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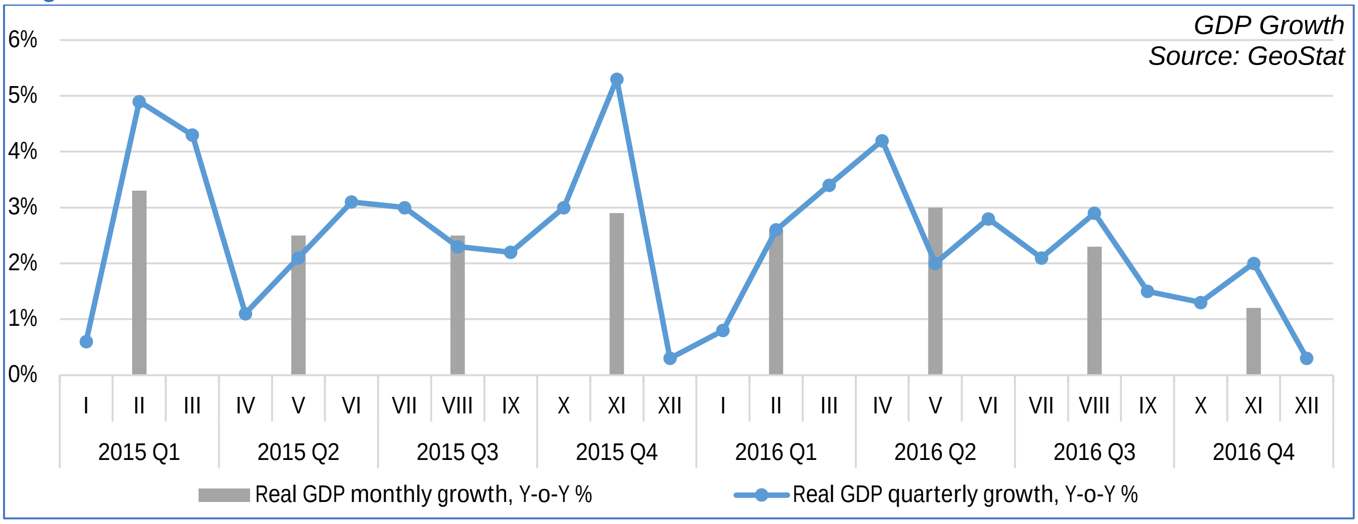
Georgian economy in 2016 – a year in review

Despite a disappointing year, Georgia remains the country with the highest economic growth among its neighbors



Economic growth in 2016

According to the preliminary statistics released by GeoStat, Georgia's real GDP growth was 2.2% year over year (YoY) in 2016. This result fell behind the World Bank's, IMF's and EBRD's last growth projections of 3.4%. The NBG's 3.5% growth projection from November also overestimated Georgia's economic growth in 2016.

The ISET-PI annual GDP growth forecast made in June was more realistic. At that time, we predicted a 2.7% annual growth rate in the worst-case scenario, and 4.1% in the best-case. However, in November, as growth rates slowed down, the ISET-PI GDP forecast predicted 2.7% YoY growth in 2016.

Weak external demand (stemming from recessions in Russia and Azerbaijan and a slowdown of economic growth in Turkey and Armenia) as well as low internal demand were the main factors that hindered economic growth in Georgia in 2016. Meanwhile, fiscal stimulus and increased revenues from tourism were the main factors positively affecting growth.

The growth estimates of the World Bank, ADB and other international organizations tend to significantly differ from the estimates of national statistics offices, usually in an upward direction. However, based on available data, Georgia is the fastest growing economy among its immediate neighbors. According to World Bank estimates, Georgia leads the region in terms of the economic growth forecast – with 5.2% YoY growth in 2017. The ADB has projected a more conservative number for the current year: 4% YoY.

Table 1: Real GDP Growth Forecast *Source: World Bank, ADB*

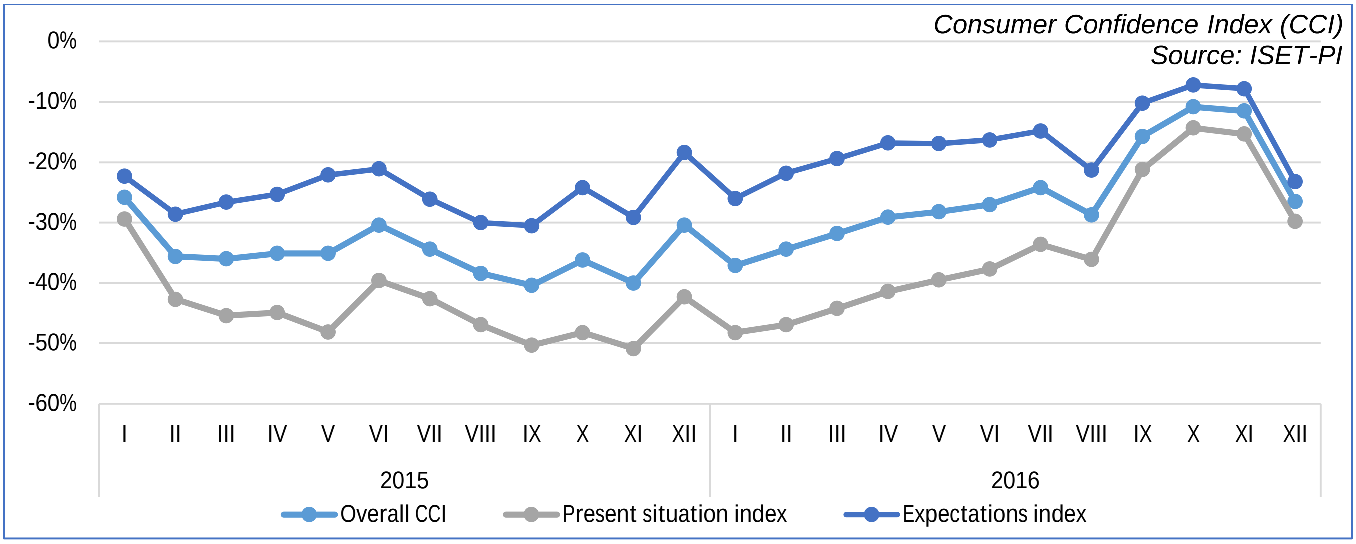
	World Bank, January 2017				National Stat. Office Data	ADB, September 2016		
Country	2015	**2016 (est.)**	2017 (forecast)	2018 (forecast)	**2016 (est.)**	2015	**2016 (est.)**	2017 (forecast)
Armenia	3.0	**2.4**	2.7	3.0	**0.5**	3.0	**2.0**	2.3
Azerbaijan	1.1	**-3.0**	1.2	2.3	**-3.7**	1.1	**-2.5**	1.0
Georgia	2.8	**3.4**	5.2	5.3	**2.2**	2.8	**3.0**	4.0
Russia	-3.7	**-0.6**	1.5	1.7	**-0.6**	-	**-**	-
Turkey	6.1	**2.5**	3.0	3.5	**1.9**	-	**-**	-
Eastern Europe	-7.7	**-0.1**	1.3	2.5		-	**-**	-
Central Asia	3.1	**2.8**	3.8	4.8		3.0	**1.5**	2.6

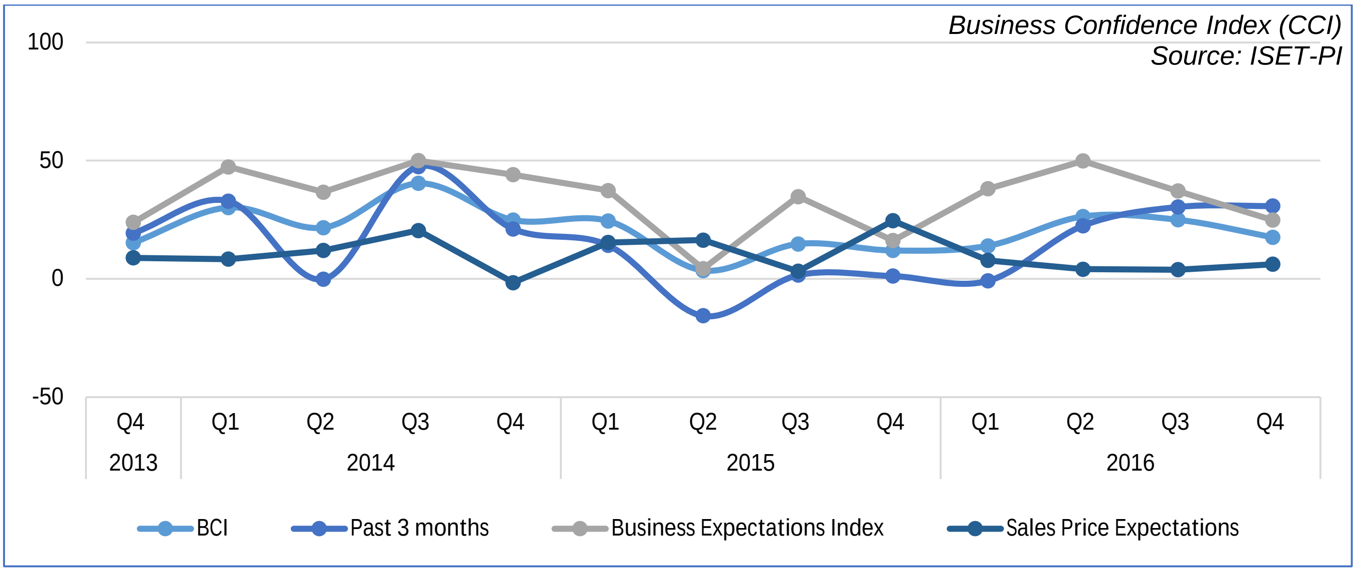
According to the latest data from ISET-PI's leading GDP indicator forecast, annual real GDP growth is predicted to be 2.5% in the worst-case or "no-growth" scenario, 2.7% in the "middle-of-the-road" (based on the average growth in the last four quarters), and 3.5% in the best-case or "average long-term growth" scenario. Thus, World Bank and ADB forecasts for 2017 seem to be overly optimistic.

