ECONOMIC MONITOR GEORGIA

German Economic Team

Issue 11 | January 2020

Overview

- Strong economic growth of 4.9% in 2019, despite Russian sanctions
- Slight deceleration to 4.3% in 2020, in view of a difficult external environment
- Russian sanctions in mid 2019 contributed to depreciation expectations
- This was the main factor for Lari depreciation of 7.3% vs the USD in 2019
- As a consequence, inflation accelerated during the year, peaking at 7.0% at end-2019
- National Bank reacted by increasing its policy rate and intervening in the FX market
- Import contraction contributed to a reduction of current account deficit to 5.4% of GDP
- Budget deficit amounted to 2.3% of GDP in 2019, in compliance with IMF programme

➢ **All in all: good economic performance despite Russian sanctions**

Topics

- **Agro-food exports.** The role of transport and logistics sector
- **DCFTA.** Sectoral analysis reveals sizeable DCFTA effect on EU exports to Georgia
- **Banking sector**. Georgian banking sector on a more stable footing
- **Capital markets.** Georgian capital markets remain underdeveloped

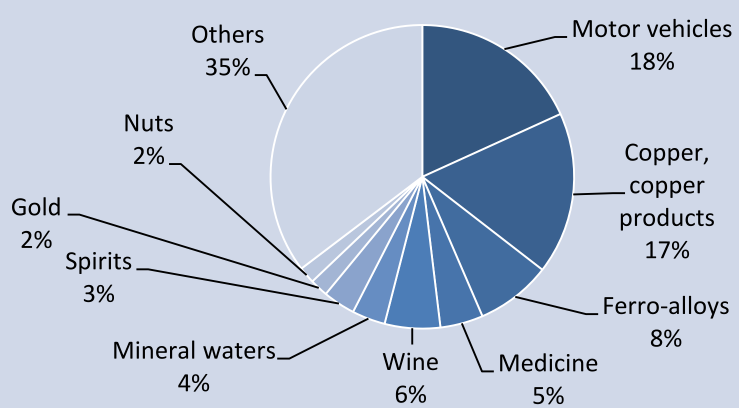
Basic indicators

	Georgia	Armenia	Azerbaijan	Ukraine	Russia
GDP, USD bn	16.1	13.4	47.2	150.4	1,637.9
GDP/capita, USD	4,380	4,528	4,689	3,592	11,163
Population, m	3.7	3.0	10.1	41.9	146.7

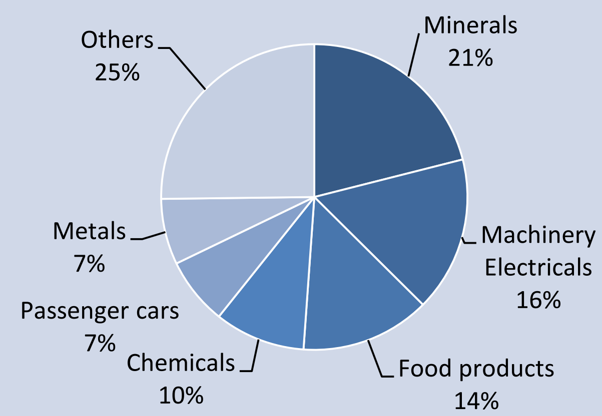
Source: IMF 2019, forecast for 2019; Note: Geostat recalculated the GDP according to the 2008 System of National Accounts (SNA) standard. Despite this, we mainly use the old GDP figures in this publication, unless otherwise indicated, in order to allow for comparability.

