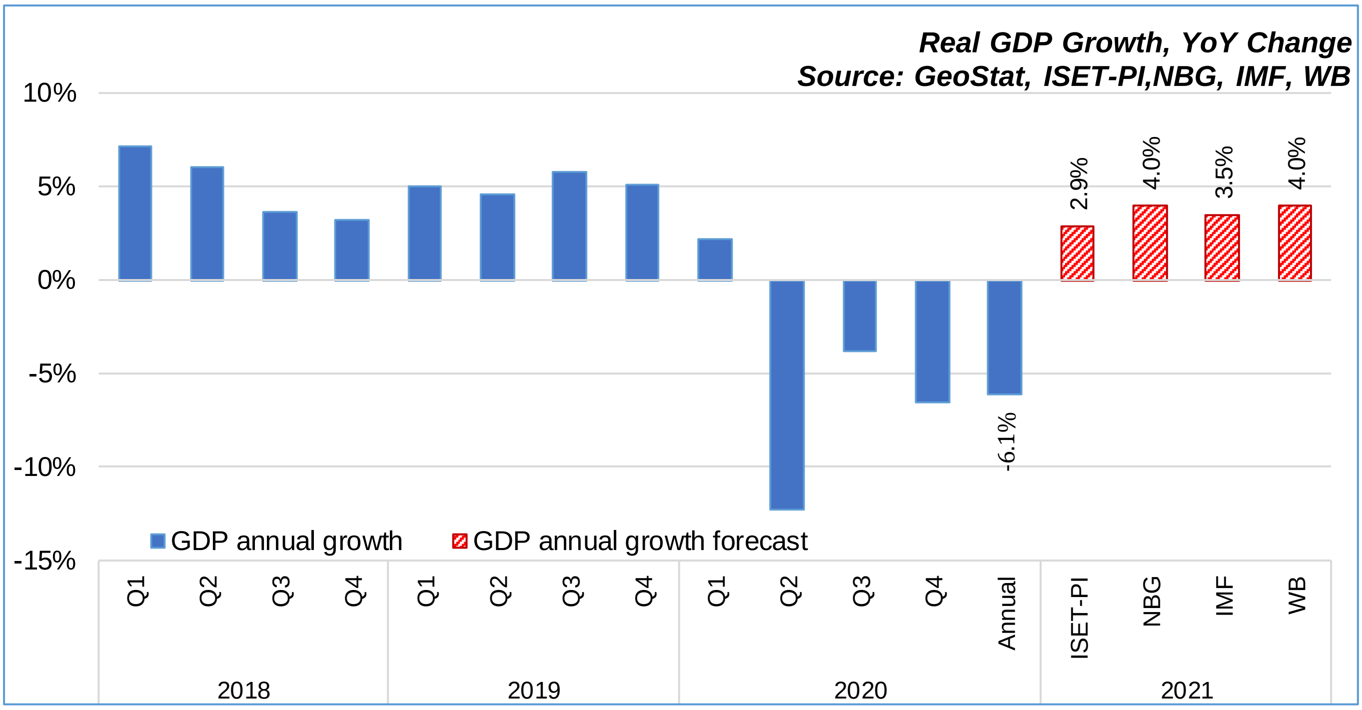
Authors: Yaroslava Babych and Giorgi Mzhavanadze