Weak growth reflected in consumer and business confidence

The Consumer Confidence Index (CCI) and the Business Confidence Index (BCI) are important barometers of internal demand in Georgia.

Fluctuations in the exchange rate and the parliamentary elections were the main factors affecting consumer and business confidence in 2016. **Although both indices increased in the first half of 2016, those gains were wiped out towards the end of the year**. By the end of 2016, both indices reverted to the levels of December 2015.

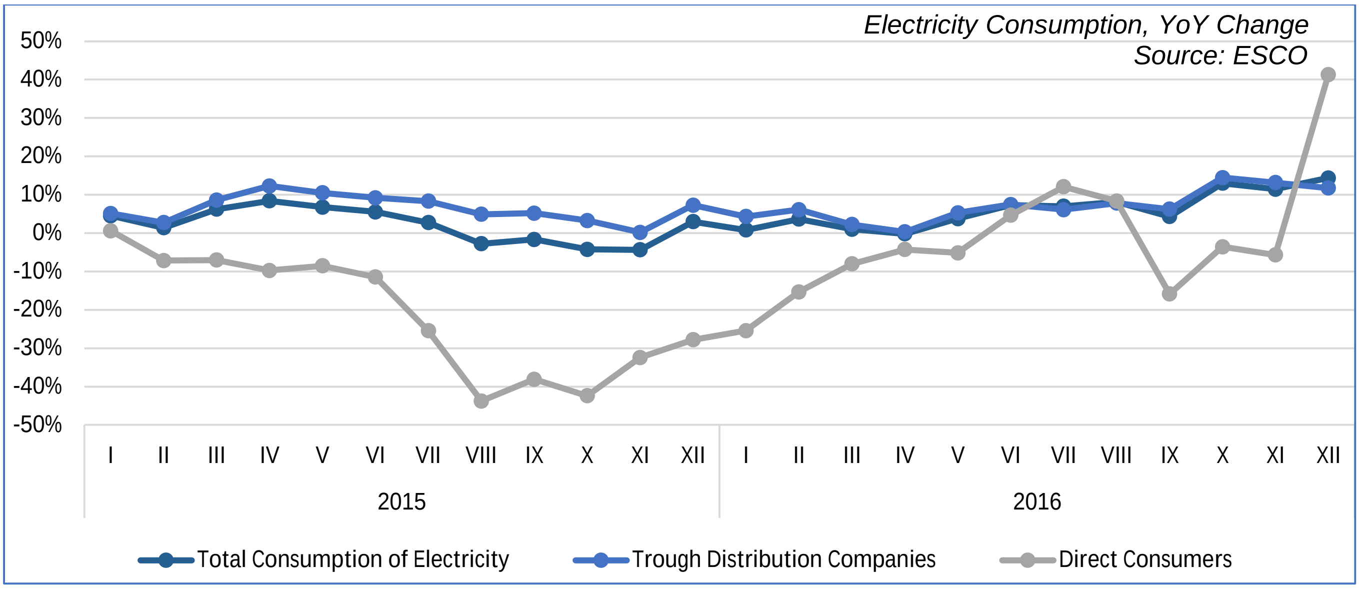




Energy Demand

Total consumption of electricity, a common proxy for real GDP growth, increased by 6.2% YoY in 2016. The main driver of this growth was electricity consumption through distribution companies, which showed a 7.1% YoY increase. Electricity consumption of direct consumers fell by 2.4% compared to 2015.

The biggest direct consumer of electricity, the "Georgian Manganese" company, experienced hardship in the beginning of the year due to a fall of ore prices on the world market. The company – one of the largest exporters and employers in Georgia – was forced to introduce a special working regime, according to which they temporarily fired 3,200 employees at the beginning of the year and cut production. However, the General Director of Georgian Manganese, Volodymyr Lozynskyy, has mentioned that positive dynamics for manganese alloys gives the company reason to expect positive trends in the modernization of production and fulfillment of investment projects in 2017.

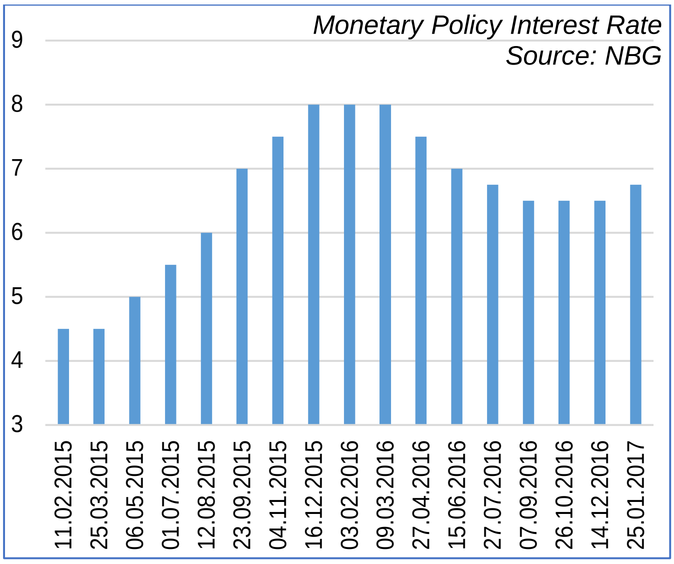


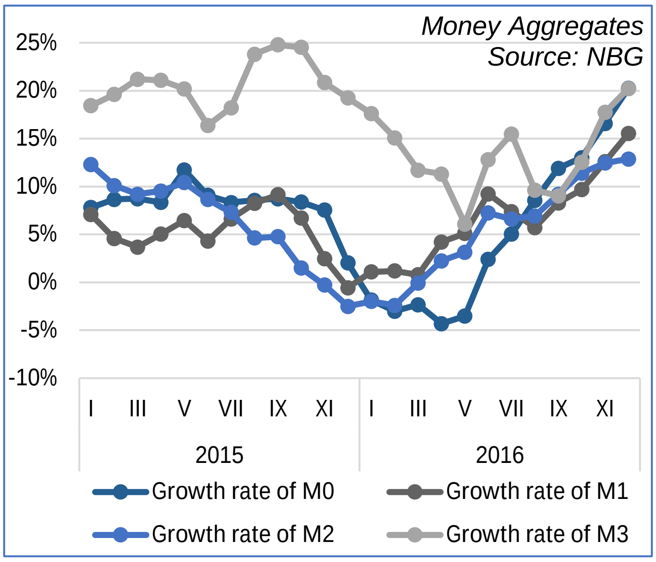
In 2016, electricity import decreased by 31.5% YoY and constituted 4.34% of the total consumption (478.9 million KWh), while electricity export decreased by 15.3% YoY and constituted 4.8% of the total generation (559 million KWh). As a result, Georgia became – for the first since 2011 – a net exporter of electricity in 2016.

Money and credit markets

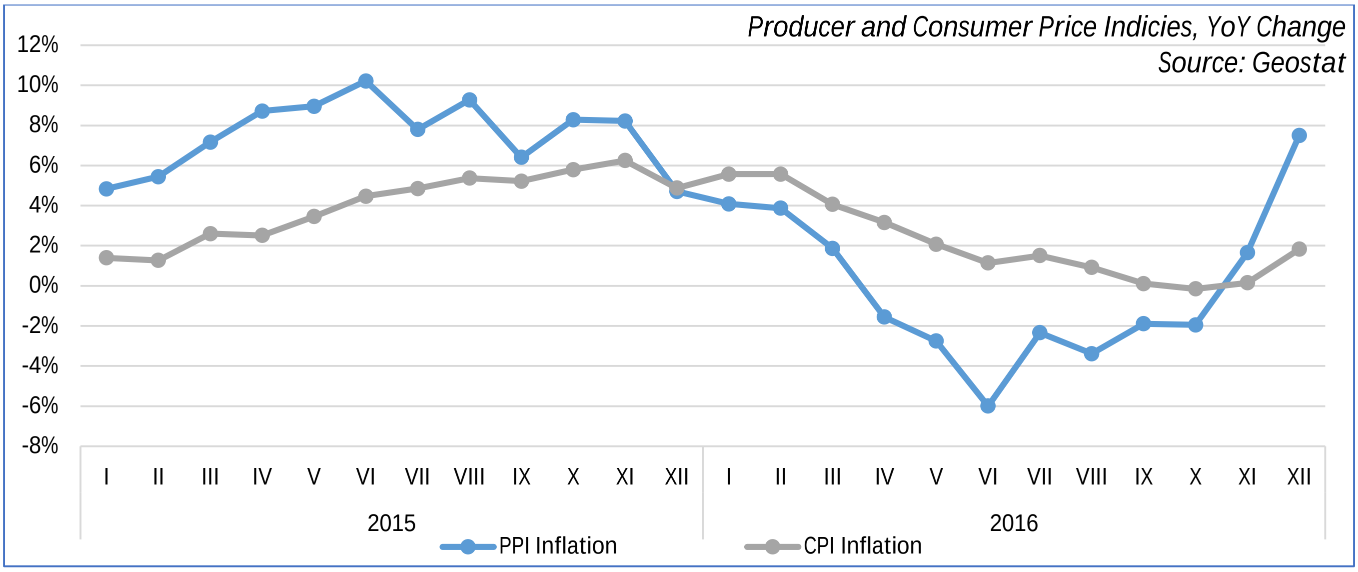
The year 2016 was characterized by monetary policy normalization after a period of monetary policy tightening in 2015. Weak internal demand and decreased inflation expectations were the main factors that affected the NBG's decision to gradually decrease the refinancing rate by 1.5 percentage points in January-September 2016. However, at the end of the year the NBG maintained the policy rate at 6.5%, explaining their decision by the effects of external shocks (on the exchange rate) and the planned increase of excise tax, which will cause a one-time increase in the price level.