Trade structure

Exports	Imports
EU 22% | CIS 53% | Other 25%	EU 26% | CIS 27% | Other 47%

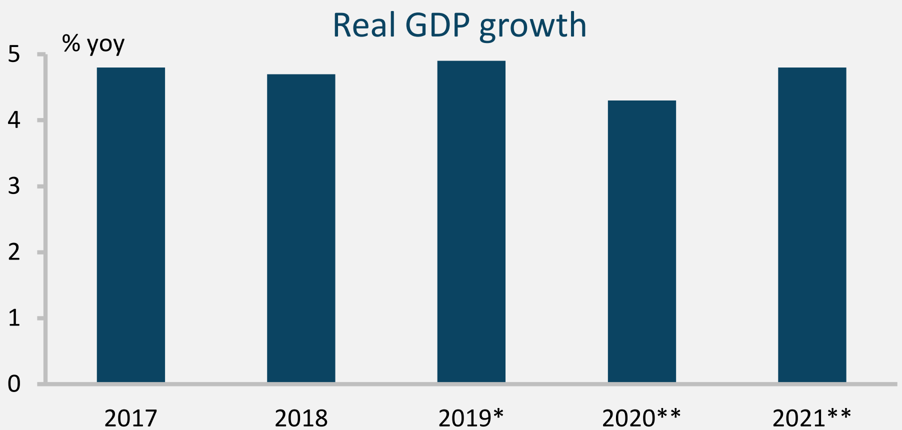


Source: Geostat, 2019; Note: Trade in goods

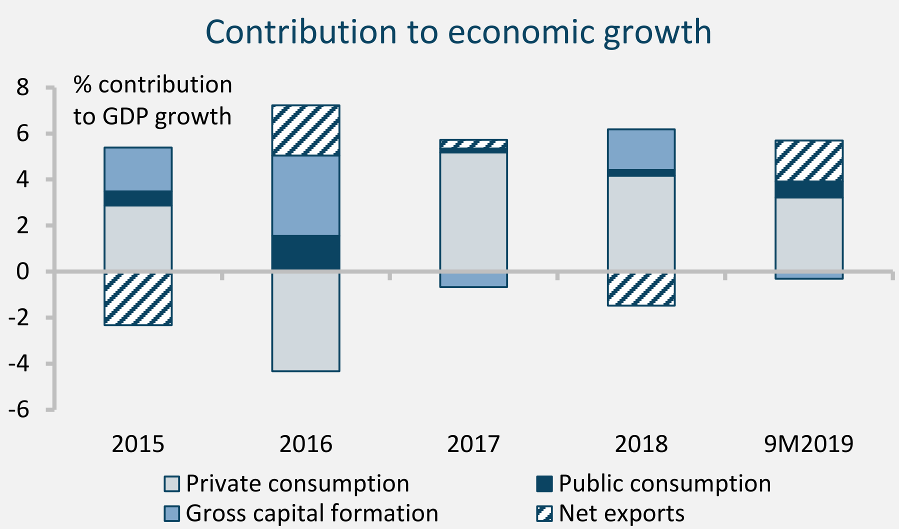


Source: Geostat, 2019; Note: Trade in goods

Economic growth



*Sources: IMF December 2019, ISET-PI Macro Review; *ISET forecast, **IMF forecast*



Sources: Geostat, German Economic Team; Note: data are based on the "new" GDP (2008 SNA)

GDP

- 2019: Strong economic growth at ca. 4.9%, despite Russian sanctions in the tourist sector
- 2020: Growth forecast at 4.3%, due to a more difficult external environment

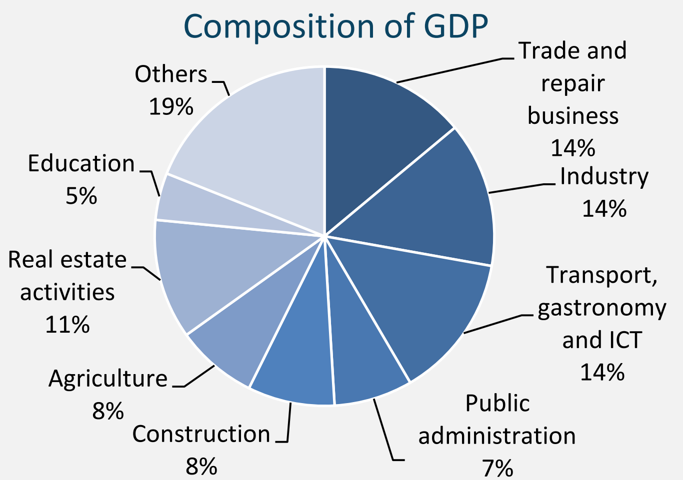
Contributors to growth

- Positive contribution by 3 components
  - Private consumption
  - Net exports
  - Government consumption due to higher public investment

