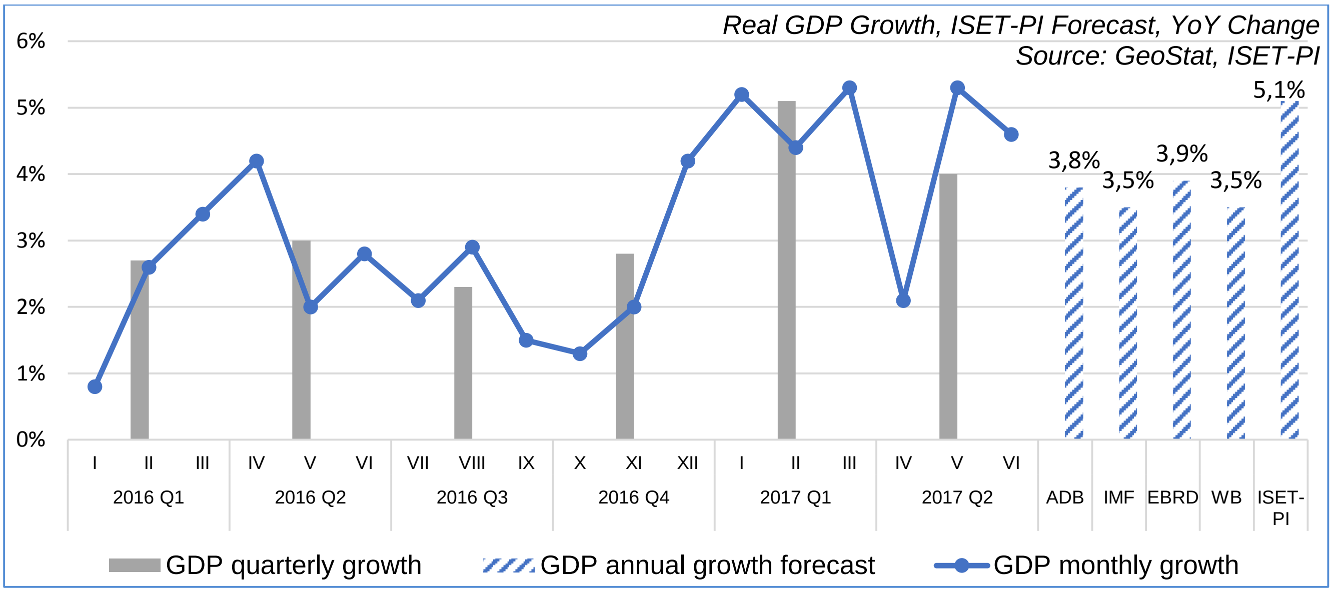
Authors: Yaroslava Babych and Giorgi Mzhavanadze

STRONG Q2 DATA PUTS GEORGIA'S ANNUAL GROWTH ON TRACK TO REACH TARGET

Growth

According to the preliminary statistics released by GeoStat, Georgia's real GDP growth was 4% year over year (YoY) in Q2 2017, which fell short of the 5.8% growth predicted by ISET-PI's GDP forecast from July. The main reason behind the forecast error was higher-than-expected actual growth in the first quarter (5.1% YoY). In light of recent data, the Georgian government's 4% target of real GDP growth does not seem overambitious. The National Bank of Georgia also left its forecast of annual growth unchanged (see the latest monetary policy report from August 2017).



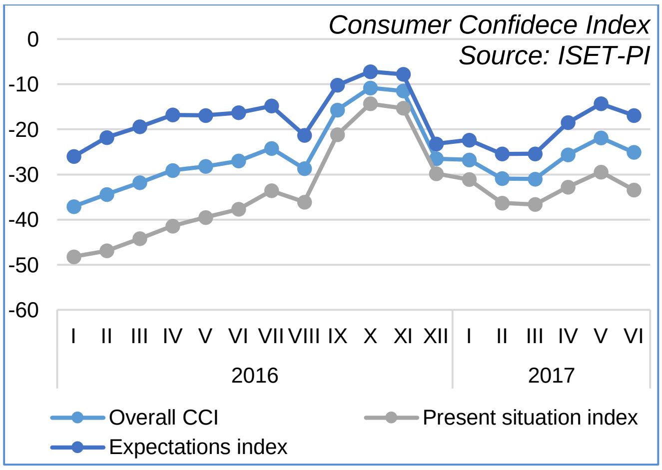
Data on the second quarter of 2017 suggests that the Georgian economy is continuing to recover from its sluggish growth of previous years. The recovery is due to improvements in both the domestic and external environment. In particular, improvements in consumer and business confidence, the growth of government expenditure, an increase in loans, hikes in exports of goods, rising tourism, and increased money transfers were the main drivers of economic growth in Q2 2017. On other hand, weaker-than-expected FDI inflow hindered growth in the reported period.