The normalization policy had an immediate effect on the growth rates of monetary aggregates. Growth rates of both M1 (narrow money) and M2 (broad money, excluding foreign currency denominated deposits) increased to 16% and 13% respectively in December 2016.



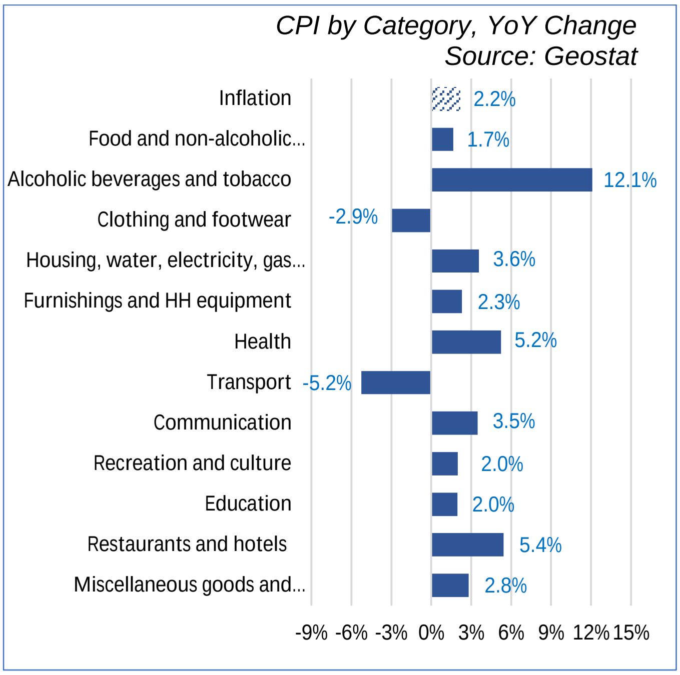


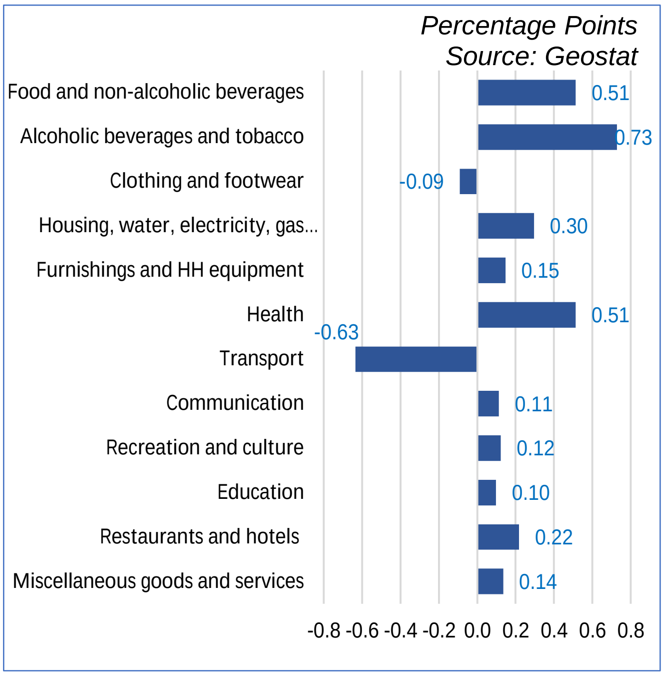
According to Geostat, both producer and consumer prices showed moderate growth in 2016. The PPI constituted 0.1% deflation, while the CPI stood at 2.2% (significantly below the 5% annual target).



The decomposition of the consumer price index shows that **the main drivers of inflation in 2016 were alcoholic beverages (+12.1% YoY), food and non-alcoholic beverages (+1.7% YoY) and healthcare (+5.2% YoY).** Taken together, these categories contributed 1.75 percentage points to annual inflation. The increase in prices of alcoholic beverages and tobacco was mainly due to the higher excise tax introduced in January 2016.

Prices for used motor cars (-15.1% YoY), gasoline (-10.6% YoY) and diesel (-13.5% YoY) drove transport prices down by 5.2% YoY, which lowered annual inflation by 0.63 percentage points. Prices for other product categories increased slightly by 2-3.6% YoY.

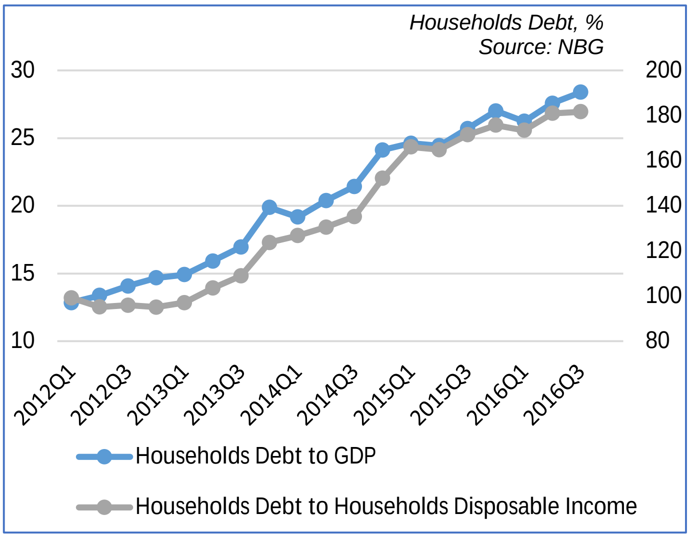


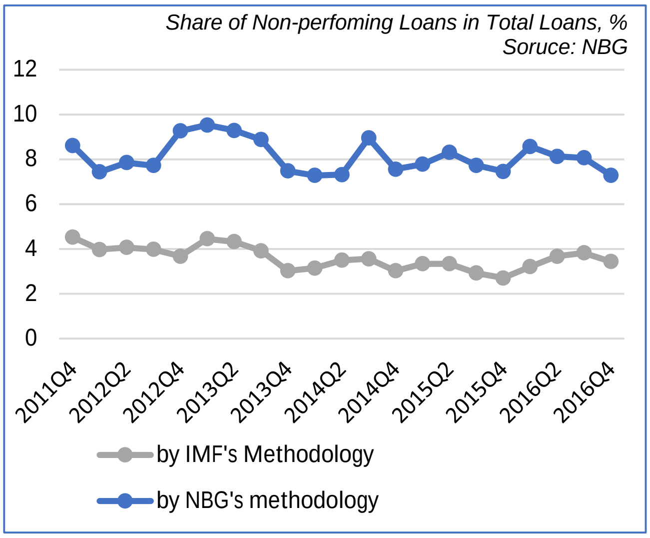


Financial Sector

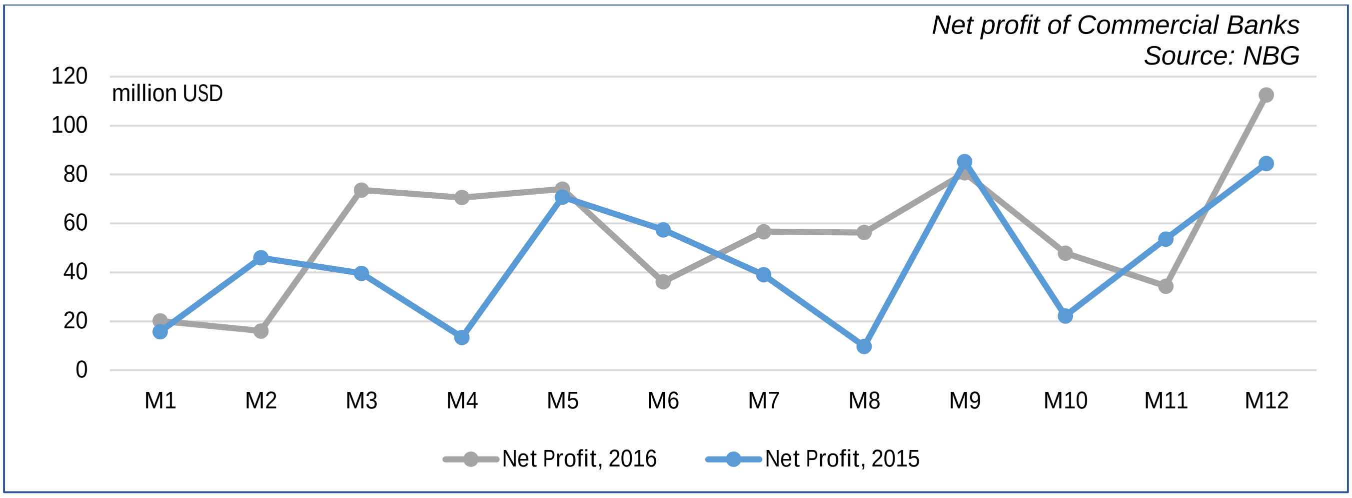
Household debt as a share of GDP has been growing in recent years, and reached 28.4% in Q3 2016. This was 2.7 percentage points higher than in the same period of 2015. **Household debt to disposable income constituted 181.7% in Q3 2016**, which was 10.1 percentage points higher than in the same period of 2015.