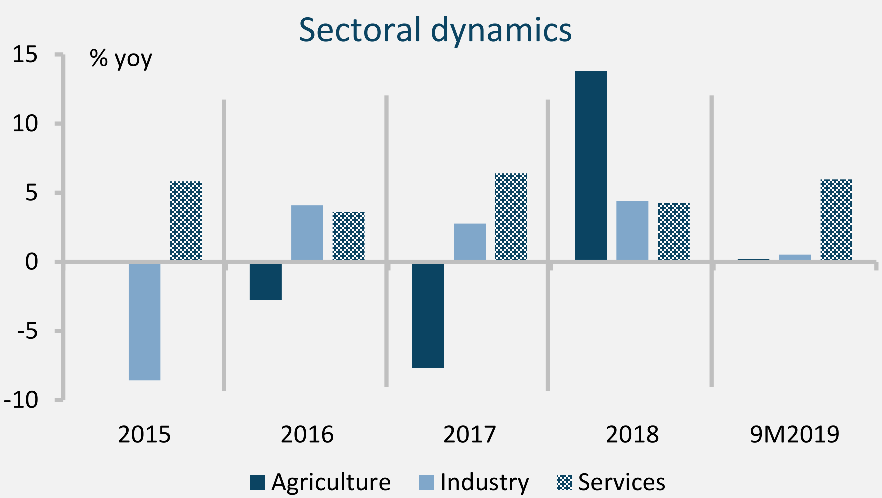
➢ **Georgian economy quite resilient to external shocks**

➢ **Slight deceleration expected for 2020**

Sectoral perspective



Source: Geostat, 2018; Note: data are based on the "new" GDP (2008 SNA)



Source: Geostat, Note: data are based on the "new" GDP (2008 SNA)

2018

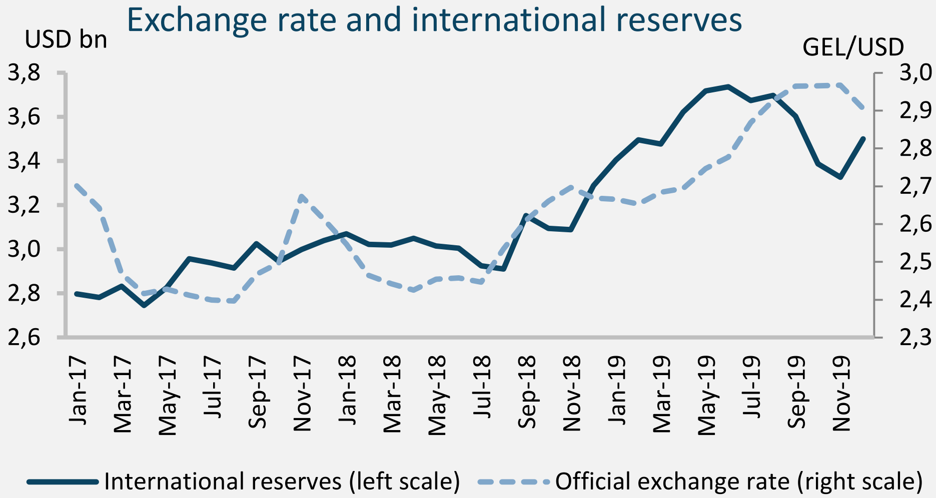
- Key driver: agriculture
- Reasons:
  - Stink bug invasion in 2017, i.e. low statistical base
  - Good harvest in 2018
- Remark: previous data for 2018 based on old GDP accounting methodology showed only a minor increase in agriculture

9M2019

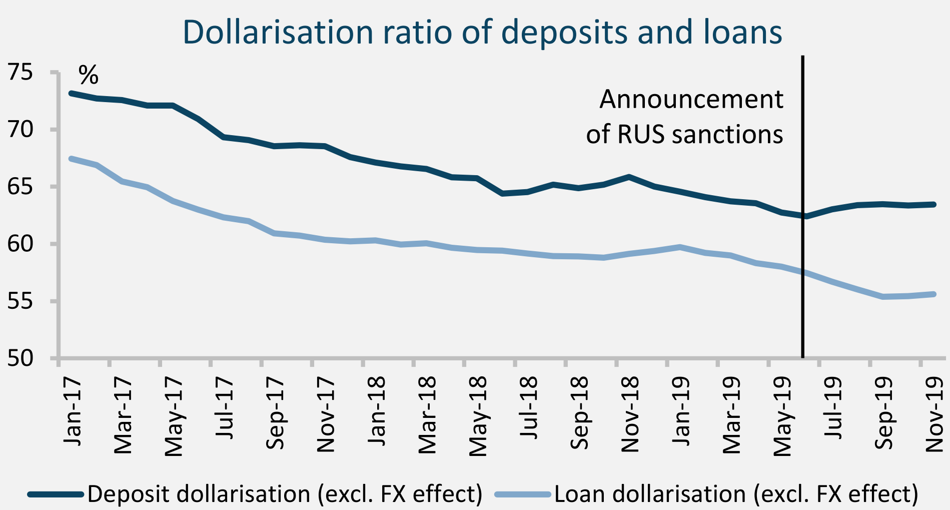
- Main driver: services
- Practically no contribution from other sectors

