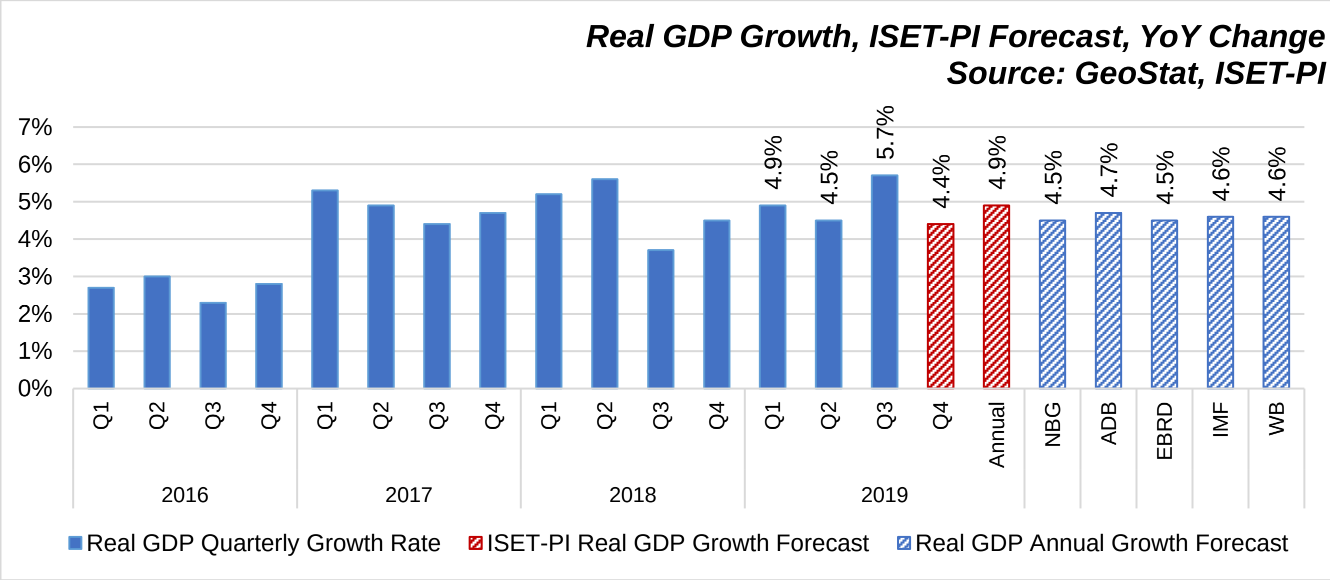
Georgia's external demand and projected GDP growth remain strong – for now. But headwinds from the global economic slowdown pose a real threat.

Economic Growth

According to the preliminary statistics released by GeoStat, Georgia's real GDP growth constituted 5.7% year over year (y/y) in Q3 2019. As a result, estimated real GDP growth for the first nine months of 2019 amounted to 5.0%, which is above the National Bank of Georgia's (NBG) growth forecast for 2019 (the forecast remained unchanged at 4.5%). Meanwhile, based on September's data, ISET-PI expects annual growth in 2019 to be 4.9%.



The economic growth in Q3 2019 was driven by increased external demand, which stimulated net exports of goods and services, and strong fiscal stimulus. A rise in remittances also positively affected the economy, while lower revenues from international travelers caused by the Russian ban on air travel to Georgia hindered economic growth in the reported period. Data on foreign direct investment (FDI) for Q3 is not available yet. However, we expect the negative trend in FDI to continue in the second half of the year. Furthermore, lower inflows of foreign currency from tourism and FDI caused the recent depreciation of the lari against the currencies of major trading partners, resulting in increased prices of imported products, and a higher inflation rate.

Despite the strong external demand in Q3 2019, risks that emerged from the slowdown of the global economy could harm GDP growth in the future. According to the IMF, "*Global growth is forecast at 3.0 percent for 2019, its lowest level since 2008-09 and a 0.3 percentage point downgrade from the last World Economic Outlook*".[1] Trade tensions between the USA and China escalated, resulting in slowing economic activity in these countries; 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 regional level, the situation is more heterogeneous. Economic growth in Russia slowed notably after the agreement with OPEC on oil production cuts took effect earlier this year, while Turkey started to recover following a deep contraction in the second half of 2018, benefiting from fiscal and credit activity expansion.

[1] World Economic Outlook, October 2019: Global Manufacturing Downturn, Rising Trade Barriers.

According to the IMF's forecast, the Russian economy is expected to grow by 1.1% in 2019 (0.1 pp lower than the previous forecast), while the real GDP growth forecast for Turkey in 2019 stood at 0.2%, which is significantly higher than the previous IMF estimate of -2.5%. The real GDP growth forecast for Azerbaijan remains stable at 2.1%, while Armenia is expected to reach a remarkable 6% annual growth in 2019.