The 2020 Georgian economy – the year in review



Summary

The COVID-19 outbreak had a devastating effect on the Georgian economy in 2020. Real GDP contracted by 6.1% according to Geostat's rapid estimates of economic growth. This was the worst performance of real GDP growth in the country in more than two decades. According to the latest estimates, the economic reality turned out to be far worse than the mid-year projections from NBG, IMF and the World Bank for 2020, which ranged from -4% to -5% y/y. Unemployment increased by 0.9% y/y, while labor force participation decreased by 1.3% y/y in 2020. Hired employees were among those worst affected by the crisis: their number decreased by 5.8% y/y. The unprecedented simultaneous negative demand and supply shocks were at the heart of the economic devastation caused by the virus. Uncertainties related to the pandemic itself and containment measures against it considerably reduced aggregate demand both in Georgia and globally. Domestic and external demand for tourism and related services weakened significantly. As a result, the current account deficit widened even as imports declined. The deficit, driven by lower revenues from export of services and curtailed foreign direct investments (FDI), put significant devaluation pressure on the lari exchange rate throughout the year. In addition to demand pressures, pandemic-related constraints distorted global and regional supply chains and increased production costs. This, in turn, negatively affected aggregate supply. On the positive side, the economic impact of COVID-19 in Georgia could have been much deeper if it were not for strong fiscal stimulus, substantial bank lending, and better-than-expected remittances performance. These three factors helped mitigate the economic fallout from the epidemic in 2020.

Georgia and international partners: economic spillover effects

As a small open economy, Georgia, unsurprisingly, is highly dependent on the economic performance of its larger partner countries. Table 1 highlights the connections between Georgia's selected top economic partners, with respect to trade, FDI, remittances, and the number of international arrivals in 2019. The darker blue colors correspond to stronger linkages and, consequently, stronger spillover effects from other countries. For example, one can see that Russia absorbed the highest proportion of Georgian exports, at 13.2%. These countries were moreover the main sources for international arrivals in 2019. Their share in total imports was also dominant; Russia was the largest source of money transfers to Georgia. Aside from FDI, Georgia is also strongly linked with Armenia and Azerbaijan in every dimension. Thus, economic developments in the countries with darker colors had stronger effects on the Georgian economy in 2020.

Table 1: Economic linkages and real GDP growth

Partner	Linkages with partners in 2019, % of total					Real GDP Growth, %		
	Export	Import	FDI	Remittances	Int. Arrivals	2019	2020	2021
CIS	53.2	26.9	9.1	30.7	62.1			
Russia	13.2	10.8	4.0	24.7	19.0	2.0	-3.1	3.8
Armenia	10.9	3.0	1.1	0.8	17.7	7.6	-7.6	1.0
Azerbaijan	13.2	6.1	3.0	1.3	19.8	2.2	-4.3	2.3
Ukraine	6.5	4.6	0.6	2.5	2.7	3.2	-4.2	4.0
Uzbekistan	2.4	0.2	0.2	0.3	0.2	5.8	1.6	5.0
EU	21.8	25.6	47.5	38.3	6.3			
Italy	1.1	2.5	0.1	13.8	0.3	0.3	-8.9	4.2
Spain	1.2	1.2	-0.1	2.7	0.2	2.0	-11.0	6.4
Germany	1.4	4.9	0.6	2.9	1.2	0.6	-4.9	3.6
France	0.8	1.8	1.4	0.1	0.4	1.5	-8.2	5.8
UK	0.8	1.1	19.7	1.0	0.5	1.4	-9.9	5.3
Greece	0.1	0.7	0.2	11.1	0.3	1.9	-8.2	3.8
Bulgaria	7.5	1.4	0.6	0.0	0.1	3.7	-3.8	4.4
Romania	4.7	2.3	0.0	0.0	0.1	4.1	-3.9	6.0
ROW	25.0	47.6	43.4	31.0	31.6			
Turkey	5.4	17.8	18.8	5.5	15.0	0.9	1.8	6.0
China	6.0	9.5	3.2	0.1	0.6	5.8	2.3	8.4
USA	3.5	4.3	7.9	10.3	0.6	2.2	-3.5	6.4
Iran	1.9	2.1	0.1	0.0	1.8	-6.8	1.5	2.5
Israel	0.4	0.1	1.5	9.4	2.7	3.4	-2.4	5.0
Korea	0.2	0.7	1.7	0.0	0.2	2.0	-1.0	3.6
Switzerland	2.2	0.6	0.0	1.5	0.1	1.1	-3.0	3.5
Total (GEL million)	**3,765**	**9,066**	**1,261**	**1,733**	**7,727***			

** Number of international visitor trips*
Source: GeoStat, NBG, IMF

The final three columns on the right-hand side of Table 1 represent the growth rates for 2019 and 2020 and next year's projections. According to the IMF, most of Georgia's neighboring countries and main economic partners showed the sharpest declines in their respective GDPs since the Global Financial Crisis. The United States and the Euro Area shrank by 3.5% and 6.6% respectively. At the same time, the Chinese economy recovered in the second half of the year exhibiting a 2.3% y/y growth. Turkey, Uzbekistan, and Iran also showed positive growth in 2020.