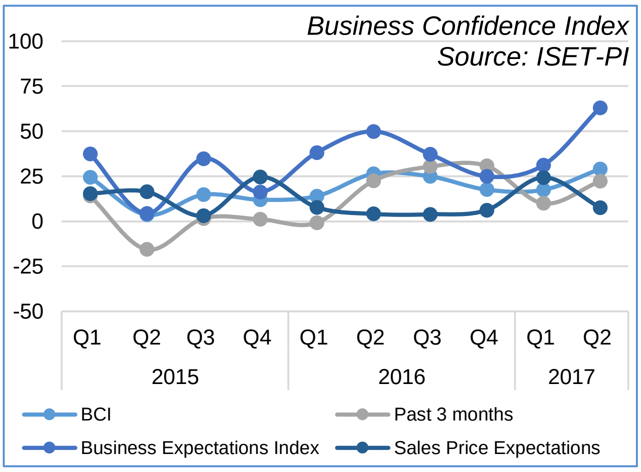
High economic growth rates in neighboring countries reflect positive dynamics in external factors, which also benefit the Georgian economy. Both Armenia and Russia showed high annual growth rates of real GDP in Q2 2017. Meanwhile, Turkey is expected to reach 6% YoY growth in Q2. Each of these countries grew faster than Georgia in the second quarter and this can mainly be explained by the low base (relative to Georgia) of Q2 2016. Only Azerbaijan exhibited weaker economic performance, down by 1.3% in the first half of 2017.

Consumer and Business Confidence

The Consumer Confidence Index (CCI), a barometer of consumer sentiment and a guide to domestic spending, was slightly higher in Q2 than in the same period last year – an increase of 1.9 index points. The present situation index was also affected positively in that period, up by 3.3 index points; while expectations fell by 0.6 index points.

The Georgian Business Confidence Index (BCI) also showed positive changes in Q2 2017, reaching 29.0 index points, which is a 2.6-point improvement YoY. The second quarter increase in the BCI was mostly driven by strong performance in the last quarter and a quite significant improvement in expectations. The expectations index gained 13.2 index points, rising to 63.1, which is the highest value in Georgia's BCI history (see the full BCI report here).





Inflation

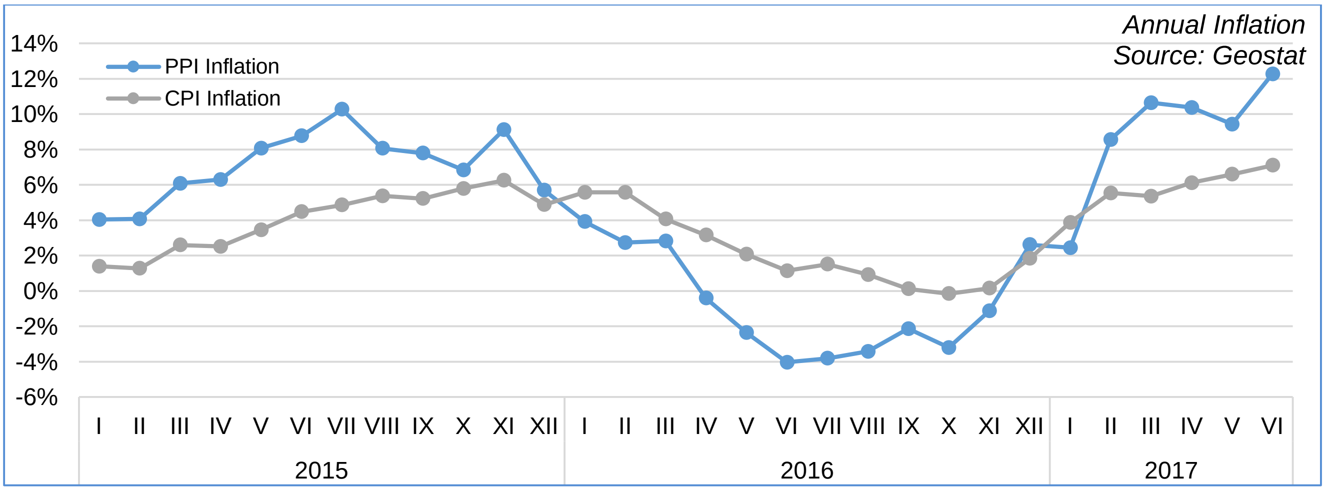
Inflation was the underlying economic indicator that consumers and producers alike were worried about in the second quarter of the year. According to Geostat, producer and consumer prices increased on average by 10.7% and 6.6% respectively in Q2. The annual hike in prices was mainly caused by one-time factors, specifically the significant increase of excise tax on fuel and tobacco products. However, in Q2 2017 two additional factors put pressure on transportation prices in Georgia:

a) The price increase of oil products on the world market. On average, fuel prices (IMF fuel index) increased by 12.7% YoY.

b) Nominal depreciation in annual terms. Despite the trend of monthly appreciation against the US dollar since January 2017, the Georgian lari lost on average 6.1% against the USD year on year.