Despite the continued increase in household debt indicators and the national currency depreciation against US dollar in 2016, **the share of non-performing loans (NPL) to total loans was not affected**. This indicator increased by the methodologies of the IMF (3.4% in Q4 2016 vs. 2.7% in Q4 2015) and decreased by the NBG's methodology (7.3% in Q4 2016 vs. 7.5% in Q4 2015). The possible explanation for stable NPL statistics could be the low inflation in 2016 and the buffers commercial banks put in place while granting loans. However, high expected inflation and the rise in excise tax from the beginning of 2017 will affect households' ability to pay their debts.



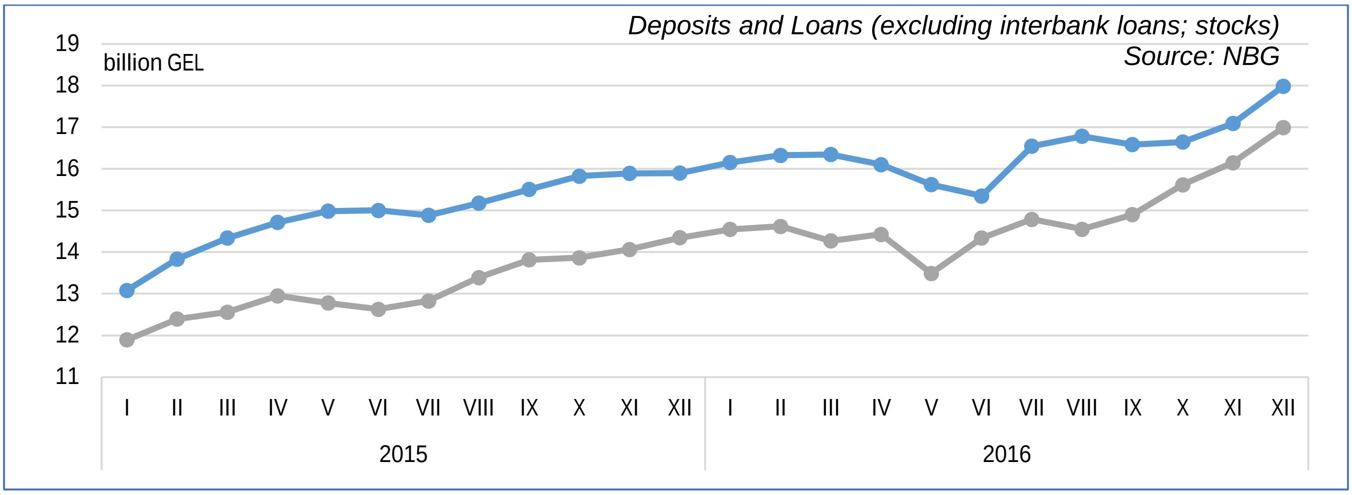


The profitability of the Georgian financial sector increased by 26.4% YoY in 2016, reaching 679 million GEL (a 13% YoY increase).

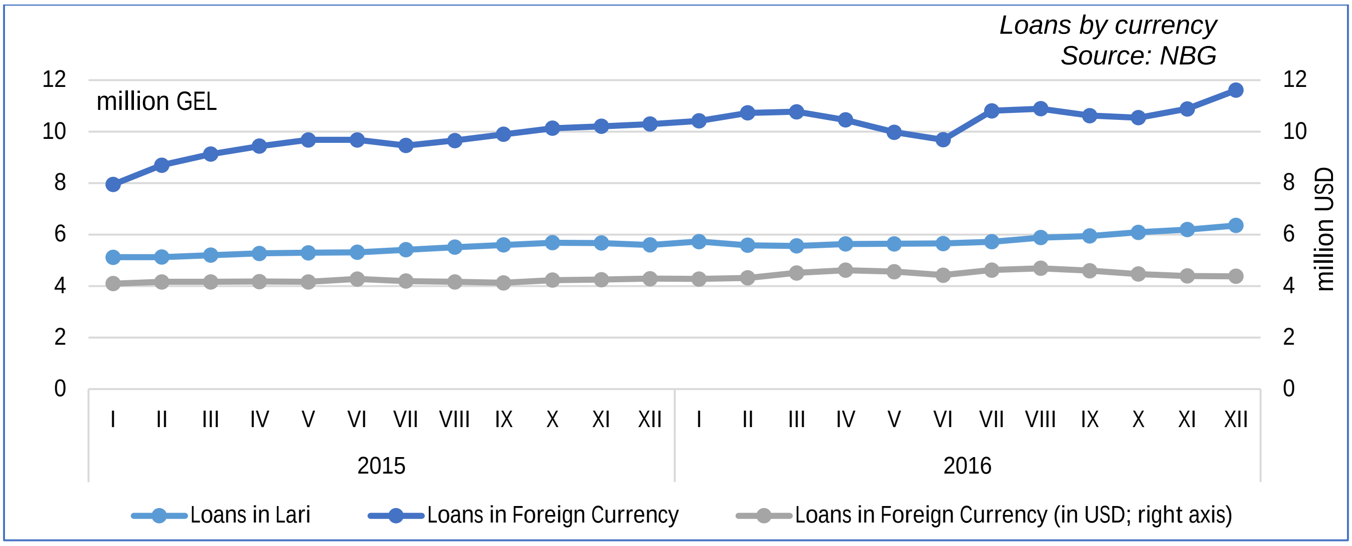


Total loans (stocks) granted by commercial banks, excluding interbank loans, amounted to 17.98 billion GEL in the end of 2016, a 13.1% YoY increase.

Total deposits of enterprises and households in commercial banks amounted to 16.991 billion GEL, which was an 18.4% YoY increase.

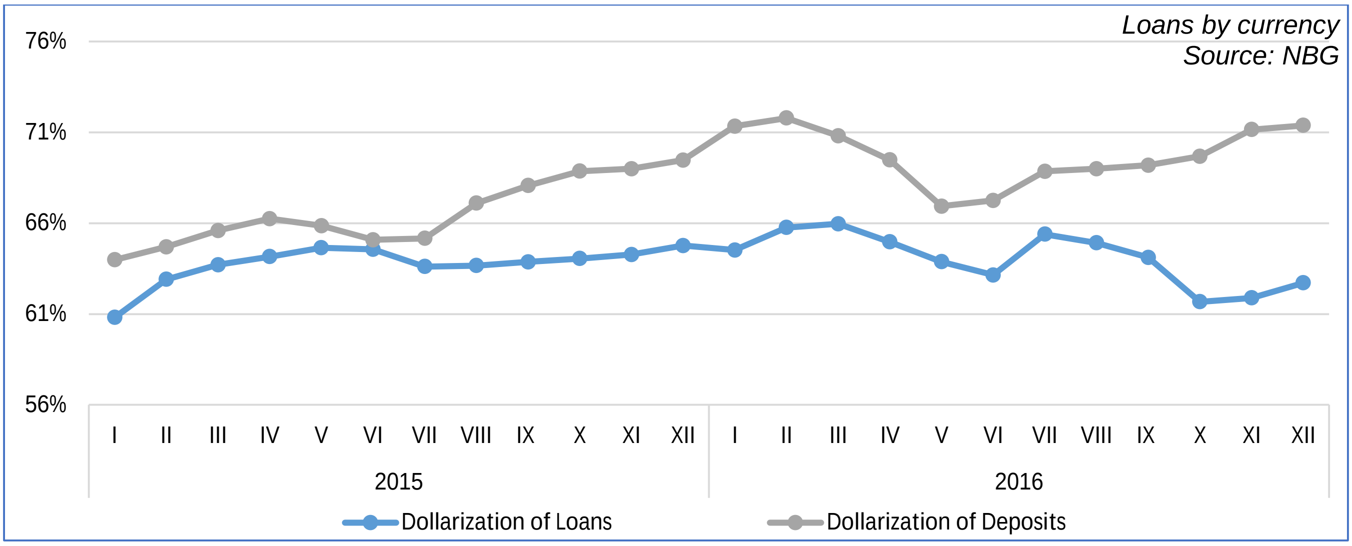


The “valuation effect” associated with the lari exchange rate fluctuation significantly affected the statistics of deposits and loans. Stocks of loans granted by commercial banks in the national currency increased by 13.6% YoY to 6.362 billion lari. Loans granted in foreign currency increased by 12.8% to 11.619 billion lari, although in US dollar denominated terms the stock of foreign currency loans increased by only 2.1% to 4.383 billion USD.



Loans by currency
Source: NBG

Dollarization rates of non-bank deposits have gone up, while the dollarization of loans decreased in 2016. Once again, the fluctuation of the lari exchange rate against the dollar was one of the main factors behind the changes in dollarization rates. **At the end of the year, the gap between deposits and loans dollarization significantly increased.** This indicates that depositors were losing their trust in the lari, while borrowers preferred to take out loans in lari to hedge further depreciation. At the end of 2016, the dollarization rate of non-bank deposits was 71.4%, while 64.8% of non-bank loans were dollarized.