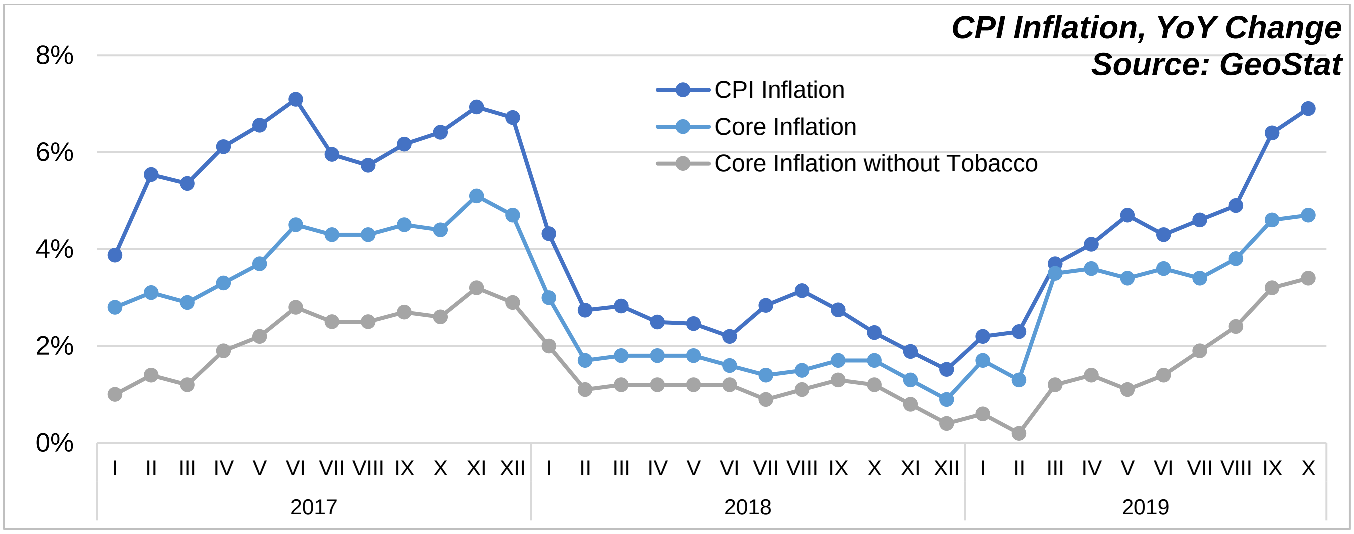
As for internal risks, rising inflation, tightened monetary policy, escalating political tensions and worsening business sentiments are the main factors which could potentially hinder economic growth in the next quarters. At the same time, fiscal stimulus will positively contribute to growth.

Inflation

In the third quarter of 2019, annual CPI inflation reached 5.3%, which is 2.3 percentage points (pp) higher than the targeted 3%. The main drivers of annual inflation were increased food prices (+9.2% y/y), which contributed 2.8 percentage points to annual inflation.[2] Additionally, the increase in excise tax on filtered cigarettes at the beginning of the year (prices of alcoholic beverages and tobacco hiked by 14% y/y in Q3) contributed about 0.9 pp to total annual inflation in the reported quarter. At the same time, prices of clothing and footwear dropped by 6.5% y/y. Together with communication (-2.5% y/y) these categories drove inflation down by 0.3 pp in Q3 2019.

Though the recent jump in food prices is partially explained by price increases in certain components of the food category, the inflationary pressure is mainly coming from depreciation of the local currency against the US dollar and the currencies of major trading partners.

In response to rising inflation, NBG increased the monetary policy rate three times in Q3 2019 – twice in September by 0.5 percentage points each, and once in October by 1 percentage point, reaching a level of 8.5%. The policy rate increase restricts borrowing through increasing market interest rates, weakens aggregate demand, and drives inflationary expectations down. Furthermore, savings in local currency become more attractive, which leads to increased demand for the lari and, therefore, contributes to the appreciation of the exchange rate. However, tightened monetary policy is expected to have a negative impact on the future growth rate of the economy.



[2] It should be mentioned that the poor are more vulnerable to increases in food prices, as the food category has a greater share in their consumption basket.

