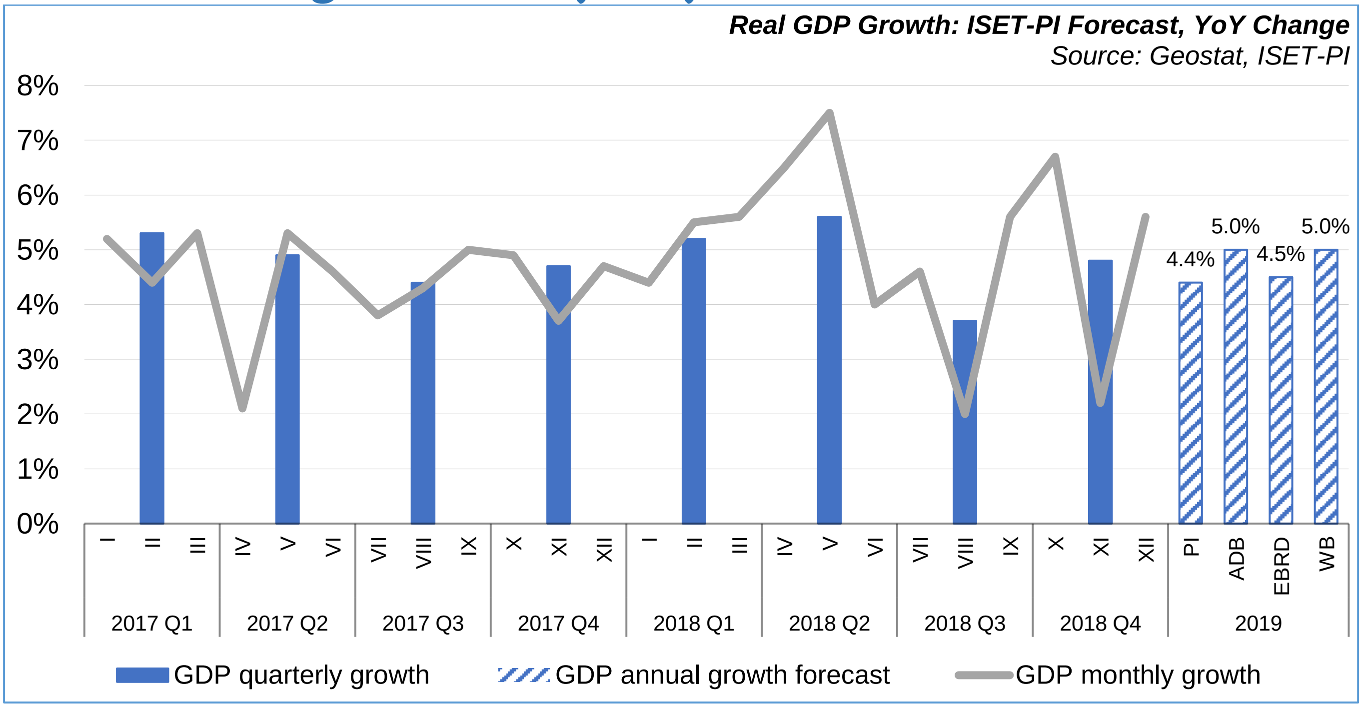
Authors: Yaroslava Babych and Giorgi Mzhavanadze

The 2018 Georgian economy – a year in review



Economic growth

The preliminary statistics released by Geostat reveal that Georgia's real GDP growth was 4.8% year over year (YoY) in 2018. These results are behind the World Bank's, IMF's, ADB's and NBG's latest growth projections of 5%-5.5%.

ISET-PI's leading GDP indicator forecast, made at the beginning of the year, was more precise. At the time, we predicted 4.6% annual growth in the worst-case, "no growth" scenario, and 5.6% in the best case or "average long-term growth" scenario. While, our "middle-of-the road" scenario predicted the exact 4.8% real GDP growth.

In 2018, Georgia's growth was characterized by high volatility. The economy grew by 5.4% in the first half of the year, though the growth rate slowed to 4.3% YoY by the second half, including 2% and 2.2% YoY growth in August and November. This was driven by both external and domestic factors. A marked weakness of activity in Turkey and the 30% depreciation of the lira, reflected capital outflows in response to accelerating inflation, as a perceived delay in monetary tightening, which negatively affected Georgia's growth through trade, FDI inflow, money transfers and tourism channels. Among domestic factors in 2018, weakened fiscal stimulus, delays in infrastructural projects, and tightened regulations granting construction permits and construction processes, each deteriorated growth.