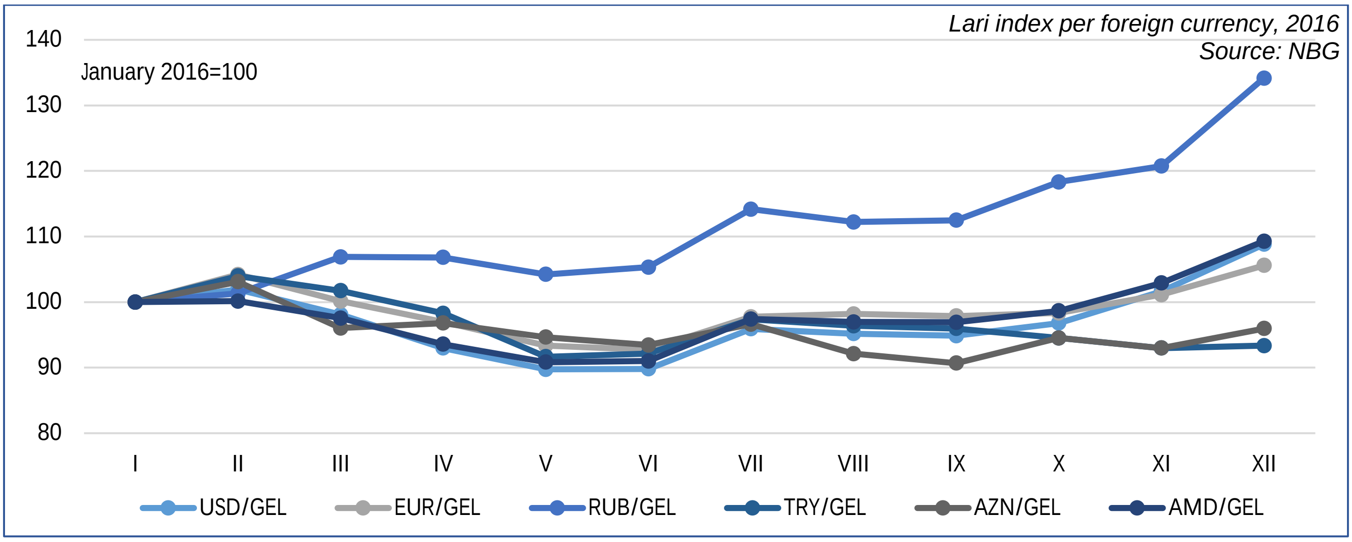
Loans by currency
Source: NBG

In January 2017, the government of Georgia and the NBG implemented macroprudential mechanisms to reduce dollarization rates: the issue of small loans (under 100,000 GEL) only in local currency and the voluntary conversion of foreign currency mortgage loans to the domestic currency. International and domestic experience shows that macroeconomic stability (decreasing the fiscal and current account deficit and the appreciation of the national currency) is a necessary and sufficient factor for successful de-dollarization, while artificial tools can only be used to accelerate the process. **While the government’s measures will have an effect on the dollarization of loans, dollarization of deposits will remain high, causing currency mismatches in commercial banks’ balance sheets.** See the ISET-PI blog article *“How to De-Dollarize in a Smart Way: Lessons from the Georgian and Foreign Experiences”* on this issue.

Exchange Rates

The year 2016 was characterized by high volatility of the national currency against the currencies of Georgia’s main trading partners. The lari exchange rate fluctuated in the range of +/- 10% against the US dollar, euro, Turkish lira, Azerbaijani manat, and Armenian dram. The Russian ruble was the only currency in the region that had a strong appreciation trend.

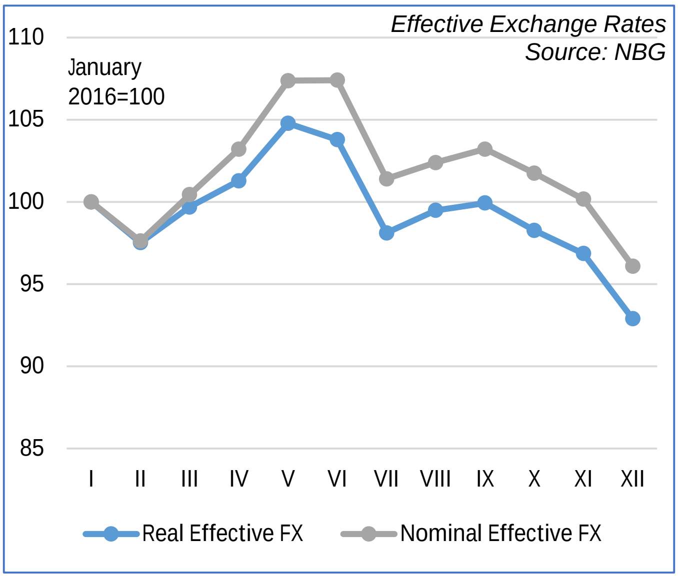
Overall, the lari **appreciated against other currencies in the first half of 2016 due to strong FDI and tourism inflows**; while in the second half of the year it experienced an episode of **depreciation caused by the global appreciation of the US dollar, pressure from a weakened Turkish lira and uncertainties brought to businesses by the new government's 10-point reform plan**.

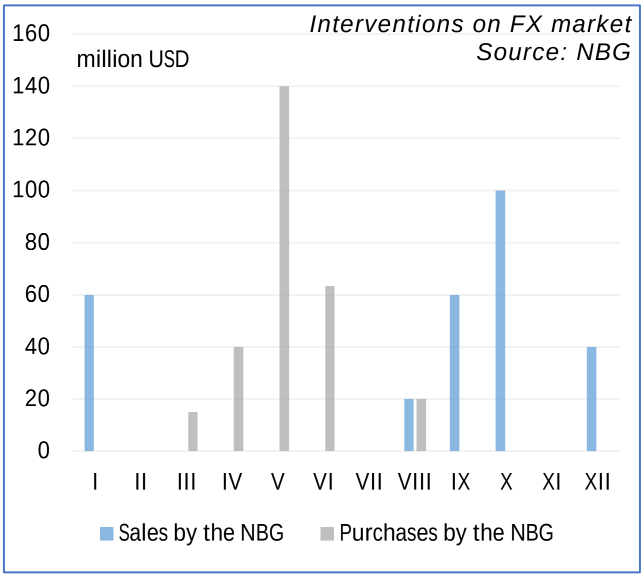


*An increase means depreciation

From January to December 2016, the lari lost 8.8% and 5.6% against the US dollar and euro respectively. Against the ruble, the lari weakened by 34.2%, while it gained 4% and 6.6% against the manat and lira respectively.

The NBG actively intervened in the foreign exchange market in 2016. The National Bank performed ten selling auctions of 280 million USD at the beginning and end of the year. Between selling auctions, the NBG bought 278.35 million USD in 14 auctions. As a result, the NBG partially managed to smooth the lari's fluctuation against other currencies.



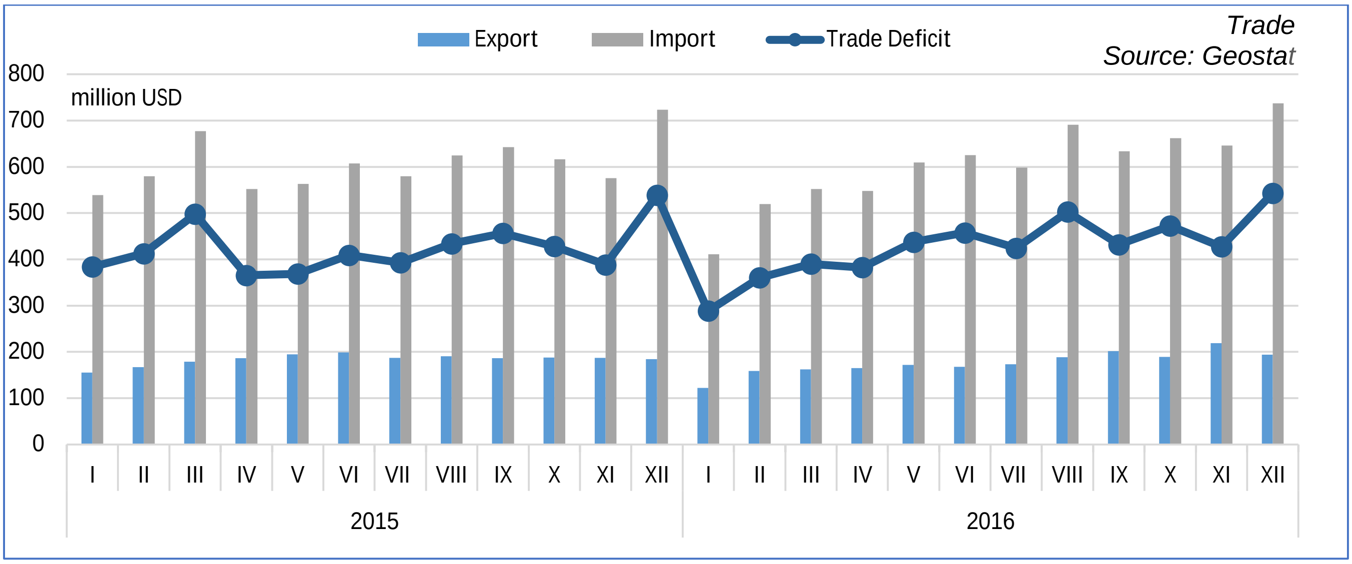


These currency trends were reflected in effective exchange rates. **In the period January-December 2016, the Georgian lari depreciated in both nominal and real terms by 4% and 7.1% respectively.** This means that Georgia's main trading partners had higher annual inflation rates, which made Georgian export goods relatively cheaper.

Trade

The year 2016 continued the previous year's downward trend in trade statistics. External merchandise trade turnover (excluding hepatitis C medicaments donated from Canada and Ireland) declined by 1.5% YoY and amounted to 9.346 billion USD, according to Geostat data.

Exports decreased by 4.1% and totaled 2.114 billion USD, while imports shrank by 0.7% to 7.233 billion USD (excluding hepatitis C donations). The hepatitis C medicine donations from Canada and Ireland amounted to an unprecedented 2.619 billion USD, about five times higher than in 2015. As a result, the trade deficit showed insignificant change – increasing by 0.8% YoY.