➢ **Agriculture in 2018 much stronger than originally accounted for; dominant role of services in 2019**

Current account and exchange rate



Source: National Bank of Georgia



Source: National Bank of Georgia

Exchange rate

- Sizeable depreciation of the Lari by 7.3% vs the USD in the course of 2019
- Reasons:
  - Depreciations expectations, also due to Russian sanctions
  - Switch of bank deposits from Lari to USD starting in mid 2019
  - Decrease in FDI

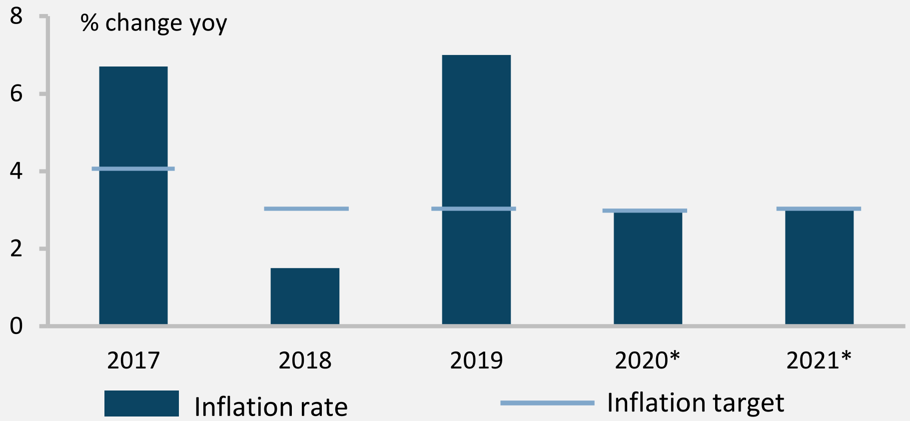
Current account deficit

- Sizeable reduction of deficit to ca. 5.4% of GDP in 2019
- Depreciation and tighter lending standards for consumer loans led to an import contraction
- Reduction of FDI inflows by USD 185 m, or 1.1% of GDP, also contributed to less imports and a lower deficit