As a result, prices on transport and tobacco increased by 16.8% and 15.9% respectively. Taken together, these products contributed 3 percentage points (pp) to annual inflation in Q2.

The biggest driver of annual inflation in the reported period was the price change on food products, which rose by 8.5% YoY (2.6 pp) and was also affected by higher fuel prices. Supply side pressures will keep annual inflation above its target level (of 4%) during 2017 and, holding other things constant, inflation should return to the 3% target in 2018.

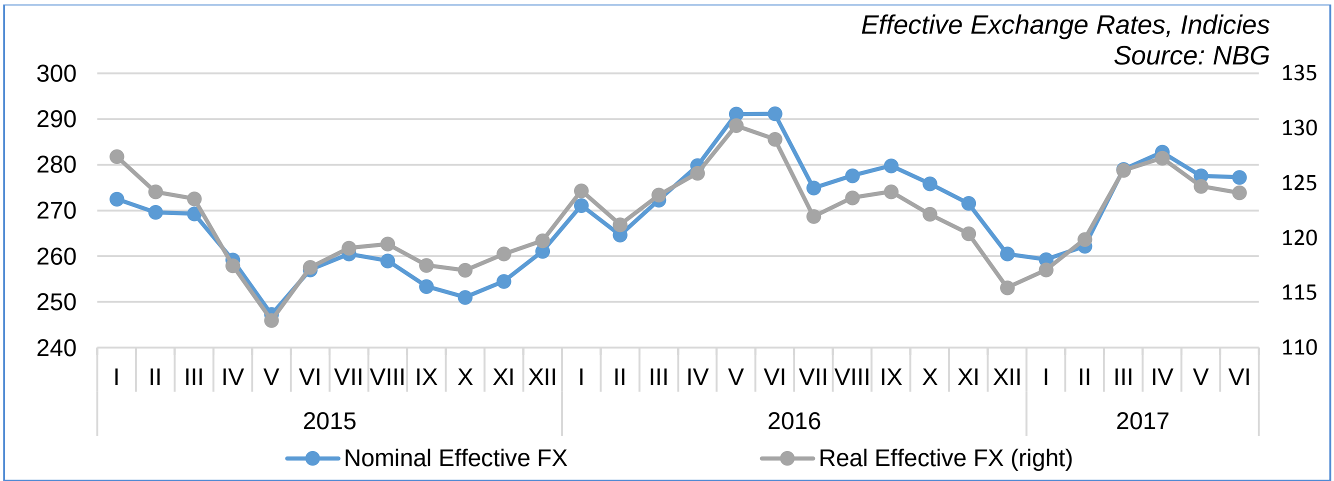


Exchange rate

In Q2, the lari nominal exchange rate appreciated on average against both the US dollar (7.3%) and the euro (4.4%) compared to the first quarter of 2017. This appreciation was caused by positive dynamics in exports, money inflows and tourism. However, in annual terms the lari was down against these currencies, by 6.1% and 3.6% respectively.

The real and nominal effective exchange rates followed the same pattern, albeit with different amplitude, seeing a 3.6% and 4.6% quarter-on-quarter increase respectively. In annual terms, real and nominal effective exchange rates both depreciated by 2.3% and 2.8% respectively.

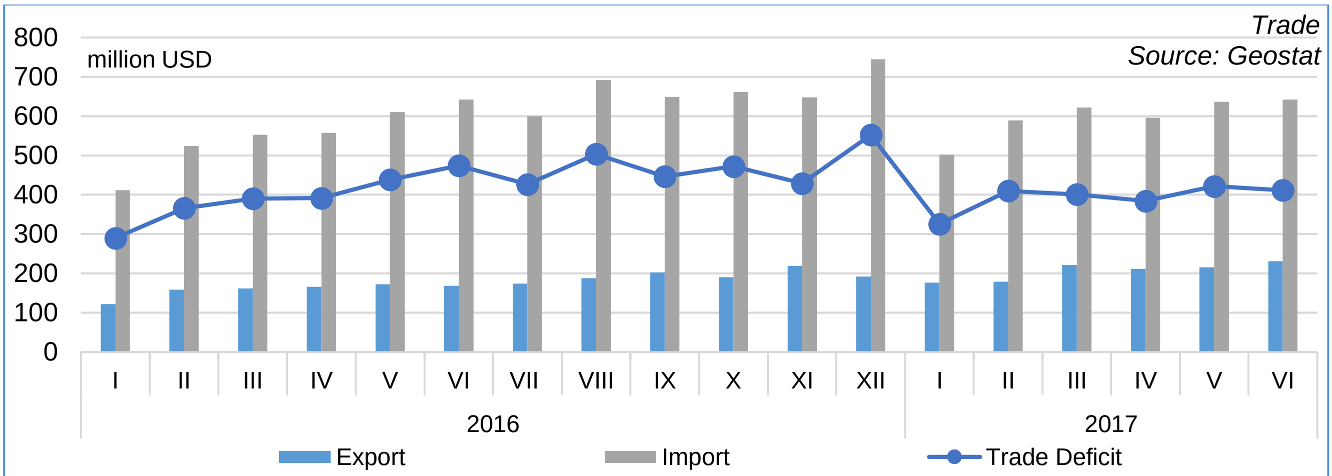
The National Bank of Georgia bought 70 million US dollars in seven auctions. The same pattern, albeit at a greater scale, was observed in the same period last year, when the NBG bought 203.35 million USD to smooth the national currency appreciation. Since Georgia is officially pursuing a floating exchange rate regime, a question can be posed: are the active interventions of the NBG on the FX market a signal that the NBG is trying to manage the exchange rate? For a detailed analysis of that question, see the ISET-PI blog *"Free or Fearful? The Fear of Floating in the South Caucasus"*.