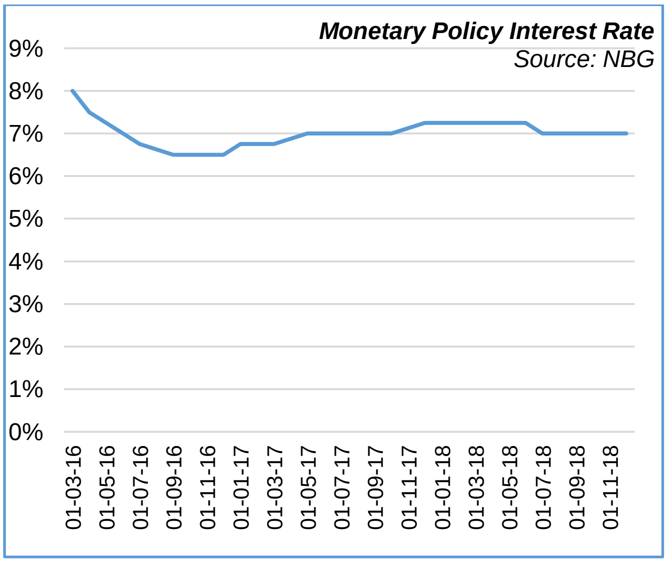
According to the World Bank, the effects of financial stress in Turkey are expected to further weaken regional growth in 2019. The most significant risk is the possibility that the recent economic pressure on Turkey will worsen and trigger widespread bank failure. Equally, there is an upside to the forecast, as stronger-than-expected energy prices may support activity in Russia and Azerbaijan, and create a positive spillover effect on their neighboring countries.

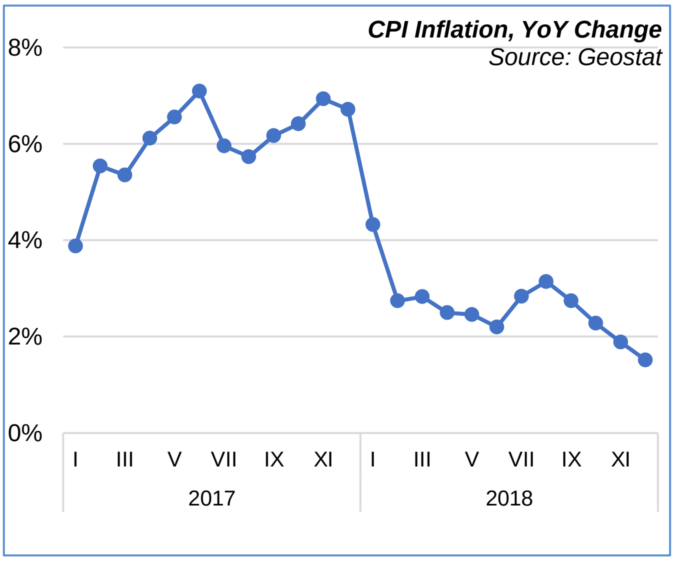
The latest data from ISET-PI's GDP forecast predicts 2019 annual real GDP growth to be 4.1% in the worst-case scenario and 5.2% in the best-case scenario. Our middle-of-the-road scenario (based on the average growth in the last four quarters) predicts a 4.4% increase in real GDP.

Inflation

According to Geostat, the CPI inflation rate fluctuated around NBG's 3% target in 2018, and remained at the 2.6% level after the one-off supply side factors had been exhausted by the beginning of the year. International markets' increased oil prices, elevated water and electricity tariffs, and rising tobacco prices were the main drivers of CPI inflation. However, appreciation of the real effective exchange rate and weak aggregate demand kept inflation below its target.