➢ **Key role of flexible exchange rate in stabilising the external sector**

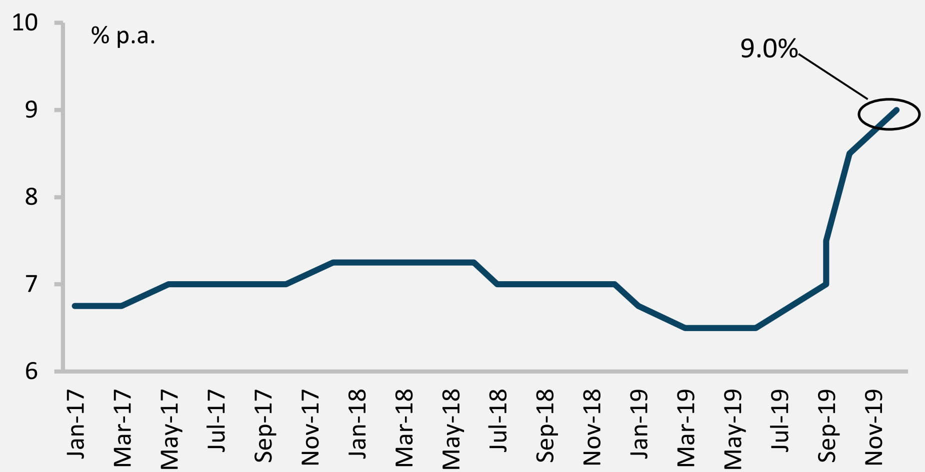
Inflation and monetary policy

Inflation rate and inflation target



*Sources: Geostat, IMF; *forecast; Note: end of period consumer prices*

NBG policy rate



Source: National Bank of Georgia

2019

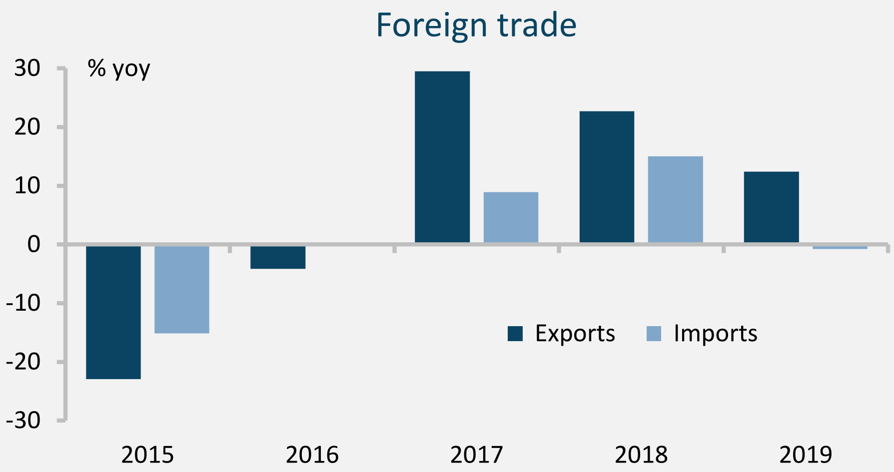
- Increase in inflation to 7.0% by end-2019, which is higher than the NBG's 3% target
- Reasons
  - Pass through effect of Lari depreciation
  - Increase in excise tax on cigarettes
- NBG reacted accordingly by
  - Increasing its policy rate in four steps from 6.5% to 9.0%
  - Interventions in the FX market
  - Decreasing reserve requirements for FX deposits from 30% to 25%

2020

- Disinflation expected, provided no further depreciation takes place

➢ **Stabilisation of exchange rate key for bringing back inflation to a low level**

Foreign trade



Source: Geostat, Note: trade in goods

Source: Georgian National Tourism Administration

Exports of goods

- Exports of goods increased by 12% in 2019
- Main drivers: wine and fertilizers, as well as re-exports of cars and copper ores

Imports of goods

- Reduction by 1% in 2019
- Reasons: depreciation of Lari, tighter lending standards for consumer loans, lower oil prices and less FDI inflows

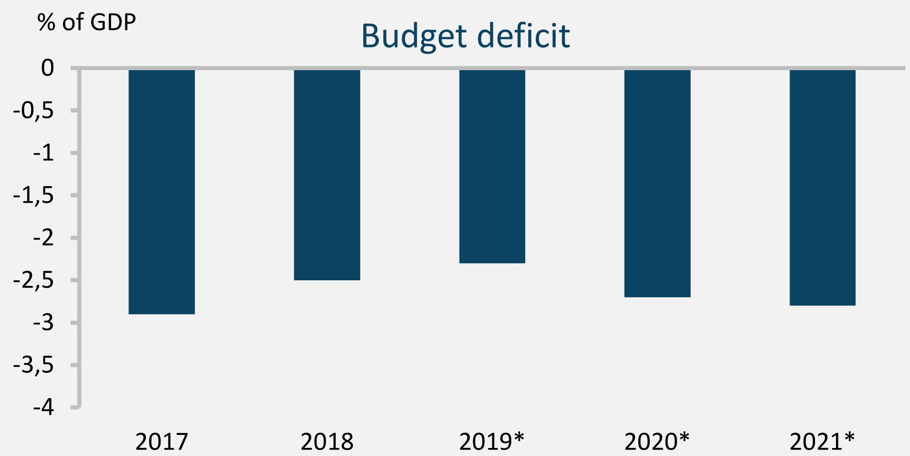
➢ **Sizeable reduction of traditionally high trade deficit**

Exports of services and tourism revenues

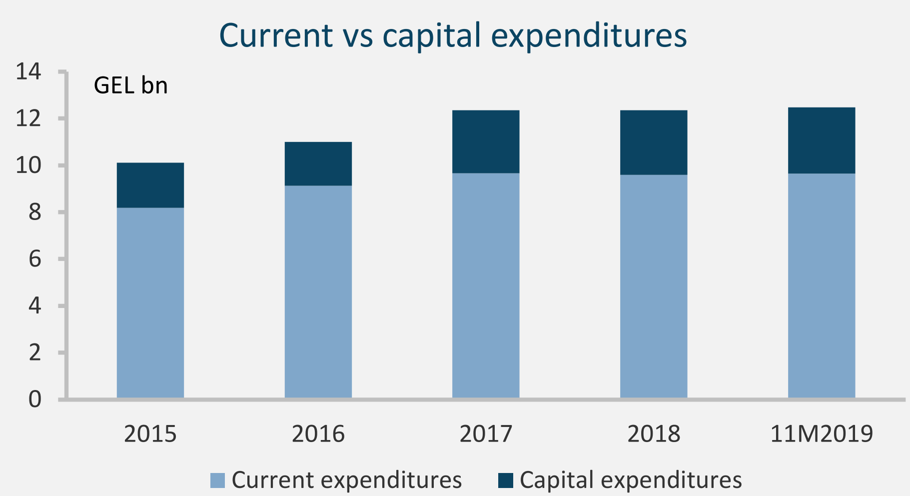
- Strong increase in tourism revenues in 2015-2018; process discontinued in 2019
- Still, 2018-level could be sustained