External Trade

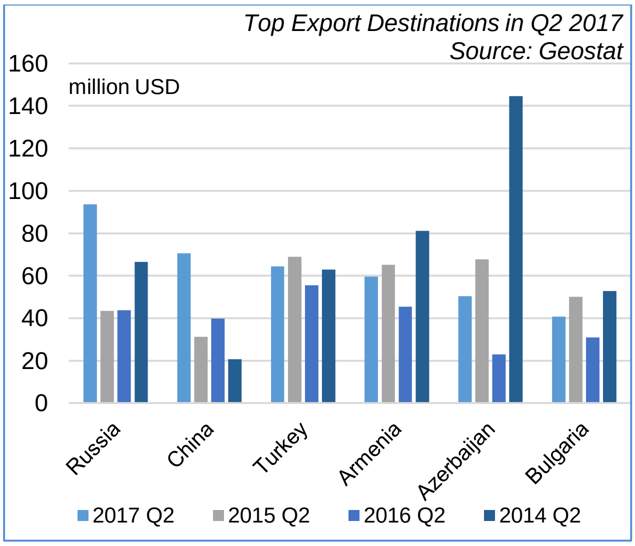
The second quarter of 2017 continued to show positive dynamics in external merchandise trade. Trade turnover increased by 9.4% year over year and amounted to 2,533 million USD, according to Geostat data. This rise was mostly driven by a notable increase in exports (+30% YoY), which constituted 657.6 million USD, while imports were almost flat (a 3.8% YoY increase to 1,875 million USD). As a result, the trade balance of the country has improved, with the deficit shrinking by 6.4% YoY.

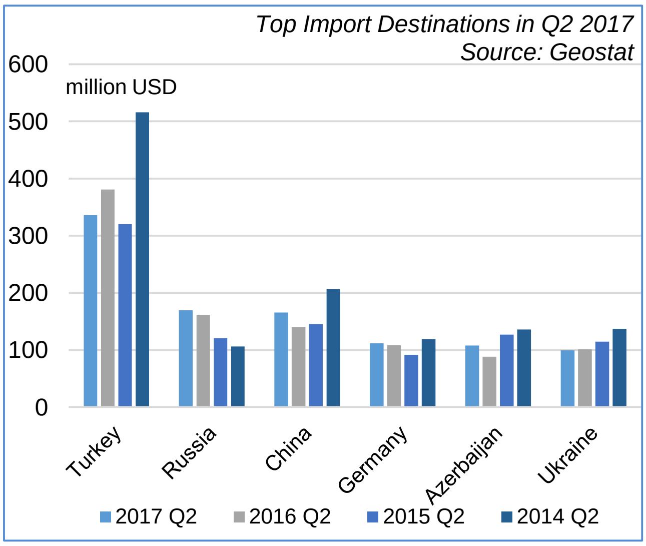
The boost in export volume was driven by improved external demand conditions and a surge in metal prices (+12.7% YoY in Q2).



Export of copper ores and ferro-alloys increased by 84.9% and 52.6% YoY respectively, contributing 15.7 pp to the total. Wine (+46% YoY), cars, (+32.5% YoY) and petroleum (+505.8% YoY) were the other main drivers of the export surge in Q2.

Exports to CIS countries increased by 62.8%. Exports to EU countries increased by 17.6% and those to other countries rose by 12.5% YoY in Q2. The main contributors to export growth were Russia (+114.2% YoY) and China (+77.5% YoY), which became the largest destination countries for Georgian products. Together with Azerbaijan (+ 5.4% YoY), those countries contributed 21.4 pp to total export growth in second quarter of 2017.