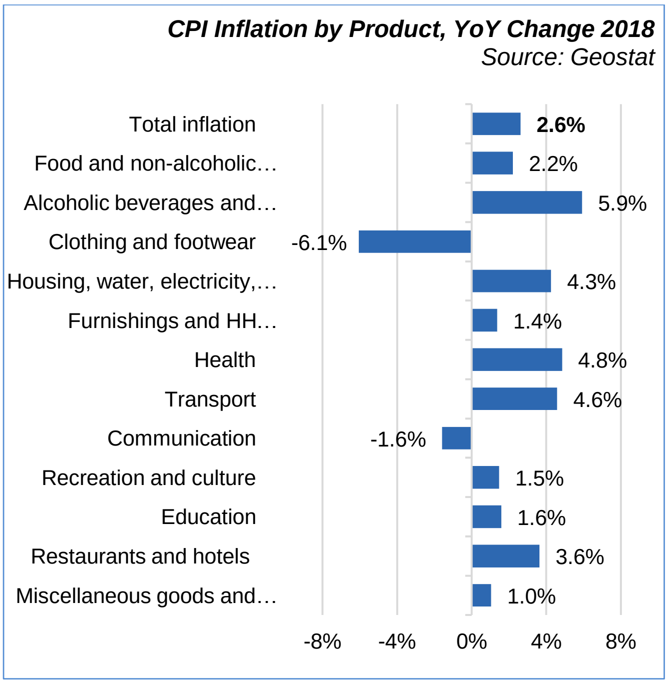
In 2018, NBG maintained a moderately tight monetary policy (of 7-7.25%) to help neutralize the inflationary risks primarily associated with the economic growth of Georgia's main trading partners; the global trends of the euro and US dollar; and the prices of oil and food on international markets. However, "*based on the current macroeconomic forecast, following the decline of inflation to its target level of 3% and remaining close to it, in the medium term the monetary policy rate is expected to decline gradually to its neutral level. Despite still weak economic activity, the reduction of the monetary policy rate will proceed at a slow pace, given heightened risks in the region. As a result, the policy rate will only return to its neutral level (of around 5.5-6% as per current estimates) after two years.*"[1]

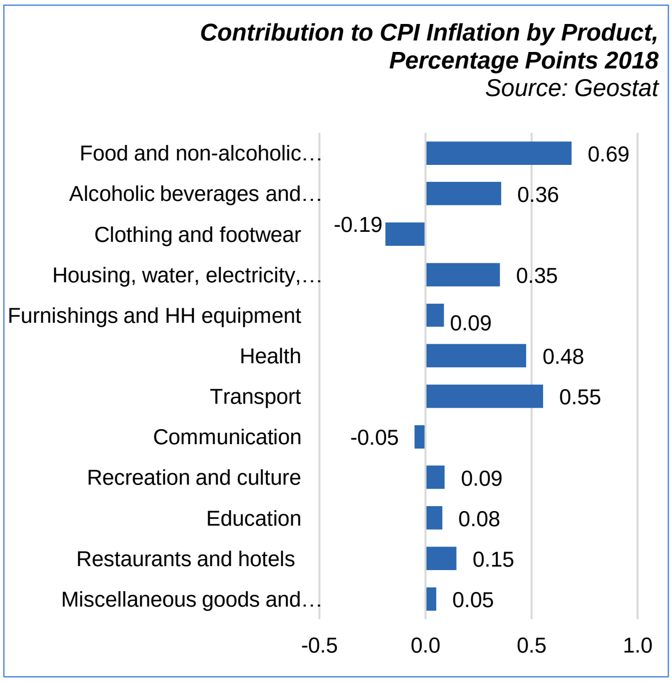




The degradation of the consumer price index helps identify the main drivers of inflation: food and non-alcoholic beverages (+2.2% YoY), transport (+4.6% YoY), healthcare (+4.8%YoY), and alcoholic beverages and tobacco products (+5.9% YoY). Together, these categories contributed 2.13 percentage points to annual inflation.

In 2018, the prices of clothing and footwear dropped by 6.1% YoY. This decline can be explained by the depreciation of the lira, as Turkey remains Georgia's main import source for textiles and apparel. These factors, alongside communication (-1.6% YoY), drove annual inflation down in 2018 (contributing -0.24 pp to total inflation).