Despite positive 2021 growth projections, most of Georgia's partner countries are expected to only partially regain their 2019 GDP levels. Once again, China will be a leader in terms of economic growth in 2021, which will likely strengthen its ties with the Georgian economy in the next few years.

According to NBG's monetary report from February, GDP is expected to increase by 4% y/y in 2021. This figure is the same as the World Bank's estimates made in January, while IMF projections from April predict 3.5% y/y. However, in the same report NBG also provided an alternative scenario according to which, due to weak net exports and investment, real GDP is expected to grow by only 1% in 2021. The latest data from ISET-PI's GDP forecast predicts 2021 annual real GDP growth to be 2.5% in the worst-case scenario and 3.6% in the best-case scenario. Our middle-of-the-road scenario predicts a 2.9% increase in real GDP.

The high variation in growth projections reflects the existing uncertainties about economic developments in 2021. These uncertainties stem from the possibility of new variants of the virus and new waves of the epidemic. The situation in Georgia will be highly dependent on the severity of future containment measures, if any, and the efficacy of vaccination efforts both in the country and among its main economic partners. However, even in the case of successful vaccination, the speed of tourism's recovery still remains uncertain. Initially people are likely to reduce their mobility even after the reopening of borders. Therefore, though external demand seems to recover at modest rates in the upcoming years, Georgia's economic performance will be dictated by the perceived effectiveness of economic reforms, the investment climate, and vigorous trade promotion policies.

Inflation

The inflation dynamic was determined by several factors in 2020. While weak domestic (due to increased uncertainties and unemployment, and lower incomes) and external demand (mainly due to the standstill in tourism) put a downward pressure on inflation, disruption in value chains and increased production costs created an upward inflationary pressure. Consequently, food prices were among the main drivers of inflation, while lower oil prices had the biggest impact on the reduction of inflation in 2020. The national currency, which depreciated by 10.3% y/y against the USD and 4.2% against a basket of trading partners' foreign currencies (nominal effective exchange rate), put additional upward pressure on inflation in 2020.

Consequently, annual CPI inflation reached 5.2% y/y in 2020, 2.2 percentage points (pp) higher than the targeted 3%. Increased food prices (+10.6% y/y), contributed the most to overall inflation (3.3 pp). Additionally, price increases on furnishings (+8% y/y), health (+6.5% y/y) and miscellaneous goods and services (+8.7% y/y) contributed 0.5 pp each to total inflation in 2020. Concurrently, the prices of goods and services in the transport and recreation categories dropped by 3.6% y/y and 1.9% y/y respectively. Together these categories drove inflation down by 0.5 pp in 2020.

It should be mentioned that inflation initially picked up in September 2019 but then exhibited a declining trend in 2020 despite the pandemic. NBG gradually reduced its monetary policy rate in the middle of the year – from 9% to 8%. However, as *"the prolongation of the pandemic might cause expectations to further deteriorate"* NBG maintained the policy rate at 8% in 2020. In parallel, NBG actively intervened in the foreign exchange market to smooth lari depreciation and decrease its impact on inflation in the course of the year. The National Bank performed 26 selling auctions of an unprecedented 873 million USD, which was the historical maximum.

External Sector: Trade, Tourism, Remittances, FDI

The restrictive measures introduced by the majority of countries to prevent the spread of COVID-19 negatively affected not only Georgia's internal economic activity, but also international trade in goods and services and FDI.