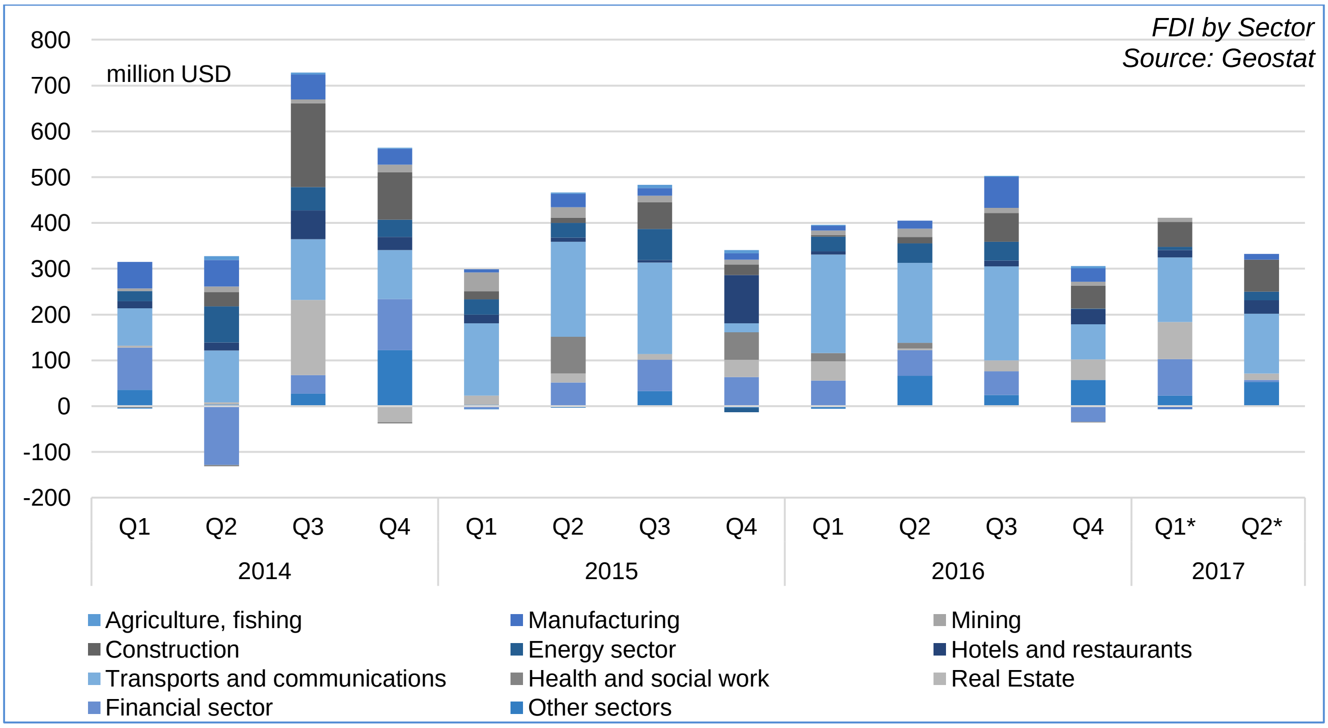




Foreign Direct Investment

According to Geostat's preliminary estimates, FDI in Georgia amounted to 346.3 million USD in Q2 2017, a 14.8% YoY decrease. The top five source countries by share of total FDI were Azerbaijan (36.6%), the Netherlands (12.4%), Turkey (11.3%), the UK (9.1%), and the Czech Republic (6%).

In Q2 2016, transport and communications was the largest FDI recipient sector, receiving 130.4 million USD (37.6% of total FDI), while the construction sector followed with 70 million USD (20.2%).

