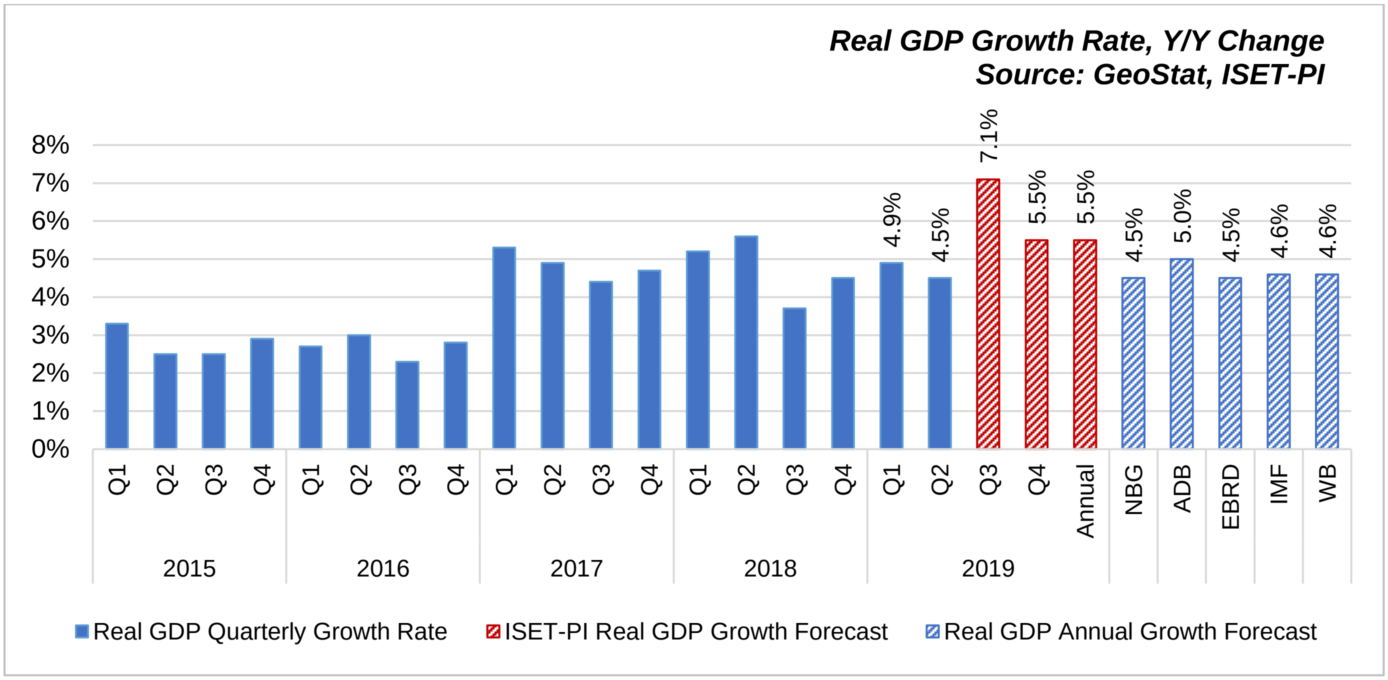
Economic Growth

According to the preliminary statistics released by GeoStat, Georgia's real GDP growth was 4.5% year over year (y/y) in Q2 2019, which fell slightly below the 4.8% growth predicted by ISET-PI's GDP forecast from July (see link). As economic growth constituted 4.9% y/y in Q1, the Georgian government's 4.5% target of real GDP growth for 2019 does not seem overambitious.



The economic growth in Q2 2019 was mostly driven by stronger external demand, which stimulated net exports of goods and services. Raised remittances also positively affected the economy, however an extremely low level of foreign direct investment (FDI) drove down GDP growth in the reported quarter. Accelerated fiscal spending, moderate growth of credit activity, and consumption were the internal drivers of growth, while deteriorated business sentiments and a decreased level of investment hindered economic growth in the second quarter.

Despite the robust economic performance in the first half of 2019, the external and domestic risks that have emerged could harm GDP growth in the future.

According to the World Bank *"Global growth in 2019 is projected to slow to 2.6%, 0.3 percentage point below previous forecasts, due to weaker-than-expected trade and investment at the start of the year."*[1] Escalating trade tensions between large economies (mainly the USA and China), slowing economic activity in China, uncertainties surrounding "Brexit" and sluggish economic growth in the EU are the main global factors which contain risks in the downward direction for Georgia. On the positive side, the effects of the recent fiscal stimulus in the United States are kicking in as GDP growth is expected to be 2.5% y/y in 2019.