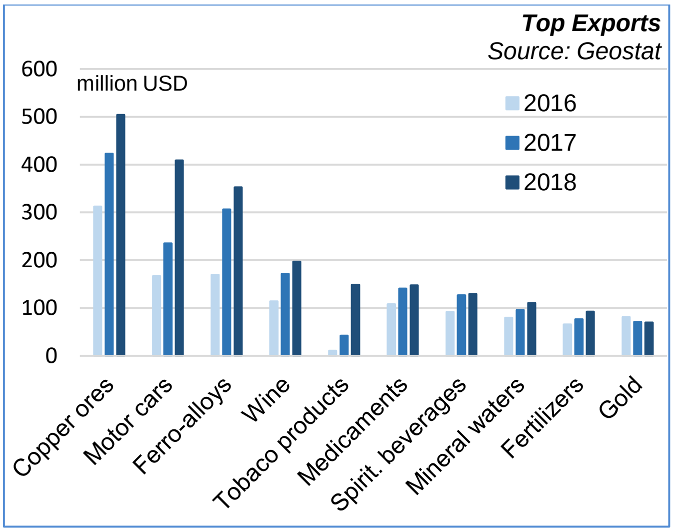
[1] NBG, Monetary Policy Report, February 2019 - Brief Overview

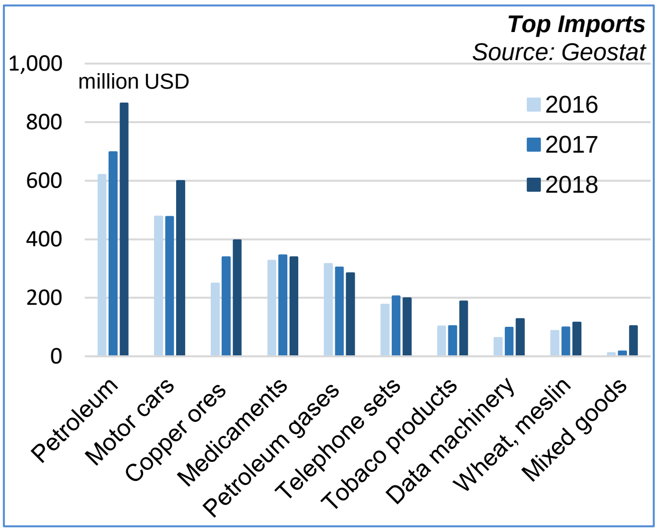
External Sector

The upward trend in trade statistics continued in 2018 from the previous year. With Georgian external merchandise trade surging by 17% YoY and amounting to 12,484 million US dollars.

Georgia's total exports jumped by 22.9% YoY and amounted to 3,362 million US dollars. The growth was driven by a nearly doubled re-export of cars, a quadrupled increase in the re-export of tobacco products, and an increase in copper ore (+19% YoY) and ferro-alloy (+15% YoY) exports. The Georgian "car" industry, which includes the repair and re-export of both automobiles and spare parts, benefitted from the improving economic performance within the region, especially in Azerbaijan – the major market for car re-exports. From 2014, due to a recession in Azerbaijan, the market was temporarily halted by the imposition of non-tariff regulations on car imports, which allowed only the import of cars meeting Euro-4 ecological standards. However, it seems the excise tax scheme on cars, introduced to Georgia in 2017, facilitated adaptation to Azeri requirements. The hike in the export of tobacco products might also be explained by tax incentives. Increased excise tax on cigarettes and other tobacco products, alongside the regulations imposed on the promotion of tobacco products, shrank sales and consumption on the domestic market. The main destinations for Georgian tobacco products were Azerbaijan, Uzbekistan, and Singapore. While, the hazelnuts industry has continued to experience hardships, caused by the invasion of the Asian stinkbug and fungal diseases. The export of hazelnuts has consequently declined for the second consecutive year (-16.2% YoY in 2018) and hazelnuts have fallen from Georgia's top ten export products.

Overall, the key markets for Georgian export products in 2018 were Azerbaijan (15% of total), Russia (13%), Armenia (8.5%), Bulgaria (7.7%), Turkey (6.9%), and China (5.9%). Despite the notable growth of exports to the EU in recent years, exports to the CIS have grown significantly faster. In 2018, exports from Georgia to CIS countries stood at 1,677 million US dollars (+41.6 YoY) and accounted for 49.9 percent of the total export. Whereas, exports to the EU amounted to 730 million US dollars (+11.5 YoY) and constituted only 21.7% of the total.