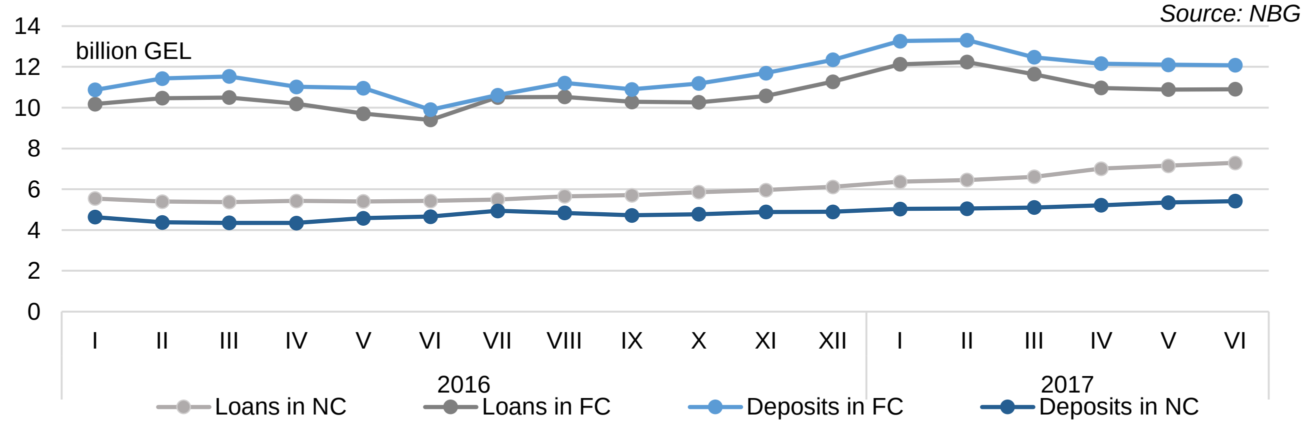


Financial Sector

Credit activity improved in the second quarter of 2017. Total loans (stocks) granted by commercial banks amounted to 18.2 billion GEL, a 22.7% YoY increase (15.9% YoY excluding the exchange rate effect). Retail loans increased by 27.4% YoY, while business loans showed a 17.8% increase. In terms of currencies, the growth of the loan portfolio was primarily driven by a significant increase in national currency loans (+34.4% YoY). The stock of loans granted in foreign currency increased by only 5.3%, excluding the exchange rate effect.

Total deposits allocated in commercial banks amounted to 17.499 billion GEL, which was a 20.1% YoY increase (+12.4 YoY excluding the exchange rate effect). Deposits of households increased by 27.6% YoY, while deposits of businesses showed a 12.9% YoY increase. In terms of currencies, deposits in national and foreign currency both grew substantially by 16.3% and 21.9% respectively (by 10.6% YoY excluding the exchange rate effect).

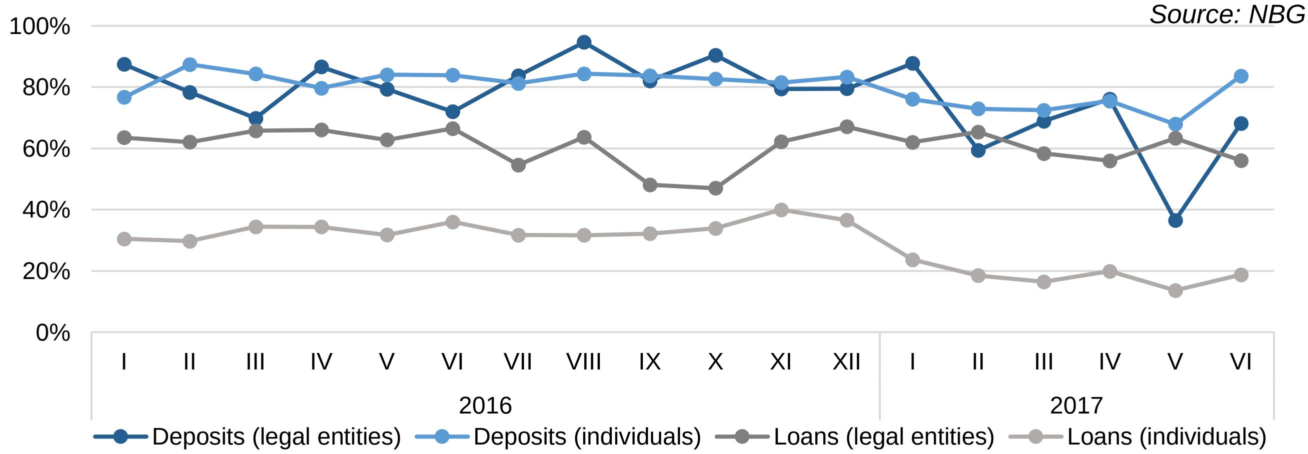
Loans and Deposits in Commercial Banks by Currencies (stocks; excluding interbank loans)
Source: NBG



In Q2 2017, dollarization rates of both loans and deposits fell. Loan dollarization decreased by 3.5 pp YoY (to 59.9%). However, if the exchange rate effect is excluded, the reduction was even more notable at 5.8 pp YoY. On the contrary, the dollarization rate of deposits increased by 1 pp to 69%; but excluding the exchange rate effect, the rate decreased by 1.1 pp.

If one looks at loans and deposits flows rather than stocks, the picture does not change much. During Q2 2017, commercial banks granted 36.7% more loans than in the same period a year ago. Of that amount, only 34.6% (32.6% excluding the exchange rate effect) were granted in foreign currency – a huge drop from the 48.9% recorded in 2016. Deposits during Q2 2017 increased by 55% YoY. Traditionally, depositors prefer to save money in foreign currency and the dollarization of deposits stood at 74.7% (73% excluding the exchange rate effect), which was a significant reduction compared to the 82.3% figure from Q2 last year.