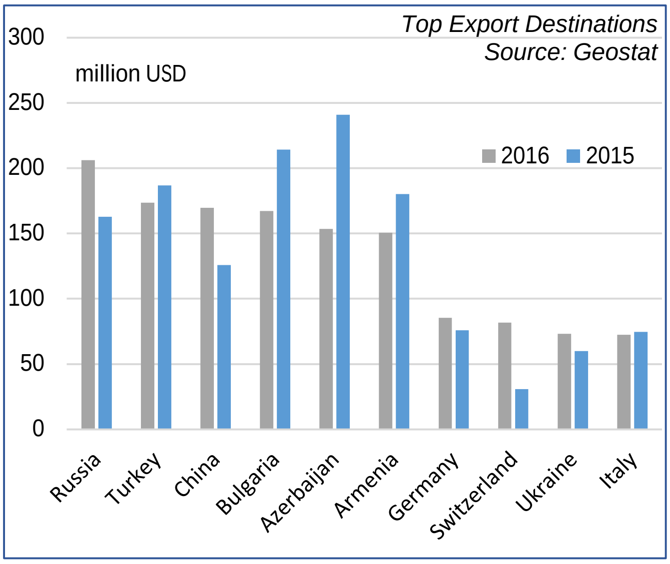
The negative dynamics in export and import volumes were driven by weak external demand conditions, including the recessions in Russia and Azerbaijan, and economic slowdown in Turkey and Armenia.

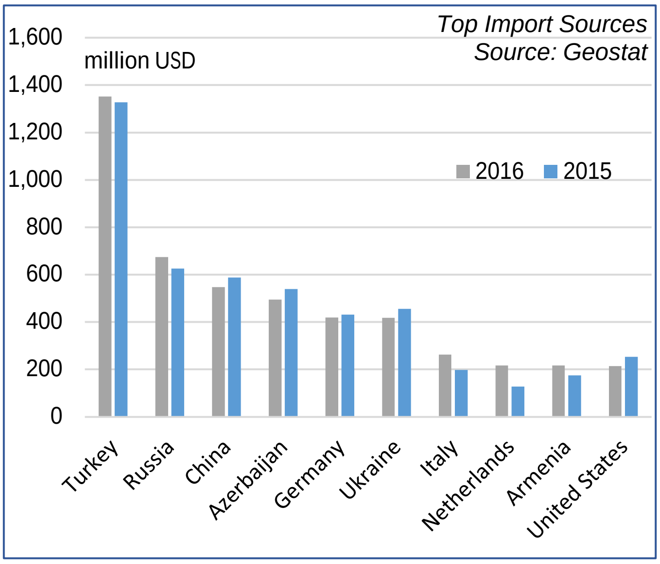
Russia became the biggest destination for Georgian exports in 2016, followed by Turkey and China. Exports to these countries changed by +26.6%, -7.1% and +34.8% YoY respectively. YoY exports to Bulgaria (-22%), Azerbaijan (-36.3%) and Armenia (-16.4%) each fell. Exports to EU countries surprisingly also declined by 11.7% YoY in 2016, with only exports to Germany (+12.5% YoY) and Switzerland (+165.1% YoY) showing noteworthy improvement.

Turkey remained the leader in terms of source country for Georgian imports, constituting 18.7% of total imports in 2016, which was two times higher than imports from Russia. Imports from these two countries increased by 1.8% and 8.0% YoY respectively. Imports from China decreased by 6.8% YoY, while imports from EU countries increased by 6% YoY.

Country comparison in terms of trade statistics in 2016 emphasizes several points:

a) Georgia benefited from both the trade restrictions between Turkey and Russia and the trade sanctions against Russia imposed by EU countries and the USA.
b) The increasing importance of the Russian market for Georgian exporters contains political risks for producers in light of previous embargos.
c) The Association Agreement and Deep and Comprehensive Free Trade Agreement with the European Union did not positively affect Georgian exports to the EU, while imports from the EU increased. A possible explanation for this could be the long and costly harmonization process, which constrained exports.
d) China has been the fastest growing export destination for Georgia in the last two years. The free trade agreement signed in September 2016 is expected to boost exports to China in upcoming years. China and other Asian countries, which do not protect their markets with non-tariff restrictions, have greater export potential for Georgia than the EU market





The structure of Georgian exports was characterized by relatively low diversification in 2016 – the top ten export commodities accounted for 64.6% of total exports. After a huge fall in motor cars' re-exports in 2015 due to new import regulations in Azerbaijan, copper ores became a leading export commodity, holding a 14.7% share in total Georgian exports and showing a 15.2% YoY increase. Wine (+18.5% YoY), undenatured ethyl alcohol (+41.5% YoY) and gold (+30.6% YoY) were the main success stories among the top export commodities, while ferro-alloys (-13.1% YoY), medicaments (-24.1% YoY) and fertilizers (-40.2% YoY) saw heavy falls in 2016.

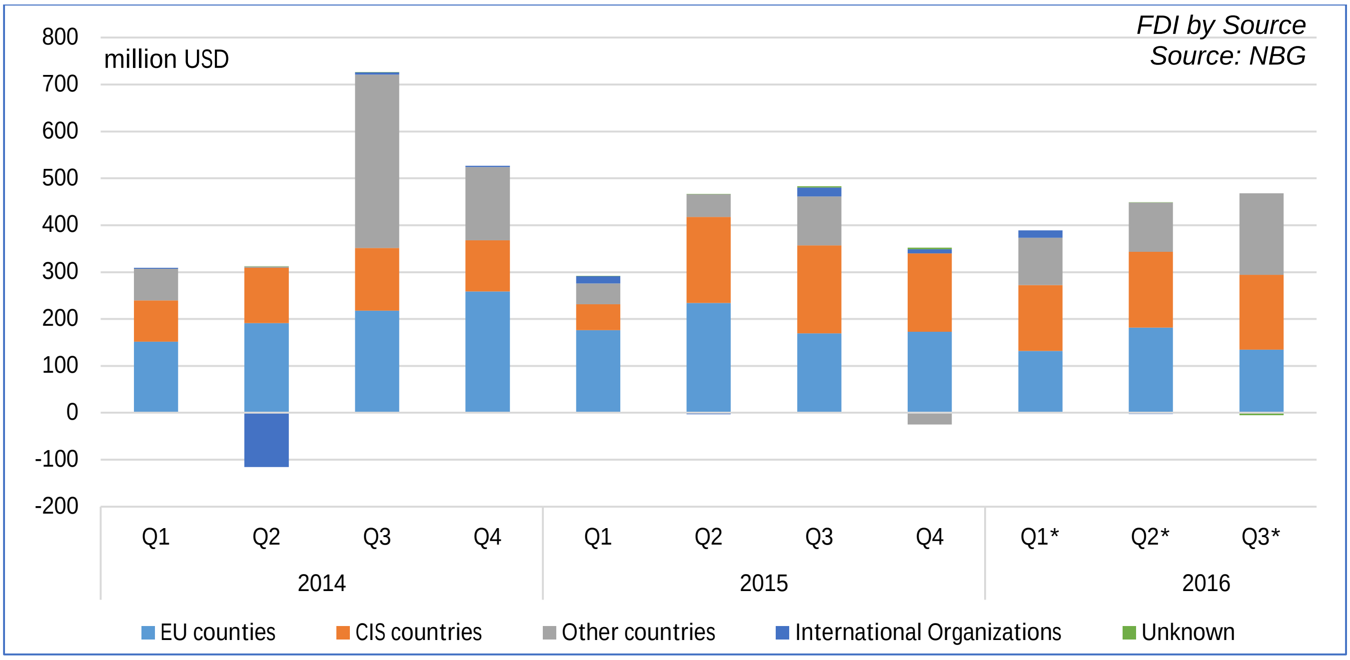
In the case of ferro-alloy exports, the main producer, "Georgian Manganese", claimed weak external demand and low world prices as the main factors behind the export decline, while a producer of fertilizers, "Rustavi Azot", mentioned high gas prices as being the main constraint in remaining competitive with Russian and Kazakh producers.

