisi-Ceyhan pipeline.

What could be expected for future however would be decreasing interest from U.S. due to expected Iraqi oil in the market which would make Caspian pipelines less profitable. Since Middle East is richer in terms of resources, U.S. might stop conflicting with Russia on relatively small resources of Caspian states, but instead focus on Iraqi resources and the dynamics in north of Iraq.

VI. Summary & Conclusion

In order to generate higher growth rates that are also sustainable, Azerbaijan must direct investment into non-oil sectors, by first allocating oil revenues in funds and then redistributing subsidies to tradable good sectors such as agriculture and manufacturing.

Currently Azeri economy is dependent on rising oil rents. By 2002 the oil sector provided 89 percent of exports and 55 percent of government revenues. On the other hand only 1.1 percent of employment was in this sector. Another striking ratio is the difference between rate of growth in oil sector versus the non-oil sector. Oil sector in Azerbaijan grew by 20 percent per annum in late 1990s whereas the latter grew only 6 percent (Auty, p. 67). “Azerbaijan was meeting half of world’s demand in 1911” writes Hadjian, in his analysis of the region. The drop in production during USSR period was due to different distribution of labor among soviet states. Azerbaijan, instead of using its reserves was assigned to provide 60 percent of the material employed in the Soviet energy sector. This might not be as bad as it sounds because today thanks to those unused resources Azerbaijan is transforming its economy (pg.113-115). So the increasing difference between growths of two sectors could be caused not by over investment in these sectors, but merely functioning of these sectors as they used to in beginning of 20th century.

It is true that other factors have played a role in these numbers such as USSR's reluctance to explore Azeri oil fields and the boom in oil prices, but still the gap between oil and non-oil sectors should be diminished in order to avoid negative implications of Dutch disease.

Ensuring efficient and transparent management of the energy economy is a major task. Dutch disease is probable if the country becomes too much dependent on imports, and weak in producing goods. This might result in two negative effects, either imports would increase so much that it would offset the revenues from energy sector, or the country would remain with no resources at all in case of a withdrawal of foreign capital from the markets (Kalyuzhnova, 2002, p.60). Using oil revenues in investing in public sector especially in sectors that produce tradable goods such as manufacturing and agriculture is the policy that is promoted in this paper.

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APPENDIX

O'Lear and Gray, Table 1 - 2

Note about the data set: "Two distinct data sets were used in the paper. The first data set is comprised of information obtained through a nation-wide survey of 1200 Azerbaijani citizens. 1200 respondents were selected from 16 geographic zones excluding Nagorno Karabakh, proportional to each zone's population. The second data set draws from 36 in-depth, structured interviews conducted in Azerbaijan during the summer of 2004" (O'Lear and Gray, 2006)

Table 1 Percentage of respondents indicating concern

	Survey (<i>n</i> = 1200)	Interviews (<i>n</i> = 36)
Environmental concerns		
Overall ecological situation	50	64
Pollution/degradation problems:	49	
<i>Forest depletion</i>		58
<i>Agricultural issues</i>		56
<i>Water pollution</i>		47
<i>Impacts of oil</i>		39
<i>Health risks</i>		33
<i>Air pollution</i>		31
Dissatisfaction with access to:		
<i>Gas</i>	54	81
<i>Electricity</i>	40	83
<i>Water</i>	27	53
Non-environmental concerns		
Nagorno-Karabakh	88	94
Material well-being:	73	
<i>Unemployment</i>	66	89
<i>Pensions</i>		14
<i>Credits</i>		11
<i>Corruption</i>		58
<i>Education</i>	38	58
<i>Political freedom/democracy</i>	31	44
<i>Infrastructure</i>		47
<i>Access to healthcare</i>	44	
<i>Oil operations</i>		33
<i>Crime</i>	29	
<i>Inter-ethnic conflicts</i>	15	
<i>Monopolies</i>		11

Table 2 Major concerns by priority and settlement type

	Large cities	Small cities	Villages	IDPs
High priority	Nagorno-Karabakh Material well-being Unemployment	Nagorno-Karabakh Material well-being Unemployment	Nagorno-Karabakh Material well-being Unemployment	Nagorno-Karabakh Material well-being Water supply
Medium priority	Environmental pollution Access to healthcare Quality of education Crime	Environmental pollution Access to healthcare Gas supply Electricity supply	Gas supply Access to healthcare Quality of education Electricity supply	Gas supply Access to healthcare Quality of education Unemployment
Low priority	Democracy and civil rights Electricity supply Gas supply Water supply International relations	Democracy and civil rights Quality of education Crime Water supply International relations	Environmental pollution Democracy and civil rights Crime Water supply International relations	International relations Democracy and civil rights Crime Electricity supply Environmental pollution



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Table 3: Kazakhstan and Azerbaijan: Oil and Oil Products in Total Export, in percentage, 2002–2005

Country	2002	2003	2004	2005 ^a
Azerbaijan	89	86	83	90
Kazakhstan	50	53	55	61

Source: IMF Country Report No. 05/260 and IMF Country Report No. 05/244.