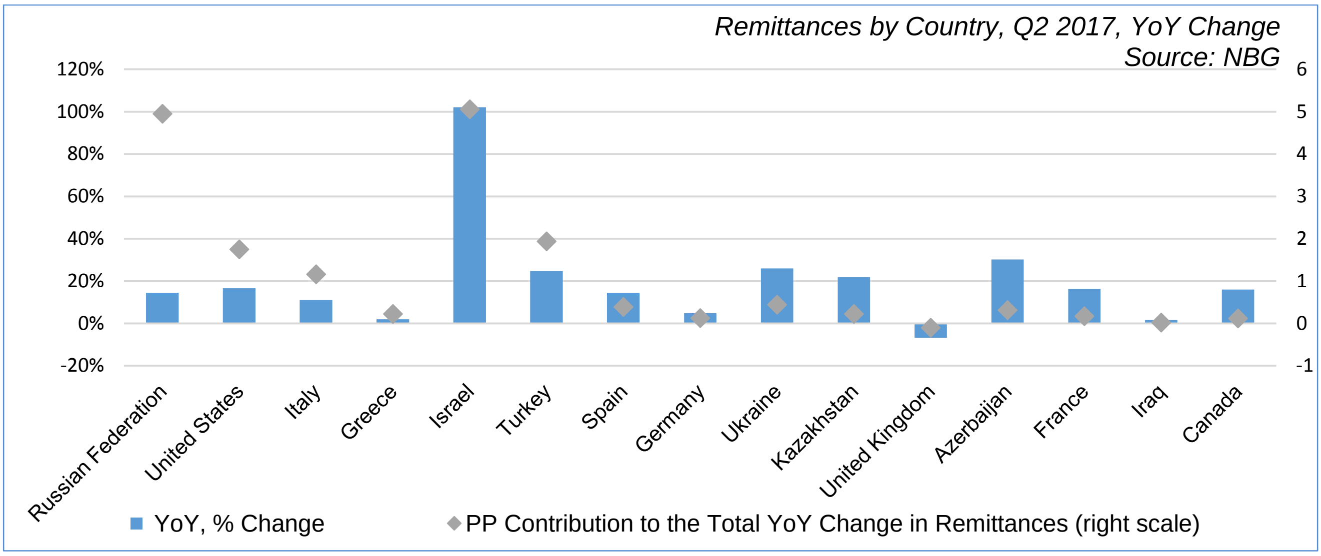
Dollarization of Deposits and Loans (flows; excluding interbank loans)
Source: NBG



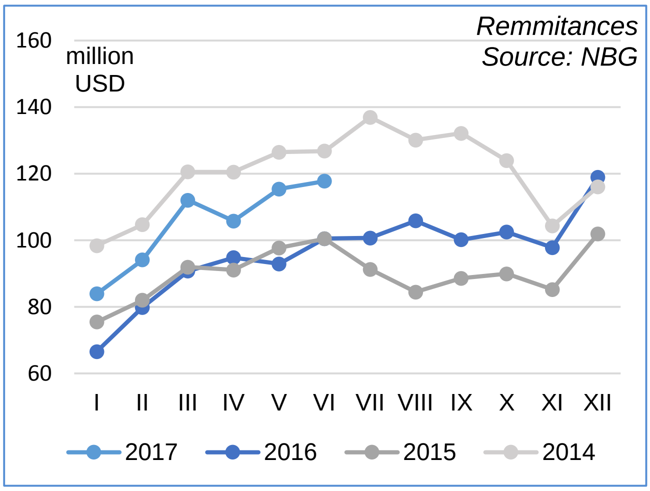
This indicates that the de-dollarization policy implemented earlier in year has started to work. It is, however, impossible to assess the results of this initiative over such a short period of time. Second, despite the willingness of banks to obtain funds in the national currency, there are high risks of a currency mismatch in balance sheets due to the increasing difference between the dollarization rates of loans and deposits.

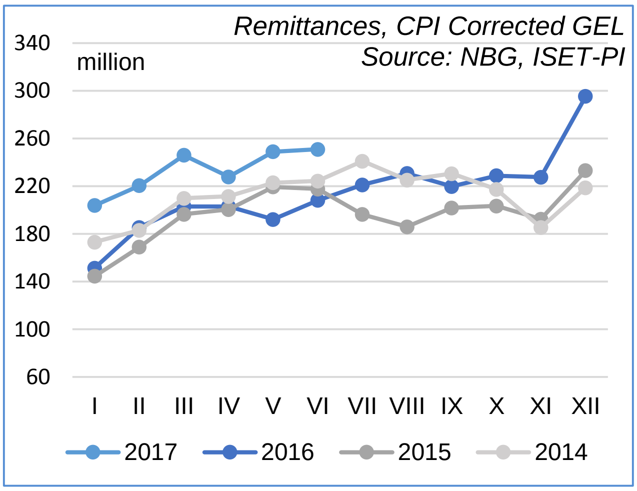
Remittances

According to the NBG, the volume of total remittances to Georgia amounted to 338.9 million USD in Q2 2017 – a 17.6% YoY increase that served as a good indicator of improved external conditions. All primary source countries of money inflows to Georgia showed a positive annual change: Russia (+14.5% YoY), the United States (+16.6% YoY), Greece (+1.9% YoY), Italy (+11.1% YoY) and Israel (+102.2% YoY). The latter continued to show unprecedented growth as a result of the waves of Georgians who stayed in Israel illegally after finding it to be a very good country to live and work in, and who then send money to their homeland.