Table 2: Top Export Commodities *Source: Geostat*

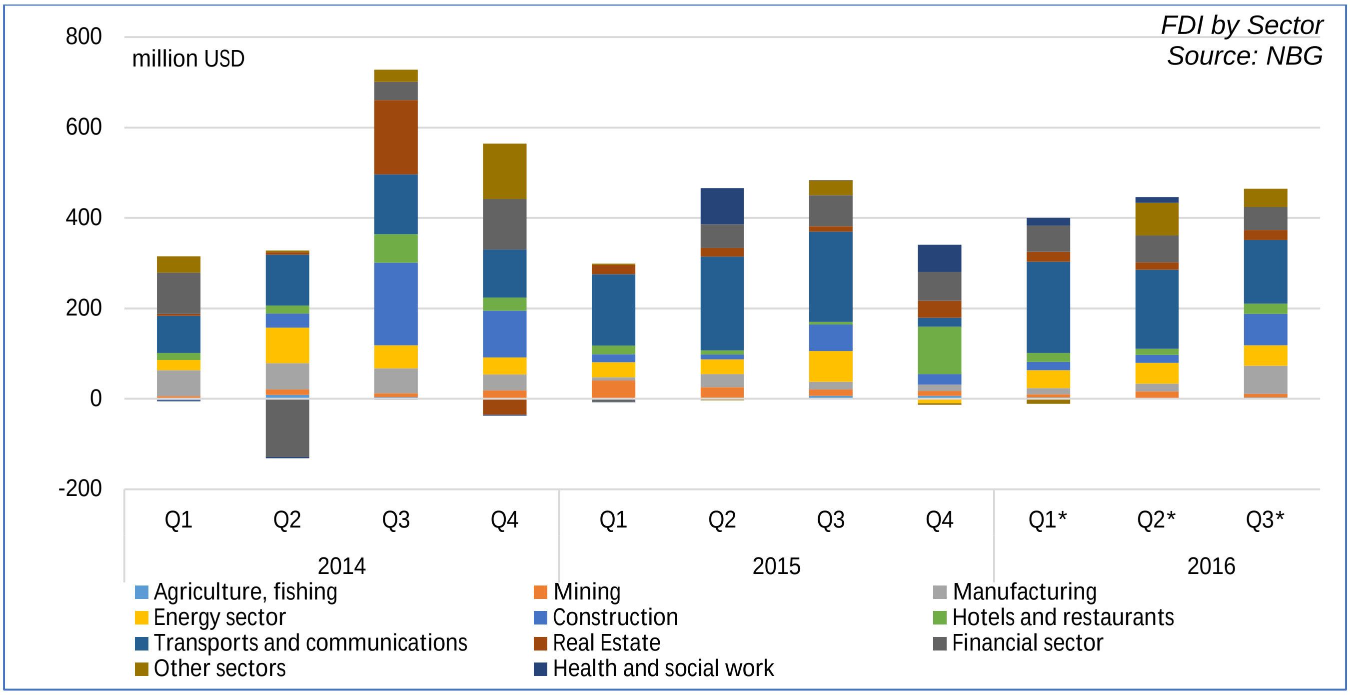
	2016		2015	
	million USD	Share in total	million USD	Share in total
Total	2 113.7	100.0%	2 204.7	100.0%
Copper ores and concentrates	311.7	14.7%	270.6	12.3%
Other nuts, fresh or dried	178.9	8.5%	176.6	8.0%
Ferro-alloys	169.3	8.0%	194.8	8.8%
Motor cars	166.6	7.9%	179.6	8.1%
Wine of fresh grapes	113.5	5.4%	95.8	4.3%
Medicaments put up in measured doses	107.4	5.1%	141.5	6.4%
Undenatured ethyl alcohol	91.8	4.3%	64.9	2.9%
Gold unwrought or semi-manufactured	81.1	3.8%	62.1	2.8%
Mineral waters	79.8	3.8%	82.2	3.7%
Mineral or chemical fertilizers, nitrogenous	65.6	3.1%	109.8	5.0%
Other commodities	748	35.4%	826.7	37.5%

Foreign Direct Investment

According to Geostat's last estimates, **net foreign direct investment in Georgia amounted to 1.298 billion USD in the first three quarters of 2016, a 4.3% YoY increase**. The FDI level steadily increased during the year. The top sources countries by share of total FDI were Azerbaijan (33.4%), Turkey (15.2%), the United Kingdom (6.2%), Luxembourg (5.2%), the Czech Republic (5.1%), and the Netherlands (4.8%).



In the first three quarters of 2016, **transport and communications was the largest FDI recipient sector with 516.8 million USD (40% of total FDI)**. The financial and energy sectors followed with 168.2 million USD (13%) and 130.8 million USD (10%) respectively. **Manufacturing and hotels and restaurants were the fastest growing FDI-recipient sectors in the first three quarters of 2016, with 73.7% and 67.3% YoY increases respectively.**

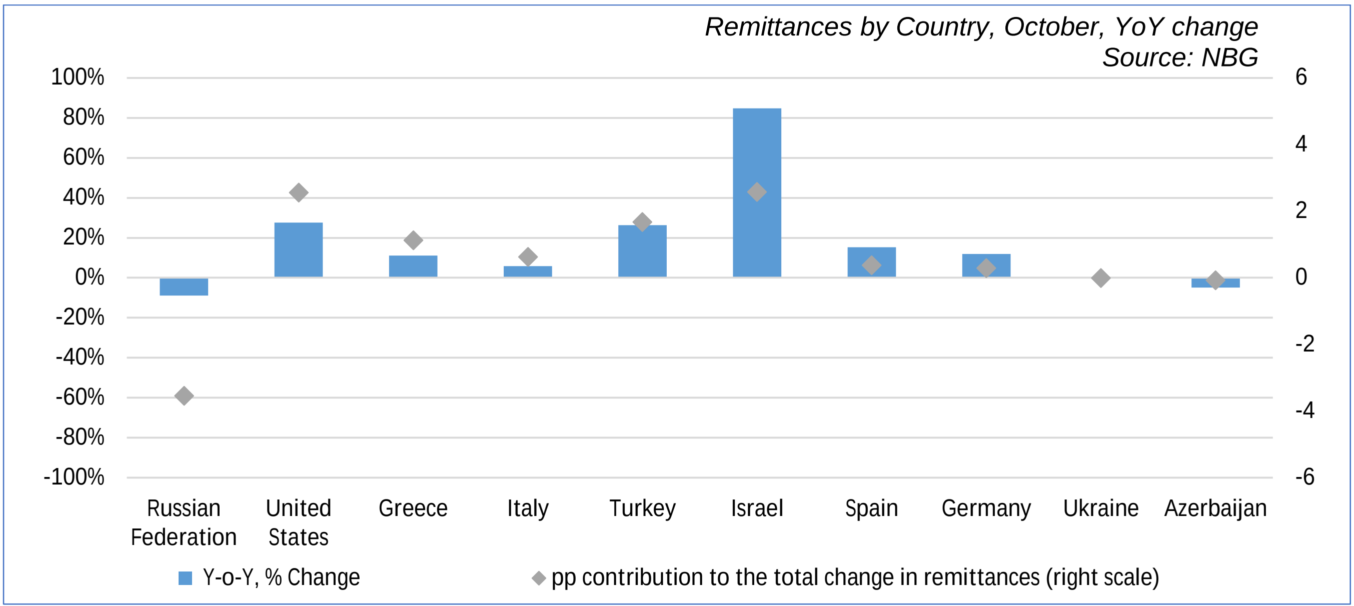


FDI statistics for Q4 are not yet available, but low economic growth and the depreciation of the nominal effective exchange rate in the last quarter of 2016 may suggest that net FDI inflow to Georgia could show a drop in this period.

Remittances

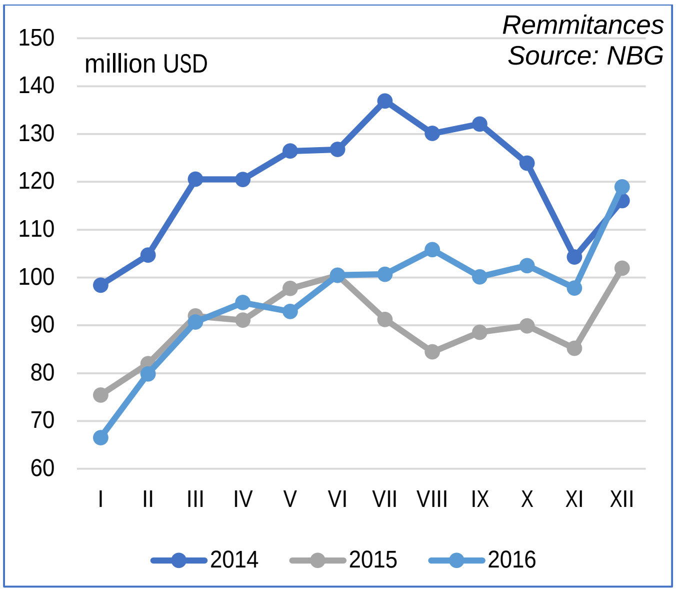
According to GeoStat, the **volume of total remittances to Georgia amounted to 1,151 million USD in 2016, a 6.6% YoY increase.** Russia (-8.8% YoY), Ukraine (-0.2% YoY) and Azerbaijan (-4.9% YoY) were the only countries that showed a YoY decrease of remittances, and together they drove total statistics down by 3.62 percentage points.

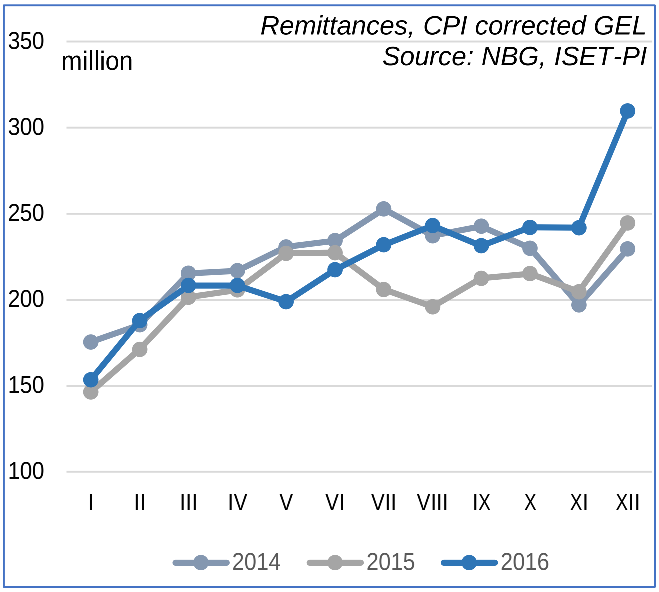
The United States (+27.6% YoY) became second largest source of money inflows to Georgia, slightly outperforming Greece (+11.2 YoY) and Italy (+5.8%) in 2016. Together, these countries contributed 4.32 percentage points to the total increase. However, **the leader in terms of the annual increase of remittances was Israel, showing an 84.7% YoY increase** and contributing 2.58 percentage points to the total YoY growth of remittances.