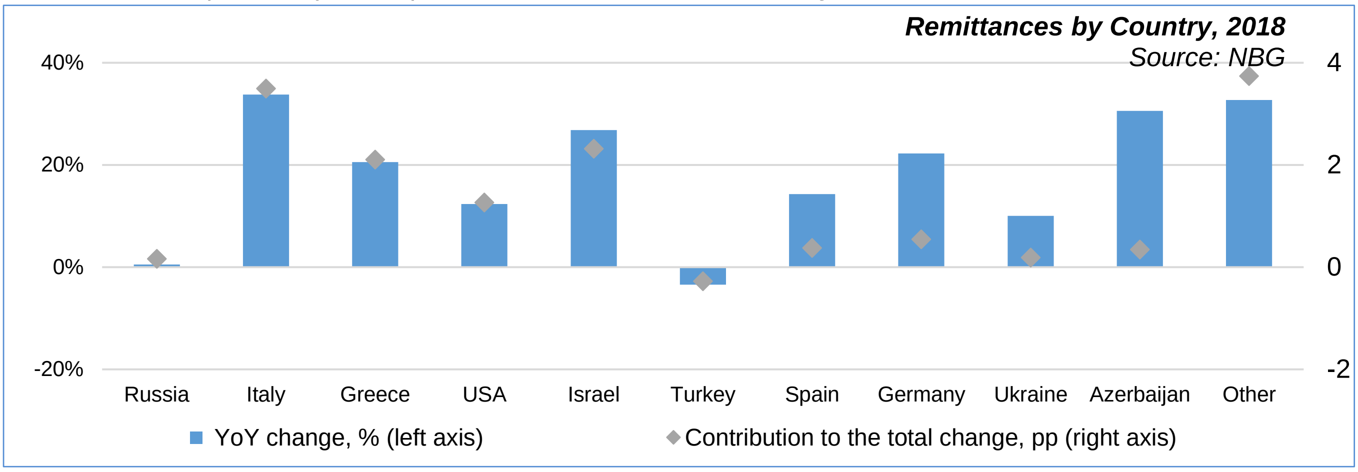




Imports increased to 9,122 million US dollars in 2018, a growth of 14.9% YoY. This rise was driven chiefly by petroleum imports (+31.6% YoY), which in turn was steered by higher oil prices on international markets. Imports of motor cars from the USA, and tobacco products and copper ores, were among the other vital drivers behind the upsurge of imports in the period. In 2018, the main source markets for Georgian imports were Russia (10.3% of the total), China (9.1%), Azerbaijan (6.4%), Ukraine (5.7%) and Germany (4.7%). Because of growing imports, the negative trade balance deepened by 10.7% YoY to 5,760 million dollars.

Both tourism and remittance transfers maintained their double-digit annual growth in 2018. The number of international visitors increased by 11.1% YoY, while additional tourist numbers (visitors who spent 24 hours or more in Georgia) was even higher, with a 16.9% annual increase. The greatest proportion of total visitors to Georgia were, as usual, from neighboring countries – Azerbaijan, Russia, Armenia, and Turkey. While, in annual percentage increase of international visitors, the leaders were Germany (+49.7% YoY), Belarus (+42.9% YoY), Poland (+36.8% YoY) and Israel (+36.4% YoY). In absolute terms, the strongest backer behind the increase of international visitors was Russia, with an additional 269,700 tourists over 2017. Consequently, income from international tourism exhibited a 20.5% YoY increase in the first three quarters of 2018, thus, an average tourist spent more than during the previous year.

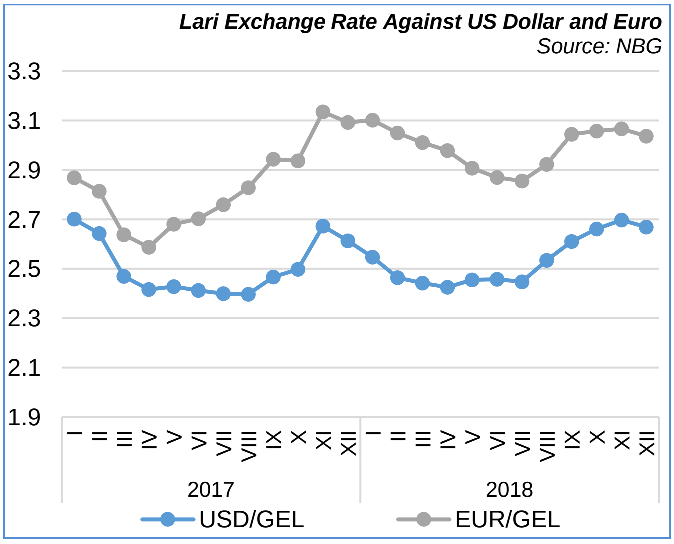
Driven by a greater inflow of money transfers from Italy (+33.8% YoY), Israel (+26.8% YoY), Greece (+20.6% YoY) and the USA (+12.4% YoY), the volume of total remittances to Georgia increased by 14.3% YoY within the reported period. Money inflow from Russia, however, was flat, and remittances from Turkey decreased by 3.4% YoY. The latter could be explained by the depreciation of the local currencies against the US dollar.