On the regional level "*economic growth in Europe and Central Asia is estimated to have slowed to 1.6% in 2019, a four-year low, partly reflecting a sharp weakening of activity in Turkey".* Turkey is experiencing high inflation, rising unemployment, and capital outflow, which together with political uncertainties are negatively

[1] The World Bank. Global Economic Prospects, Heightened Tensions, Subdued Investment. June, 2019.

affecting the country's economy. GDP growth in Turkey is expected to be -1% in 2019 according to WB estimates (-2.5% according to the IMF[2]). These recent developments in Turkey have already affected Georgia through the trade of goods and services and remittances channels. Russia, another economy on which Georgia is dependent through different channels, is expected to slow to 1.2% growth in 2019, as agreement on oil production cuts with OPEC have taken effect. Additionally, the escalation of geopolitical tensions with Russia resulted in banned flights to Georgia (from July 2019) creating a direct threat to the Georgian tourism sector and exports (especially wine export) for the rest of the year.

As for internal risks, worsening business sentiments are the main factor which could potentially hinder economic growth in the next quarters through low domestic and foreign investment. This harms not only short-term growth, but economic activity in the long-run. Additionally, risks stem from the widening fiscal deficit and sluggish credit activity.

Accounting for these factors, in July's Monetary Policy Report the National Bank of Georgia revised its expectation for real GDP growth down from 5% to 4.5% in 2019.[3] The World Bank revised their previous forecast downward from 5.0% to 4.6% in the Global Economic Prospects Report published in June.

Based on the latest data, we expect annual growth in 2019 to be 5.5%. We still expect a downward correction of the annual GDP growth numbers towards the end of the year, since we have not taken into consideration impeded tourist inflows, deteriorated foreign direct investment, and increased risk of negative external shocks (see link).

Inflation

In the second quarter of 2019, the annual inflation rate reached 4.4%, which is 1.4 percentage points (pp) higher than the targeted 3%. The main contributors to the annual price increase were the increase in excise tax on tobacco at the beginning of the year (the prices of alcoholic beverages and tobacco jumped by 20.8% y/y in Q2) and increased food prices (+6.7% y/y), which contributed to annual inflation by 1.25 and 2.1 pp respectively. It is notable that increased prices on bread contributed about 0.5 pp to annual inflation.

Prices of clothing and footwear dropped by 7.2% y/y. This decrease is explained by the depreciation of the Turkish lira compared to the Georgian lari, as Turkey remains the main import source of textiles and apparel in Georgia. Together with communication (-2.5% y/y) these categories drove annual inflation down by 0.3 pp in Q2 2019.

Excluding one-time factors, annual inflation was 3.4%, while *"the core inflation, which excludes food, energy and tobacco stands at 1.1%, indicating that the increase in inflation is only temporary. According to the current forecast, other things equal, the inflation will move towards the target level once the one-off factors fade away from the beginning of the next year."*[4] Based on this assessment, NBG kept its policy rate unchanged at 6.5% during their Monetary Policy Committee meetings in the second quarter.

External Sector

According to the estimates for Q2 2019, most of the countries in the region showed improvement compared to the same period in the previous year. The Armenian economy reached remarkable 6.6% annual growth,

[2] International Monetary Fund. World Economic Outlook, Growth Slowdown, Precarious Recovery. April, 2019.
[3] NBG. Monetary Policy Report. July, 2019.
[4] NBG. Committee Decision from 12.06.2019.

while the Azerbaijani and Russian economies advanced by 1.4% and 2.4% respectively. On the contrary, the tough economic situation in Turkey and the slowdown of the Chinese economy had negative effects on external demand.

Thus, improved economic conditions in the neighborhood stimulated the Georgian economy through trade of goods, remittances, and tourism channels. However, the effect of the reduced tourism flows due to Russia's prohibition of flights to Georgia still has not been reflected in the data.

Notably, exports grew by 10.4% y/y in Q2 2019, driven by significantly larger re-exports of copper ores and concentrates to Romania and Bulgaria, higher exports of natural wines and alcoholic beverages to Russia, increased re-exports of motor cars to Armenia and Azerbaijan and re-exports of medicaments, mainly to Ukraine. However, exports to China (copper ores and concentrates) and Turkey (ferroalloys and electricity) declined notably. Overall, the increase in exports of goods was mainly driven by higher re-exports and increased competitiveness due to exchange rate depreciation.