Despite positive YoY dynamics in remittances in 2016, money inflows were far below 2014 levels. Remittances from the Russian Federation and Greece have not recovered after their fall in 2015.

Georgian receivers of money transfers gained from the lari depreciation and low inflation in 2016. Remittances in CPI adjusted lari terms, which measures the purchasing power of money inflows to Georgia, showed an 8.8% and 1% YoY increase compared to 2015 and 2014 respectively.





International Arrivals

In 2016, there were 6,350,825 international arrivals to Georgia, a 7.6% YoY increase; of these, 81.6% arrived by land, 16.8% by air, 1% by rail and 0.7% by sea.

As usual, the highest share of total visitors to Georgia were from neighboring countries – Azerbaijan, Armenia, Turkey, and Russia. Taken together, visitors from these countries constituted 83.6% of the total. **Leaders in the YoY percentage increase of international visitors were East Asia and the Middle East regions: Iran (+485.3% YoY), India (+198.9% YoY), Saudi Arabia (+115.9% YoY) and Israel (+55% YoY).** These numbers emphasize the huge potential of Asia in terms of tourism development for Georgia.

Table 3: International Arrivals by Country *Source: GNTA*

	Country	2015	2016	Change	Change %	Share %
1	Azerbaijan	1 393 257	1 523 075	129 818	9.3%	24.0%
2	Armenia	1 468 888	1 496 246	27 358	1.9%	23.6%
3	Turkey	1 391 721	1 254 089	-137 632	-9.9%	19.7%
4	Russia	926 144	1 037 564	111 420	12.0%	16.3%
5	Ukraine	141 734	172 631	30 897	21.8%	2.7%
6	Iran	25 273	147 915	122 642	485.3%	2.3%
7	Israel	59 487	92 213	32 726	55.0%	1.5%
8	Kazakhstan	36 777	48 809	12 032	32.7%	0.8%
9	Poland	41 425	44 388	2 963	7.2%	0.7%
10	Germany	36 826	40 889	4 063	11.0%	0.6%
11	Belarus	28 959	37 099	8 140	28.1%	0.6%
12	India	12 114	36 204	24 090	198.9%	0.6%
13	USA	31 147	34 238	3 091	9.9%	0.5%
14	Saudi Arabia	9 850	21 262	11 412	115.9%	0.3%
15	Greece	19 221	20 225	1 004	5.2%	0.3%

The reported year was very successful for Georgia in terms of international tourism. The number of tourists (visitors who stayed in Georgia for 24 hours or more) constituted 2,714,773 people, a 19% YoY increase. These tourists brought 1.685 billion USD (7.3% of GDP) to Georgia in the first three quarters of 2016, which was 11.7% more than in the same period of the previous year.

Table 4: International Arrivals by Type of Visit *Source: GNTA*

Type of Visit	2013	2014	2015	2016
24 hours or more	2 065 296	2 229 094	2 281 971	2 714 773
Transit	1 188 791	1 114 036	1 400 835	1 321 000
Same-day visit	2 138 216	2 172 429	2 218 288	2 315 052
Total	5 392 303	5 515 559	5 901 094	6 350 825

Public Finances

In 2016, **central government total revenues amounted to 10.374 billion GEL, a 4.9% YoY increase.**

Revenues from taxes increased by 5.8% YoY and constituted 7.987 billion GEL, notable changes were seen in Income Tax (-3.6% YoY), Profit Tax (+3.0% YoY), VAT (-6.2% YoY), Excise (+22.9% YoY), Custom Duties (+1.2% YoY), and Other Taxes (+1887.1% YoY[1]).

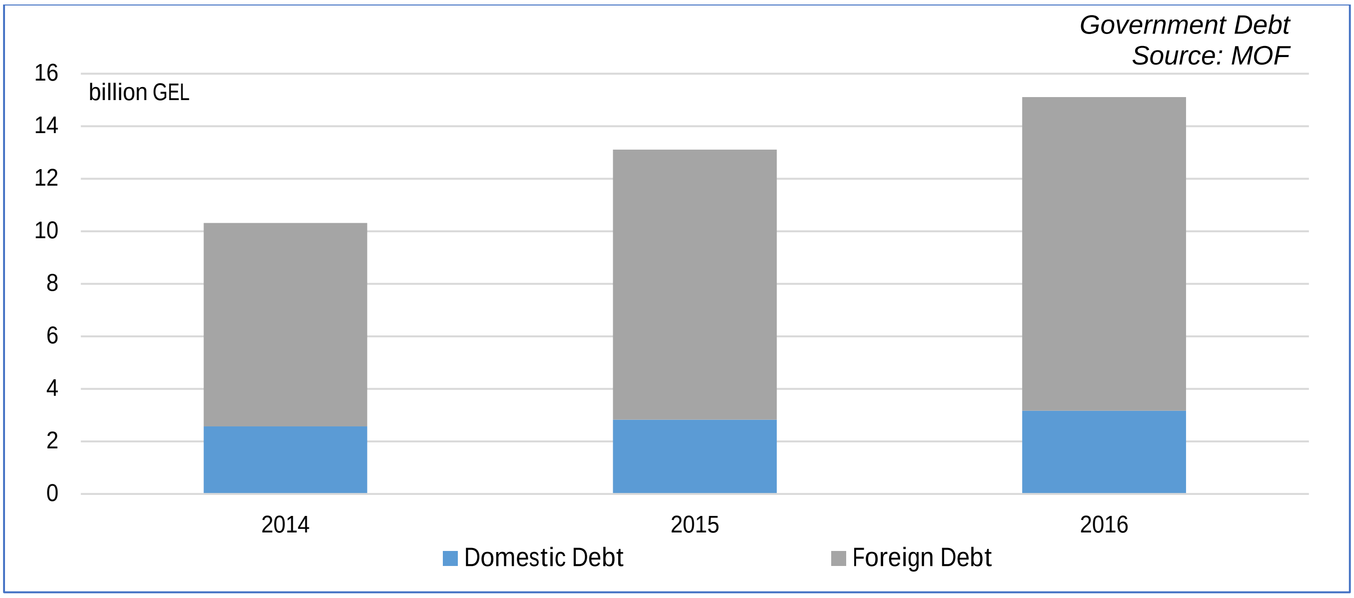
At the same time, **expenses of the central government amounted to 8.544 million GEL, a 4.7% YoY increase.** Notable changes were seen in compensation of employees (+5.5% YoY), use of goods and services (18.1% YoY), interest payments (21.8%% YoY), subsidies (+35.9% YoY), grants (-24.5% YoY), social benefits (+12.4% YoY) and other expenses (+11.8% YoY).

Overall, the central government budget execution went according to the initial plan: total revenues were executed by 100.5%, while total expenditures were executed by 99.9%. The central government budget deficit thus constituted 578 million GEL, which was 64 million GEL higher than the Ministry of Finance of Georgia projected at the beginning of the year.

[1] The large increase in “other taxes” category is due to the reform that led to technical changes in the tax administration process by Revenue Service of Georgia. This change removed the distortion that existed prior to 2016. As part of the reform, a unified treasury code for all taxes was adopted.

Revenues and Expenditures of Central Government	2014	2015	2016	2017
Milions of lari				(projected)
Total revenues	9157	9891	10374	11457
Revenues	7435	8170	8580	9489
Taxes	6847	7550	7987	8820
Income Tax	1790	2053	1978	2570
Profit Tax	829	1025	1056	681
Value Added Taxs (VAT)	3299	3505	3286	3779
Excises	810	871	1070	1627
Customs Duties	95	69	70	76
Other Taxes	24	27	527	87
Grants	279	316	297	284
Other Revenues	309	305	296	385
Decrease of Non-financial assets	81	287	246	90
Decrease of Financial assets	72	72	89	85
Increase of Liabailities	1570	1361	1459	1793
Domestic	573	315	378	400
Foreign	997	1047	1081	1393
Total expenditures	9157	9891	10292	11415
Expense	7480	8158	8742	9121
Compensation of employees	1296	1377	1452	1394
Use of goods and services	875	946	1118	1144
Interest	245	327	398	503
Subsidies	275	246	334	420
Grants	1068	1271	960	1020
Social benefits	2548	2802	3150	3313
Other expense	1173	1189	1330	1327
Increase of Non-financial assets	698	680	662	999
Increase of Financial assets	419	633	496	769
Decrease of Liabailities	560	420	392	526
Domestic	56	50	60	95
Foreign	503	370	332	431
Net operating balance	-45	12	-162	368
Net lending (+) / borrowing (-) (or Budget Deficit)	-663	-380	-578	-541

Government debt increased by 15.2% YoY in 2016 and amounted to 15.102 billion GEL. The share of domestic and foreign debt in total debt remained largely unchanged – **domestic debts constituted 21% of total debts.**



The Parliament of Georgia has already adopted a budget plan for 2017, which prioritizes fiscal stimulus. The Ministry of Finance has projected a rather large (+10.4% YoY) increase of total revenues of the central government, the main sources of which will be an increase of liabilities by 22.9% YoY (both domestic and foreign) and a hike of excise tax on gas and fuel, cigarettes, and automobiles (which was projected to finance the CIT reform).

Total expenditures are projected to increase by 10.9% YoY, which will be driven by an increase of non-financial assets (+50.8% YoY), financial assets (+55.2% YoY) and a decrease of liabilities (+34.1% YoY). Expenses are planned to increase by 4.3% with the government prioritizing infrastructural spending, subsidies and social spending.

According to the budget plan for 2017, the budget deficit will amount to 541 million GEL, which is 37 million GEL less than in 2016. However, projections of an increase of tax revenues in an uncertain external and internal macroeconomic environment seem very optimistic and creates risks for budget execution in 2017.