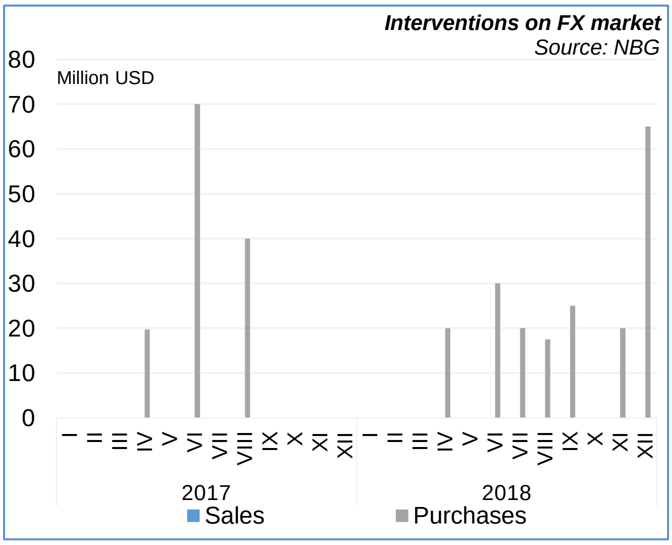


According to Geostat's latest estimates, net foreign direct investment in Georgia amounted to 998 million US dollars in the first three quarters of 2018, a 27.2% YoY decrease. FDI statistics for Q4 are not yet available, but poor economic growth suggests that the net FDI inflow to Georgia could have dropped for this period. Moving forward, a decrease in FDI levels is expected in upcoming years, as BP have finalized their gas and oil pipeline construction in the South Caucasus.

Exchange Rate

In 2018, the nominal exchange rate of the lari against the US dollar and euro repeated the pattern from the previous year – appreciation at the beginning and depreciation thereafter. Strong positive development of the external sector, in the first two quarters of the year, caused the national currency to strengthen. However, negative developments with Georgia's main trading partners (mainly Turkey), and lower FDI influxes in Q3 2018, depreciated the national currency. Overall for 2018, the lari strengthened against the Turkish lira (+26%), the Russian ruble (+12.2%) and the euro (+1.8%), while it lost value in comparison to the Azerbaijani manat (-2.3%), the US dollar (-2.1%) and the Armenian dram (-1.8%).





Such currency trends were reflected by the effective exchange rates. In December 2018, compared to the same period in 2017, the Georgian lari appreciated in both nominal and real terms by 8% and 3.4%, respectively. Therefore, Georgian export goods became more expensive in relation to the products of Georgia's main trading partners.

During the year, NBG managed to buy 197.5 million US dollars across 17 auctions, in order to fulfill the IMF foreign reserve requirements.

Financial Sector

In 2018, the total number of loans (stocks) granted by commercial banks, excluding interbank loans, increased by 19.3% YoY. The growth was driven by both the acceleration of retail (+20.1% YoY) and business loans (+18.3% YoY).

Expanding credit activity was a significant cause of economic growth in 2018, and in recent years, however in the long-term it could create risks to the financial sector and intensify the indebtedness of Georgian households. To promote sustainable credit practices and improve lending conditions, NBG tightened lending regulations for retail credits in May 2018, and introduced additional changes at the beginning of 2019. The new standards for retail loans aim to avoid the extensive growth of retail loans over transitional periods and decrease the amount high-risk financial products on the market. Indirectly, these regulations limit consumption, which will have the negative effect on economic growth in upcoming years. However, they equally stimulate savings and investments, accelerating growth in the long run.