➢ **Continuation of traditionally high export surplus of services**

Public finances



*Source: IMF, *Forecast; Note: IMF programme definition*



Source: Ministry of Finance of Georgia

Budget

- Budget deficit at ca. 2.3% of GDP in 2019, despite strong capital expenditure
- Deficit expected to rise to 2.7% of GDP in 2020, partly due to higher pensions

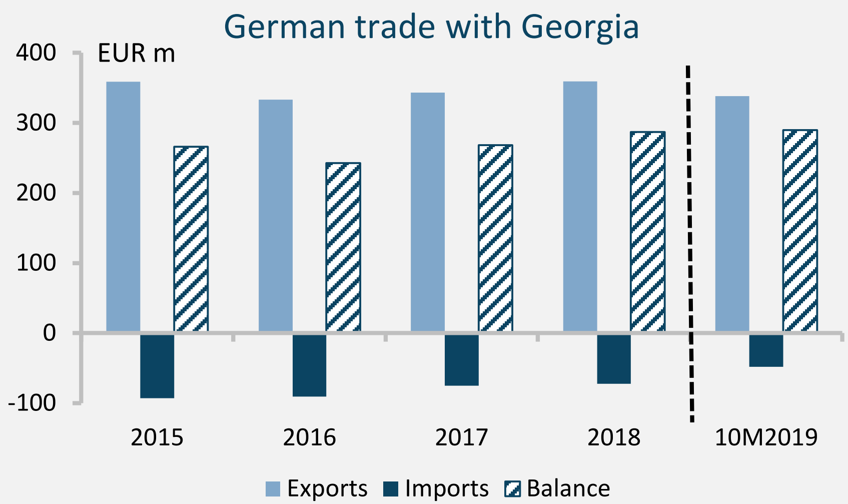
➢ **Public finances in line with IMF programme**

IMF programme

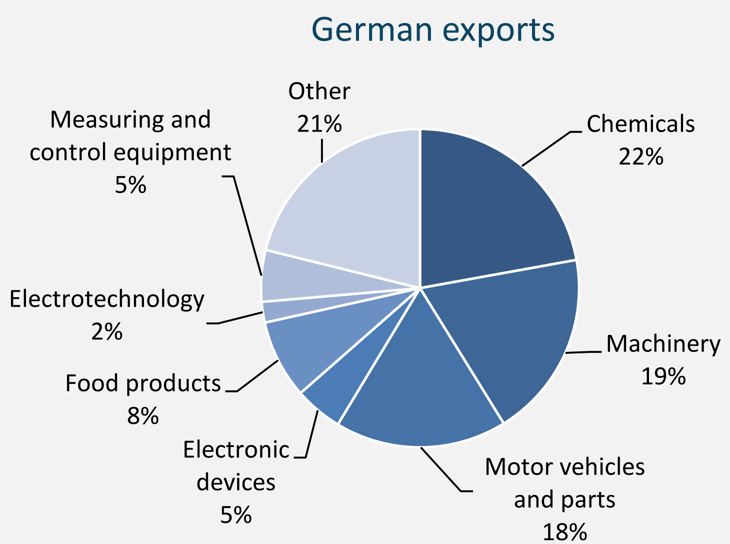
- Extension of programme by one year until April 2021
- Thus: programme goes beyond parliamentary elections in autumn 2020

➢ **Positive move for maintaining fiscal stability**

Bilateral trade between Germany and Georgia



Source: German Federal Statistics Office, Note: trade in goods



Source: German Federal Statistical Office; 10M2019, Note: trade in goods

Trade

- Trade between Georgia and Germany in Jan-Oct 2019 at EUR 386 m

Exports to Georgia

- Considerable growth in exports from Germany to Georgia by 13.2% in 10M2019

Imports from Georgia

- In contrast, imports from Georgia decreased strongly by 21.5% in 10M2019, caused by a sharp decline in imports of non-ferrous metals

➢ **Germany maintains its traditionally high bilateral trade surplus**

Agro-food exports: the role of transport and logistics sector

Background

- Less than 20% of Georgian agro-exports go to the EU, in spite of DCFTA
- There is extensive potential for exporting agro-food to the EU
- More than 50% of Georgia's population lives in rural areas, agricultural exports play a significant role in inclusive growth