From today's perspective, NBG should have started tightening monetary policy in June-July 2019, as effective exchange rates started to depreciate and revenues from tourism were expected to decline in the coming months. However, NBG's decisions were based on their forecast of inflation, which was in line with the target level in Q2 2019, as *"the core inflation, which excludes food, energy and tobacco stands at 1.1%, indicating that the increase in inflation was only temporary."* [3]

According to NBG's latest forecast "*inflation will remain above the target in the next three quarters. Subsequently, after a gradual decline in the medium term, which will see inflation fall below the target, it will approach the target from below. The below-target inflation rate at the end of 2020 will be driven by the tightened monetary policy, which is ready to temporarily accommodate lower-than-target inflation in order to ensure that long-run inflation expectations decline back to the target level."*[4]

External Sector

Strong external demand and the depreciated exchange rate stimulated net exports of goods (through increasing competitiveness). Remittances continued their rising trend of the previous quarters, while Russia's prohibition of flights to Georgia negatively affected revenues from tourism.

Exports grew by 10.6% y/y in Q3 2019, driven by significantly larger re-exports of motor cars to Armenia, exports of wine and chemical fertilizers to Ukraine, and copper ores to China and Romania. An impressive increase in exports of mineral and chemical fertilizers to Lithuania also contributed to total export growth. On the flip side, lower exports of ferro-alloys and medicaments to Russia and cigarettes to Azerbaijan negatively affected trade statistics in the reported quarter.

During the same period, import growth was slightly negative (-0.4% y/y), mainly driven by reduced imports of petroleum and petroleum oils from Turkmenistan and cigarettes from Ukraine. Imports significantly declined from China and Korea, mostly due to automatic data processing machines, which are potentially used for cryptocurrency mining, and Brazil because of copper ores. The decrease in imports is explained by lower demand for 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 16.7%[5] y/y in Q3 which partially explains the reduced import of petroleum products, while the increased excise tax on tobacco products seems to have reduced demand for these products (however import of bulk tobacco increased in the reported period). As a result, trade turnover increased by 2.5%, while the trade deficit shrank by 7% y/y in Q3 2019.

Positive external demand was not fully reflected in export of services in Q3 2019, as growth rates decreased notably after the banning of flights from Russia in late June. According to NBG's estimates,[6] revenues from international travelers declined in the reported quarter by 8.6% y/y and constituted 1,106 million US dollar. The change in tourist numbers (visitors who spent 24 hours or more in Georgia) in Q3 2019, however, was still positive and stood at a moderate +1.4% y/y level. As usual, the largest share of total visitors to Georgia was from neighboring countries. Leaders in the percentage increase of international visitors in Q3 were Kazakhstan (+48.8% y/y), China (+45.7% y/y), Saudi Arabia (+39% y/y), and Germany (+33.6% y/y). The number of international visitors from Turkey showed positive growth for the first time this year (+8.2% y/y) reflecting the Turkish economic recovery. As expected, the number of international visitors from Russia

[3] NBG, Monetary Policy Report, July.
[4] NBG, Monetary Policy Report, October.
[5] IMF Primary Commodity Prices.
[6] NBG, Monetary Policy Report, October.

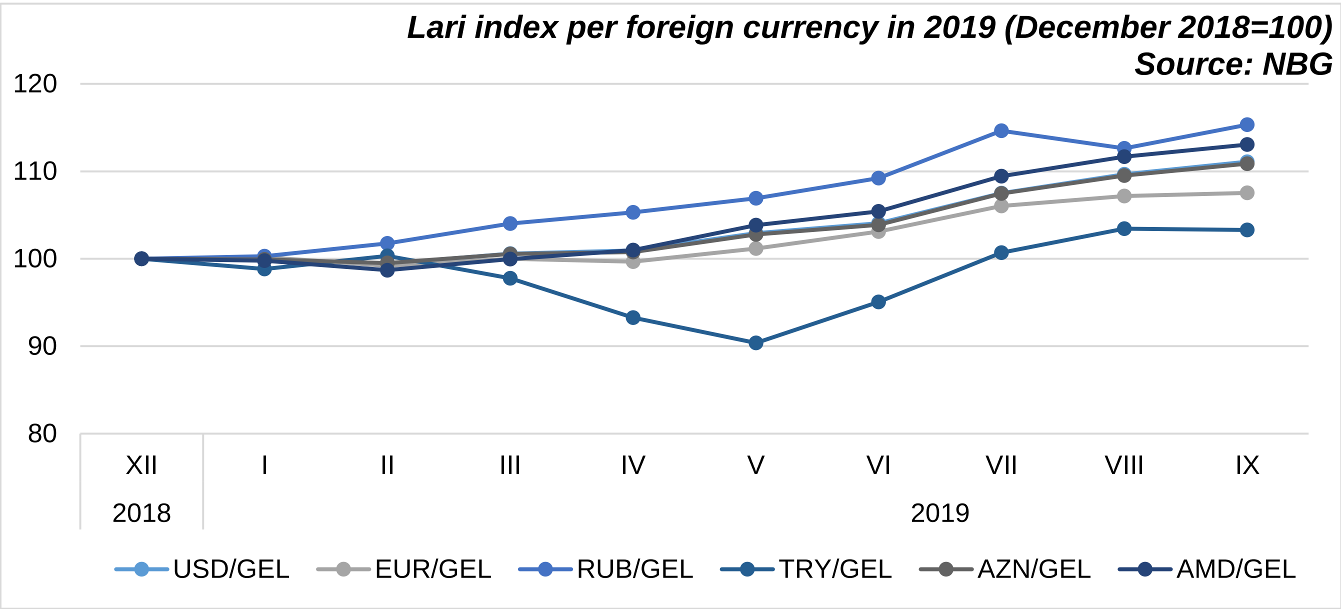
dropped (by 11.7% y/y). Together with the halving of the number of visitors from Iran, this development had a negative impact on the overall growth in export of travel services in the reported quarter.