The pandemic hit the tourism sector the most due to travel restrictions, suspended international flights, and closed state borders. The number of international visitors declined from 7.7 million in 2019 to 1.5

million in 2020, while revenues from international tourism fell from 3,269 million USD to 542 million USD in the same period.

Georgia's external merchandise trade decreased by 14.8% y/y, as both exports and imports showed negative growth in 2020. The negative trade balance in goods shrank by 18% as imports fell more sharply than exports.

Total exports decreased by 12% y/y in 2020, and amounted to 3,342 million USD. The decline was driven by lower re-export of motor cars (-44.9% y/y), medicaments (-42.6% y/y), and export of ferro-alloys (-18.5% y/y). Exports to many of the main destination markets (except China, Bulgaria, Switzerland, and Spain) have decreased. Georgian exports to China more than doubled in the reporting period, reflecting its better economic situation compared to other partners. Driven by higher exports of copper, China became the top destination country for Georgian exports in 2020. The geographical diversification of Georgian exports declined as the share of the top ten export destination countries in total exports increased from 70% in 2019 to 75.9% in 2020.

Imports amounted to 8,029 million USD in 2020, a 15.6% annual decrease. Exchange rate depreciation, economic uncertainties caused by the pandemic, and job cuts drove demand for all types of imported goods downward. Imports of motor cars (-31.4% y/y), petroleum (-34.2% y/y), copper (-11.6% y/y) and telephones (-22.3% y/y), all showed double digit negative growth rates. In parallel with the unprecedented decline in value, the geographical diversification of Georgian imports declined, as the share of top ten trading partners in the total imports of Georgia amounted to 69.9% in 2020 compared to 65.5% in 2019.

Surprisingly, the volume of remittances to Georgia, which fell sharply in March-May 2020, fully recovered and showed a strong 8.8% y/y growth in 2020 amounting to 1,886 million USD. This figure was mainly driven by higher money inflows from Italy (+24.4% y/y), Ukraine (+103.9% y/y), the United States (+22.4% y/y), Azerbaijan (+143.1% y/y), and Germany (+48.9% y/y). At the same time, remittances from Russia (-15.1% y/y) declined substantially, causing Russia to cede its leading position to Italy as Georgia's main source of remittances.

As was expected, increased economic uncertainties and deteriorated macroeconomic stability negatively affected FDI in Georgia. FDI amounted to 617 million USD in 2020 (-52.9% y/y) - the lowest value since 2005.

As a result, the current account deficit widened to 12.4% of GDP in 2020, from a record low of 5.1% the previous year, putting a depreciation pressure on the Georgian lari exchange rate and leading to a higher sovereign country risk premium.

Public Finances

In June 2020, the Parliament of Georgia adopted a revised version of the State Budget, which included a 3.4 billion GEL anti-crisis plan to support vulnerable populations, businesses, and the financial sector. The package included healthcare and virus management costs, targeted direct and indirect income transfers to affected households, tax relief, introduction of credit guarantee schemes for businesses, and payroll support.

Current governmental expenditures increased by 23.7% y/y in 2020 and amounted to 13,397 million GEL. This growth was mainly driven by higher spending on social benefits (+32.8% y/y) and subsidies (+51.6% y/y). At the same time, total revenues to the general budget amounted to 12,405 million GEL, a 2.6% y/y decrease. The latter was driven by lower tax collection (-4.3% y/y) as revenues from VAT (-7.7% y/y), income tax (-4.5% y/y), and custom duties (-8.6% y/y) showed a negative trend in 2020. However, the revenues from excise and profit taxes increased by 7.5% y/y and 6.1% y/y respectively.

Overall, in 2020 the budget deficit amounted to 4,574 million GEL (9.3% of GDP) - 3.4 times higher than in the previous year. Government debt increased by 43.9% y/y and amounted to 29,607 million GEL (59.9% of GDP). Furthermore, the share of foreign debt in total debt rose by 2.7 pp and stood at 79.2% increasing the country's exposure to exchange rate risk.