Recent study by GET

- Identification of challenges in the transport and logistics sector, and highlighting how government, the private sector and donors can address them

Key findings

- Next to low production volumes and certification challenges, transport and logistics are an obstacle for export for several agro-products: costs remain high; many logistics inputs are imported at additional cost; limited supply of services, such as aggregation and cold storage; know-how is fragmented
- Higher volumes would facilitate aggregation and increase the supply in the entire transport & logistics value chain. Targeted FDI attraction in selected sectors (including blueberries) could increase volumes and thus accelerate the development of transport and logistics value chains
- An air-cargo terminal in Kutaisi would increase export opportunities for herbs and berries
- An exporters association, if properly implemented, could help aggregate knowledge and experience

EU exports to Georgia in the context of the DCFTA

	2013, EUR m	2018, EUR m	Change, EUR m	Change
Checking & precision instruments	48	103	55	115%
Animal products	28	52	24	86%
Foodstuffs	107	177	70	66%
Textiles	48	71	24	50%
Chemical products	266	370	103	39%
Plastics/Rubbers	43	57	15	34%
Machinery (incl. electrical mach.)	348	438	90	26%
Metals	54	67	13	24%
Vegetable products	25	24	0	-2%
Transport equipment	244	150	-94	-39%
Mineral products	663	377	-286	-43%
Others	158	227	69	43%
Total	**2,031**	**2,113**	**82**	**4%**

	2013, EUR m	2018, EUR m	Change, EUR m	Change
Total (excl. mineral products & transport equipment)	1,124	1,586	462	41%

Source: Eurostat; Note: export of goods

EU exports to GEO

- We compared 2018 vs. 2013 (last full year before DCFTA)

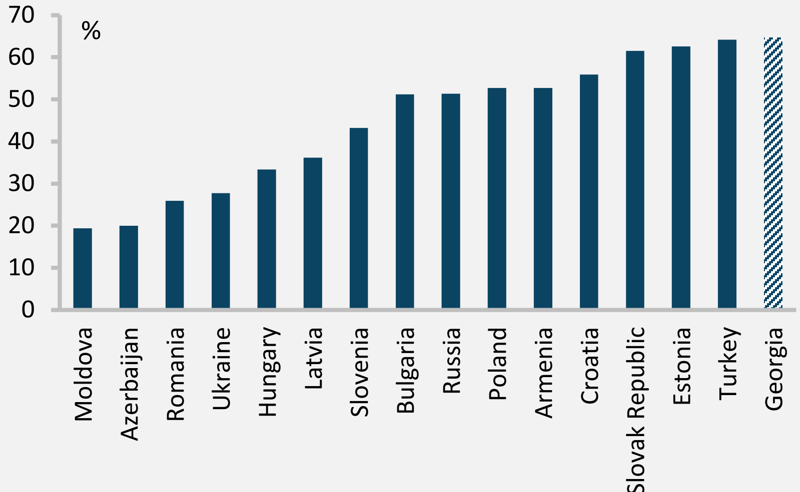
Results

- Higher exports for most EU members and also by most sectors
- Only limited increase of exports to GEO (+4%) due to special factors
  - Strong decline for energy due to lower prices
  - Also for transport equipment due to regional regulatory changes for trade with used cars
- Key role of two special factors; if excluded: 41% increase of EU exports to GEO

➢ **Sectoral analysis reveals sizeable DCFTA effect on EU exports to GEO**

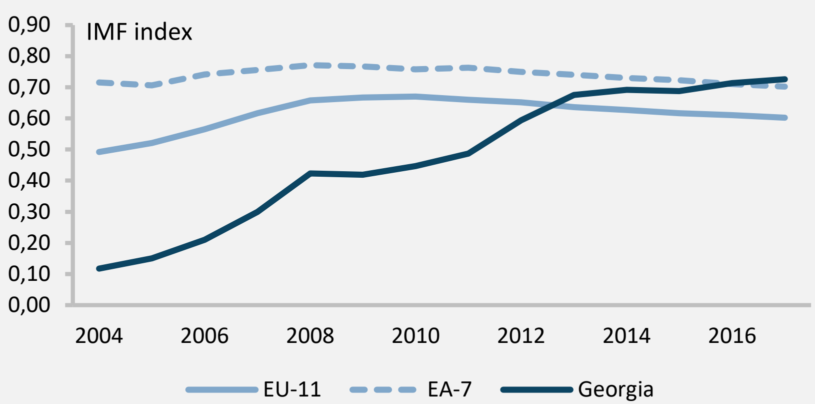
Georgian banking sector on a more stable footing