The volume of total remittances to Georgia increased by 9.5% y/y in Q3 2019. Italy (+26.4% y/y), Greece (+14.1% y/y), and Ukraine (+66.4% y/y) were the main drivers of the increase, as they contributed 5.8 pp to the total growth of money transfers in Q3 2019. Money inflows from Russia fell by 9.4% driving down the growth of total remittances by 2.8 pp, while remittances from Turkey were flat in the reported quarter. Contrary to the development of exports, the diversification of sources of money inflows is increasing over the last years as the role of Russia is declining (24.6% of the total in Q3 of 2019). The importance of EU countries is rising together with the USA and Israel.

Exchange Rate

The effect of Russian sanctions and falling FDI inflows had an impact on exchange rate movements. The depreciation of the lari gave the opportunity to adjust external imbalances and thus soften the negative shocks to the economy while improving the current account. At the same time, however, it created upward inflationary expectations through rising import inflation, which then caused monetary tightening.

Overall, in Q3 2019 compared to the same period in 2018, the lari depreciated by 15.4% and 10.4% y/y against the US dollar and euro, respectively. On a quarterly basis, depreciation was 6.6% and 5.5%. At the same time, the lari depreciated against the currencies of all neighboring countries, which is reflected in the effective exchange rates' depreciation. The real effective exchange rate fell by 7% y/y, while the nominal effective exchange rate depreciated by 9.2% y/y in the third quarter.



**Higher index means appreciation and vice versa*

To curb the depreciation and maintain the exchange rate below the "psychological" level of 3 lari per US dollar, NBG sold 72.8 million US dollars during the two auctions performed in the third quarter. In addition, NBG decreased the minimum foreign currency reserve requirements for commercial banks from a mandatory 30% to 25% in October, which allowed commercial banks to lend the freed-up $700 million to the economy.

Together with tightened monetary policy, these measures are supposed to strengthen the exchange rate and soften inflationary pressure.

Credit Market

Total loans extended by commercial banks in Q3 2019 (excluding interbank loans) constituted 14.6% y/y growth, excluding the effect of exchange rate fluctuations. Despite the tightened lending regulations introduced by NBG for retail credits in the beginning of the year, the value of outstanding retail loans was up by 10.4% y/y. However, as expected, commercial banks' lending shifted to legal entities, as loans granted to businesses increased by 20.6% y/y. In terms of currencies, the growth of the loan portfolio was driven by a significant increase in national currency loans (+23.3% y/y), while the stock of loans granted in foreign currency increased by 7.8% y/y only, excluding the exchange rate effect.

Total deposits (stocks) of enterprises and households in commercial banks showed a 12.7% y/y increase. This was driven by both accelerated savings of households (+10.5% y/y) and legal entities (+16% y/y). In terms of currencies, the growth in stock of national currency deposits grew substantially, by 26.5% y/y, while the stock of foreign currency deposits increased by 6.2% y/y.

Public Finance

In the reported period, the general budget deficit widened to 257 million lari (compared to the surplus of 173.6 million lari in Q3 2018) mainly due to accelerated spending on infrastructural projects.

Budget revenues from taxes increased by 14.3% y/y in Q3, reflecting strong economic growth. This growth was mainly driven by higher collection of VAT (+33.6% y/y). Revenues from other taxes, except custom duties, also showed positive annual growth.

At the same time, the total current expenditures of the government constituted 14.9% y/y growth, which was driven mainly by a 17.4% annual increase in spending on social benefits. All other items of the government's current expenditures showed positive growth in the reported period. Government capital spending nearly doubled as infrastructural projects accelerated this year, positively affecting the overall economic performance.