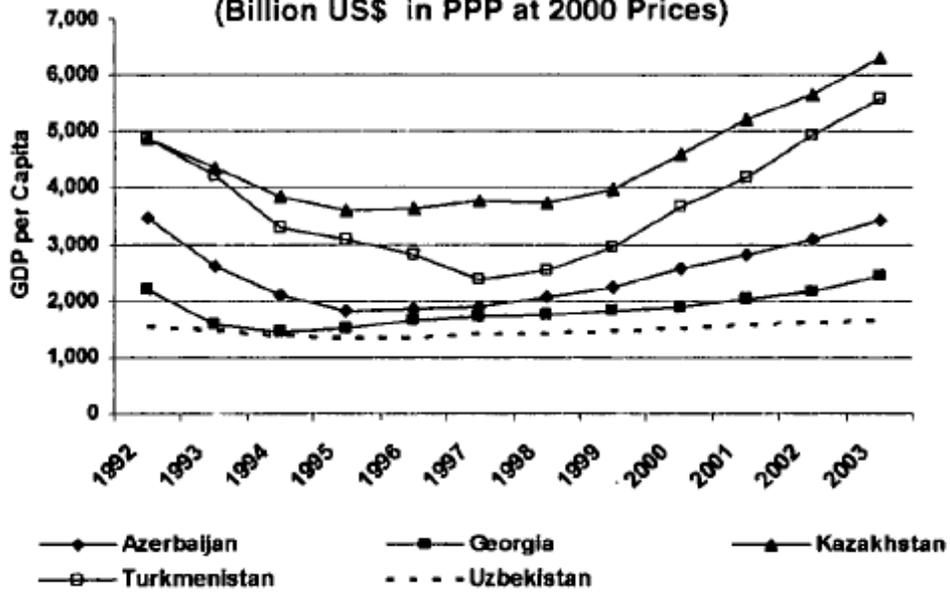
^aIMF staff projections.

Table 1
Annual Percent Change in Real GDPs, 1992-2007

	Azerbaijan	Georgia	Kazakhstan	Turkmenistan	Uzbekistan
1992	-22.7	-44.9	-5.3	-28.9	-11.1
1993	-23.1	-29.3	-9.2	-10.0	-2.3
1994	-19.7	-10.4	-12.6	-17.3	-4.2
1995	-11.8	2.6	-8.3	-7.2	-0.9
1996	1.3	10.5	0.5	-6.7	1.6
1997	5.8	10.6	1.6	-11.3	2.5
1998	6.0	2.9	-1.9	6.7	4.3
1999	11.4	3.0	2.7	16.5	4.3
2000	6.2	1.9	9.8	18.6	3.8
2001	6.5	4.7	13.5	20.4	4.2
2002	8.1	5.5	9.8	15.8	4.0
2003	10.4	11.1	9.3	17.1	4.2
2004	10.2	5.9	9.6	14.7	7.7
2005	24.3	9.3	9.4	9.6	7.0
2006*	25.6	7.5	8.3	9.0	7.2
2007*	26.4	6.5	7.7	9.0	7.0

Source: International Monetary Fund (IMF), various *World Economic Outlooks*. See October 2000, Appendix Table 7 for 1992 data, p. 207; October 2001, Appendix Table 6 for 1993-1994 data, p. 205; September 2003, Appendix Table 7 for 1995-1996 data, p. 183; September 2005, Appendix Table 6 for 1997 data, p. 213, and September 2006, Appendix Table 6, for data from 1998-2005 and estimates (*) for 2006 and 2007, p. 197.

**Figure 2. Per Capita GDP in the Caspian States Since Independence
(Billion US\$ in PPP at 2000 Prices)**



Source: OECD Data provided by the OECD Paris, FR, office

2007 Corruption Perceptions Index

Regional highlights: Eastern Europe and Central Asia

The 2007 Corruption Perceptions Index ranks 20 countries in Eastern Europe and Central Asia.

Croatia and **FYR Macedonia** were among the countries showing a significant reduction in perceived levels of corruption indicative of the galvanising effect of the European Union accession process or the fight against corruption.

Country Rank	Regional Country Rank	Country /Territory	CPI Score 2007	Confidence Intervals	Surveys Used
64	1	Croatia	4.1	3.6 - 4.5	8
64	1	Turkey	4.1	3.8 - 4.5	7
79	3	Georgia	3.4	2.9 - 4.3	6
79	3	Serbia	3.4	3.0 - 4.0	6
84	5	Bosnia and Herzegovina	3.3	2.9 - 3.7	7
84	5	Montenegro	3.3	2.4 - 4.0	4
84	5	FYR Macedonia	3.3	2.9 - 3.8	6
99	8	Armenia	3.0	2.8 - 3.2	7
99	8	Mongolia	3.0	2.6 - 3.3	6
105	10	Albania	2.9	2.6 - 3.1	6
111	11	Moldova	2.8	2.5 - 3.3	7
118	12	Ukraine	2.7	2.4 - 3.0	7
143	13	Russia	2.3	2.1 - 2.6	8
150	14	Kazakhstan	2.1	1.7 - 2.5	6
150	14	Belarus	2.1	1.7 - 2.6	5
150	14	Tajikistan	2.1	1.9 - 2.3	8
150	14	Azerbaijan	2.1	1.9 - 2.3	8
150	14	Kyrgyzstan	2.1	2.0 - 2.2	7
162	19	Turkmenistan	2.0	1.8 - 2.3	5
175	20	Uzbekistan	1.7	1.6 - 1.9	7