Credit to real sector relative to GDP



Source: World Bank, 2018

Access to finance from financial institutions



Source: IMF

General conditions

- Good access to bank credit; well capitalised and profitable sector
- High governance standards at TBC and Bank of Georgia due to listing in London
- They continue to dominate the market; the new bank resolution framework may limit excessive risk taking

'Responsible lending' regulation of Jan 2019

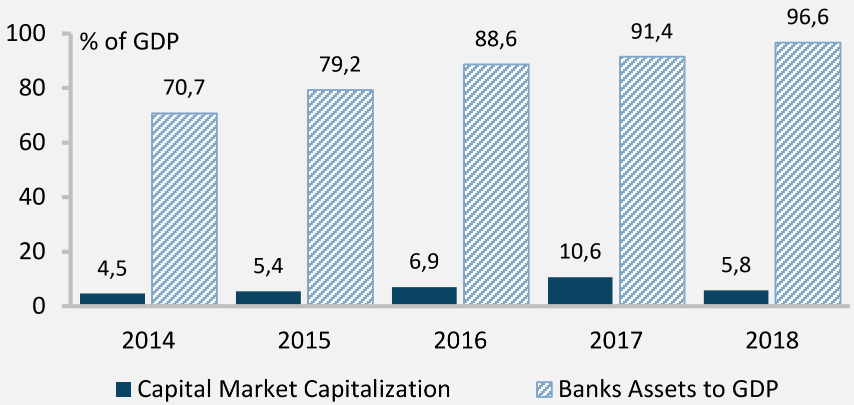
- Risks from household debt were addressed
- Corporate borrowing in foreign currency remains a key vulnerability

High level of dollarisation

- Liquidity and credit risks for banks; limited exchange rate flexibility
- Prudential measures were taken to make FX deposits more costly and limit FX lending to households

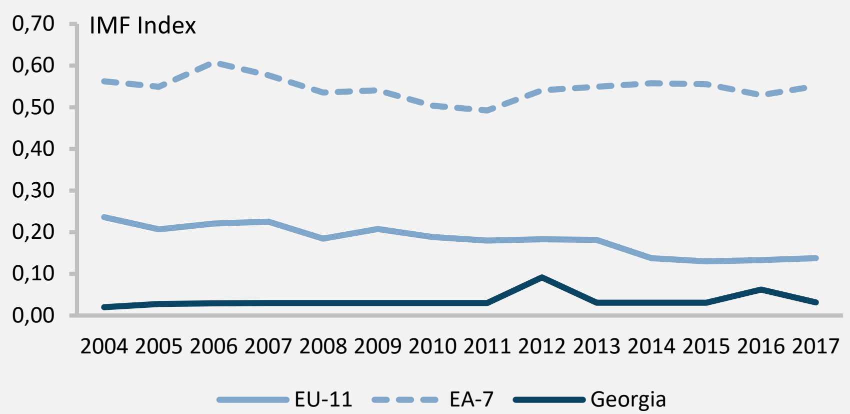
Georgian capital markets remain underdeveloped

Market capitalisation and banking sector assets



Source: National Bank of Georgia, Georgian Stock Exchange; eop

Access to finance from capital markets



Source: IMF

Georgian bond market

- Remains shallow (7.7% of GDP) and primarily in sovereign debt
- Corporate and IFI GEL bonds in Georgia account for only 12% of total capitalisation

Structural obstacles

- Lack of a local institutional investors, though a new pension scheme may bring more liquidity
- Absence of clearing mechanism for foreign investors
- Several issuers are large enough for foreign bond markets

Current developments

- The NBG repurchase facility has been an important incentive for banks to purchase corporate bonds in Lari
- However, no additional market liquidity as primary investors are almost entirely banks
- Retail bond investment only in FX

About the German Economic Team

German Economic Team

The German Economic Team (GET) advises the governments of Ukraine, Belarus, Moldova, Georgia and Uzbekistan regarding the design of economic policy reform processes and a sustainable development of the economic framework. As part of the project we also work in other countries on selected topics.

In a continuous dialogue with high-level decision makers of the project countries, we identify current problems in economic policy and then provide concrete policy recommendations based on independent analysis.

In addition, GET supports German institutions in the political, administrative and business sectors with its know-how and detailed knowledge of the region's economies.

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