During the same period, imports declined by 5.6% y/y, mainly driven by reduced import of petroleum and petroleum oils and cigars, cheroots, cigarillos and cigarettes. The decrease in imports is explained by lower demand on import goods due to exchange rate depreciation and extremely low inflow of FDI (which is one of the main sources of "financing" imports). Additionally, world prices of petroleum decreased by 5.9%[5] y/y in Q2 which partly explains reduced import of petroleum products, while increased excise tax on tobacco products seems to have reduced demand on these products (however import of bulk tobacco increased slightly in the reported period). Imports of petroleum mainly from Greece and Turkmenistan declined, while imports of tobacco products from Ukraine decreased. Imports significantly declined from China, mostly because of automatic data processing machines, which are potentially used for cryptocurrency mining.

As a result, trade turnover decreased by 1%, while the trade deficit shrank by 14.4% y/y in Q2 2019.

An increase of external demand was also reflected in terms of higher exports of services, especially tourism. The number of international visitors increased by 13% y/y, the change in tourist numbers (visitors who spent 24 hours or more in Georgia) was at the same level: a 13.8% annual increase in Q2 2019. As usual, the largest share of total visitors to Georgia were from neighboring countries, and all of them showed positive dynamics. Leaders in the percentage increase of international visitors in Q2 were Kazakhstan (+83% y/y), China (+48.8% y/y), Germany (+46.8% y/y) and Russia (+37.5% y/y). As a result, international tourism receipts in Q2 showed a 8.4% YoY increase, which means that this year the average tourist spent slightly less than in the previous year. The negative shock of prohibiting flights from Russia will be reflected in tourism data from Q3 2019. As the latter contributed more than half of the total increase of international visitors in Q2, the impact on the overall growth in export of travel services in the future might be considerable.

The volume of total remittances to Georgia increased by 9.3% y/y in Q2 2019. EU countries were the main drivers of the increase as Italy (+26.1% y/y), Greece (+18.4% y/y) and Poland (+109.8% y/y) contributed 6.2 pp to total growth of money transfers in Q2 2019. The hike in remittances from Poland is caused by rapidly increasing labor force emigration from Georgia, explained by simplified procedures for getting work permits (about 12,000 Georgian workers received temporary work permits in Poland last year). Money inflows from Russia and Turkey fell by 6.6% and 20.1% y/y respectively, driving down the growth of total remittances by 3.4 pp. Contrary to the development of exports, the diversification of sources of money

[5] IMF Primary Commodity Prices.

inflows is increasing in the last years as the role of Russia is declining (24.5% of the total in Q2 of 2019), while the importance of EU countries is rising (35% of the total in Q2 2019) together with the USA and Israel (20.3% of the total in Q2 2019).

Nevertheless, FDI in Georgia amounted to 187 million USD in the second quarter of 2019, which is 53.7% lower than the adjusted data from Q2 2018. According to Geostat, the main reasons for decreasing FDI included completion of a pipeline project, reduction in liabilities to non-resident direct investors and reduction of the amount of reinvestment. In addition, FDI experienced notable reductions in the energy (37.6% y/y), construction (91% y/y), transport (58.6% y/y), communication (162.3% y/y), real estate (63.7% y/y) and financial (153.8% y/y) sectors, while FDI increased notably in agriculture (231.7% y/y due to a low base in the same period of 2018) and manufacturing (97.3% y/y).

Exchange Rate

Despite the fact that Russian sanctions were not reflected in the external sector data, the shaping of negative factors, which impact the current account, together with fallen FDI inflow, were instantly transferred to exchange rate movements. This gave the possibility of adjusting external imbalances and thus softening the negative shocks to the economy.

Overall, in Q2 2019, compared to the same period in 2018, the lari depreciated by 12% and 5.4% against the US dollar and euro respectively. At the same time, the lari depreciated against the ruble by 7.3% y/y and appreciated by 17% y/y against the Turkish lira. As for the effective exchange rates, the real effective exchange rate depreciated by 4% y/y and by 1.6% q/q. While the nominal effective exchange rate depreciated by 2.6% y/y and 1.2% q/q.

Notably, *"…the current nominal effective exchange rate seems to be more undervalued than the size of the current external shock would suggest. Hence, a possible appreciation of the nominal effective exchange rate is expected."*[6]

Public Finance

In the reported period, the general budget deficit widened to 139 million GEL (compared to the surplus of 102.3 million GEL in Q2 2018) mainly due to accelerated capital spending.

Budget revenues from taxes increased by 9.8% y/y in Q2. The growth was driven by higher collection of VAT (+17.9% y/y), personal income (+4.8% y/y), custom (+12.6% y/y) and profit (+4.8% y/y) taxes. Excise tax mobilization dropped by 25.8% y/y mostly driven by decreased sales of imported tobacco products.

At the same time, all items of current expenditures of government showed positive growth and the total current expenditures of the government increased by 8.3% y/y. Government capital spending surged by 81.8% y/y as infrastructural projects accelerated.

[6] NBG. Monetary Policy Report. July, 2019.