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Table 4

Transparency international CPI 2007, Regional Results

Table 5
Transparency International's Corruption Perceptions Index, 1999–2006

	Year	No. Of Countries In Survey	Country Rank	Score
Azerbaijan	1999	99	96	1.7
	2000	90	87	1.5
	2001	91	84	2.0
	2002	102	95	2.0
	2003	133	124	1.8
	2004	146	140	1.9
	2005	159	137	2.2
	2006	163	130	2.4
Georgia	1999	99	84	2.3
	2000	90	n/a	n/a
	2001	91	n/a	n/a
	2002	102	85	2.4
	2003	133	124	1.8
	2004	146	133	2.0
	2005	159	130	2.3
	2006	163	99	2.8
Kazakhstan	1999	99	84	2.3
	2000	90	65	3.0
	2001	91	71	2.7
	2002	102	88	2.3
	2003	133	100	2.4
	2004	146	122	2.2
	2005	159	107	2.6
	2006	163	111	2.6
Turkmenistan	2004	146	133	2.0
	2005	159	155	1.8
	2006	163	142	2.2
Uzbekistan	2000	90	79	2.4
	2001	91	71	2.7
	2002	102	68	2.9
	2003	133	100	2.4
	2004	146	114	2.3
	2005	159	137	2.2
	2006	163	151	2.1

A score of 10 is best. Source: Transparency International, available online at <http://www.transparency.org/>, "Corruption Perceptions Index" for various years. Earlier years' data unavailable for Turkmenistan and Uzbekistan.

Table 2.6. Commonwealth of Independent States: Real GDP, Consumer Prices, and Current Account Balance

(Annual percent change unless noted otherwise)

	Real GDP				Consumer Prices ¹				Current Account Balance ²			
	2005	2006	2007	2008	2005	2006	2007	2008	2005	2006	2007	2008
Commonwealth of Independent States (CIS)	6.6	7.7	7.8	7.0	12.1	9.4	8.9	8.3	8.8	7.6	4.8	3.1
Russia	6.4	6.7	7.0	6.5	12.7	9.7	8.1	7.5	11.1	9.7	5.9	3.3
Ukraine	2.7	7.1	6.7	5.4	13.5	9.0	11.5	10.8	2.9	-1.5	-3.5	-6.2
Kazakhstan	9.7	10.7	8.7	7.8	7.6	8.6	8.6	7.8	-1.8	-2.2	-2.2	-1.1
Belarus	9.3	9.9	7.8	6.4	10.3	7.0	8.1	10.0	1.6	-4.1	-7.9	-8.1
Turkmenistan	9.0	9.0	10.0	10.0	10.7	8.2	6.5	9.0	5.1	15.3	13.0	12.5
Low-income CIS countries	12.0	14.6	15.7	13.4	8.4	10.0	12.1	11.7	2.2	7.5	13.7	19.1
Armenia	14.0	13.3	11.1	10.0	0.6	2.9	3.7	4.9	-3.9	-1.4	-4.0	-4.2
Azerbaijan	24.3	31.0	29.3	23.2	9.7	8.4	16.6	17.0	1.3	15.7	31.4	39.9
Georgia	9.6	9.4	11.0	9.0	8.3	9.2	8.5	8.1	-9.8	-13.8	-15.7	-15.2
Kyrgyz Republic	-0.2	2.7	7.5	7.0	4.3	5.6	7.0	7.0	3.2	-6.6	-17.9	-15.1
Moldova	7.5	4.0	5.0	5.0	11.9	12.7	11.2	8.9	-10.3	-12.0	-8.0	-7.3
Tajikistan	6.7	7.0	7.5	8.0	7.3	10.0	9.9	12.6	-2.5	-2.9	-11.6	-12.6
Uzbekistan	7.0	7.3	8.8	7.5	10.0	14.2	12.2	9.8	13.6	18.8	21.1	21.0
<i>Memorandum</i>												
Net energy exporters ³	7.1	7.7	7.9	7.3	12.1	9.7	8.5	7.9	10.0	9.2	6.3	4.4
Net energy importers ⁴	4.5	7.7	7.2	6.0	12.0	8.5	10.4	10.3	1.4	-3.0	-5.4	-7.2

¹Movements in consumer prices are shown as annual averages. December/December changes can be found in Table A7 in the Statistical Appendix.

²Percent of GDP.

³Includes Azerbaijan, Kazakhstan, Russia, Turkmenistan, and Uzbekistan.

⁴Includes Armenia, Belarus, Georgia, Kyrgyz Republic, Moldova, Tajikistan, and Ukraine.

Source: IMF