While money inflows have not yet recovered to 2014 levels, the lari YoY depreciation boosted the purchasing power of remittances. In Q2 2017, Georgian receivers of remittances got 20.6% more of CPI adjusted GEL than in the same period last year, and 10.5% more than in Q2 2014. The biggest portion of remittances most likely go into consumption, which has a positive influence on internal demand.





Tourism

Tourism was an additional factor that accelerated economic growth in Georgia in Q2 2017. In the reported period, Georgia hosted 1.730 million international arrivals, which was a 15% YoY increase; of these, 75.8% arrived by land, 22.9% by air, 0.7% by rail and 0.5% by sea. International tourism receipts reached 659 million USD in Q2, representing a 27.9% YoY increase.

International Arrivals *Source: GNTA*

	Country	2016 Q2	2017 Q2	Change	Change %	Share %
1	Armenia	323 828	378 594	54 766	16.9%	21.9%
2	Azerbaijan	333 296	369 481	36 185	10.9%	21.4%
3	Russia	252 799	321 445	68 646	27.2%	18.6%
4	Turkey	356 993	294 937	-62 056	-17.4%	17.0%
5	Iran	20 860	65 265	44 405	212.9%	3.8%
6	Ukraine	42 110	50 476	8 366	19.9%	2.9%
7	Israel	28 690	41 017	12 327	43.0%	2.4%
8	Poland	13 130	16 100	2 970	22.6%	0.9%
9	India	7 172	15 797	8 625	120.3%	0.9%
10	Germany	10 486	14 088	3 602	34.4%	0.8%
11	Kazakhstan	10 992	13 402	2 410	21.9%	0.8%
12	USA	9 647	11 746	2 099	21.8%	0.7%
13	Belarus	8 375	10 798	2 423	28.9%	0.6%
14	United Kingdom	4 995	6 757	1 762	35.3%	0.4%
15	Saudi Arabia	1 865	5 777	3 912	209.8%	0.3%
	Total	**1 504 993**	**1 730 045**	**225 052**	**15.0%**	**100.0%**

Real tourists (visitors who stayed in Georgia for 24 hours or more) constituted 46.0% of total arrivals (796,339 people), which was a 31.3% YoY increase. Transit visitors showed 16.9% YoY growth, while the number of same day visits fell by 3.7% YoY.

Of the top five source markets, only Turkey saw a negative change in Q2 at -17.4% YoY, while Armenia (+16.9% YoY), Azerbaijan (+10.9% YoY) and Russia (+27.2% YoY) each showed double digit growth. Iran (+212.9% YoY), Saudi Arabia (+209.8% YoY), Uzbekistan (182.2% YoY) and India (+120.3% YoY) were the source markets that made up the largest increase of international visitors.

Georgian citizens were also actively travelling abroad. In Q2, the number of outgoing citizens in the reported period constituted 968,952 people, which was a 9% YoY increase. Of these, 121,687 persons left Georgia by air, which was a 37.2% YoY increase. It appears that visa liberalization with the EU, which was gained in April this year, has already boosted tourism to Europe.

Budget

The positive economic developments of Q2 were also reflected in the budget data. General government total revenues amounted to 2.701 billion GEL, a 17.7% YoY increase. Revenues from taxes increased by 12.4% YoY and constituted 2.372 billion GEL. Notable upward changes were seen in Income Tax (+11.2% YoY) and VAT (+27.4% YoY) revenues. Revenues from excise tax, which, according to budget plan for 2017, should have constituted 400 million GEL in Q2, were actually only 330 million GEL (+24.1% YoY). This shortage can be explained by the government's over-optimistic predictions of a possible surge in revenues from higher excise tax rates. However, Georgian consumption of fuel, tobacco and cars turned out to be more sensitive to price changes than was expected. Fortunately, losses in profit tax revenues connected to the CIT reform, were lower than planned – instead of 185 million GEL, the Revenue Service collected 231 million GEL.

At the same time, expenses of the general government amounted to 2.426 million GEL, an 8.9% YoY increase. Compensation of employees (-4.6% YoY) was the only category of public spending that decreased in Q2; purchase of goods and services (+12.3% YoY), interest payments (+14.1%% YoY), subsidies (+29.6% YoY), grants (+63.6% YoY), social benefits (+8.5% YoY) and other expenses (+10.4% YoY) all rose.

In the reported quarter, the government purchased nonfinancial assets of 257 million GEL, while sales constituted 23.1 million GEL. As a result, the general government budget deficit decreased by 22.3% YoY to 126.5 million GEL.

In the first half of 2017, the central government budget execution faced some drawbacks: total revenues were executed by 106.6%, while total expenditures by 95.4%.

Budget of General Government
Source: MOF