The total deposits in commercial banks, excluding interbank deposits, also displayed a notable 14.4% increase in 2018, driven by rising deposits made by individuals (15.7% YoY) and legal entities (+12.9% YoY).

The dollarization rates of non-bank deposits and loans were at the same level in 2018 as the end of previous year, thus suggesting that the effect of macro-prudential mechanisms, implemented by NBG in 2017, have already been exhausted. However, since 2019, loans under 200,000 lari are only attainable in the local currency, which will undoubtedly reduce the dollarization of retail loans.

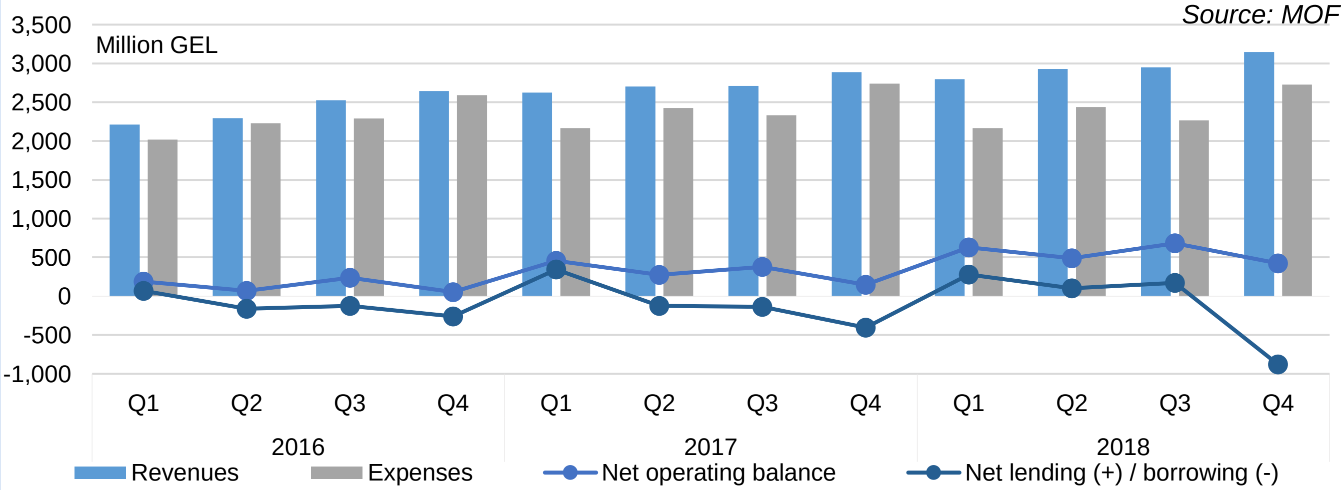
Public Finances

In 2018, the total revenues of the general budget amounted to 11,822 million lari, a 8.2% YoY increase. Moreover, revenues from tax collection increased by 10,506 million lari, at 7.4% YoY. Notable changes were also seen in custom duties (+515.3% YoY), income tax (+11.2% YoY) and VAT (+7.4% YoY). Although, revenues from excise tax increased by only 1% YoY, while profit tax collection was down by 2.6% YoY. Considering the growth rate of the economy, the latter suggests that businesses used the tax incentives created by CIT reform more actively in 2018 than in the previous year.

Furthermore, the current governmental expenditures were flat in 2018 (and amounted to 9,599 million lari), while the net acquisition of nonfinancial assets surged by 61% YoY. Nevertheless, 51.1% of governmental capital spending was made in the last quarter of 2018; the current expenditures were executed by 94.3%; and in the first nine months of 2018, net acquisition of nonfinancial assets was fulfilled by only 76.3%, which each underline the poor operation of budgetary expenditure, caused by delays in infrastructural projects. Thus, negatively impacting the effectiveness of governmental spending, creating macroeconomic risks, and producing a weaker effect on economic growth.

Budget of General Government

Source: MOF



Overall in 2018, significant tax collection was balanced by the accelerated capital spending at the end of the year, which resulted in a budget deficit of 322.2 million lari, a 0.2% YoY decrease. While, governmental debt increased by 7.7% YoY and amounted to 18,015 million lari. The proportion of domestic and foreign debt of total debt remained largely unchanged – where domestic debts constituted 21.8% of the total debt.