Macro Review February Issue

Taking stock of 2013-2014 economic developments in Georgia

February is usually a good time to take stock of the country's economic performance, because at the beginning of the month statistical agencies release data on many baseline indicators for the previous year.

Preliminary data reveals that the annual GDP growth rate in 2014 was 4.7%, which fell short of the 5% that had been expected. This shortfall was driven by weak performance, growth of just 1.6%, in the last quarter of 2014 (see Chart 1).

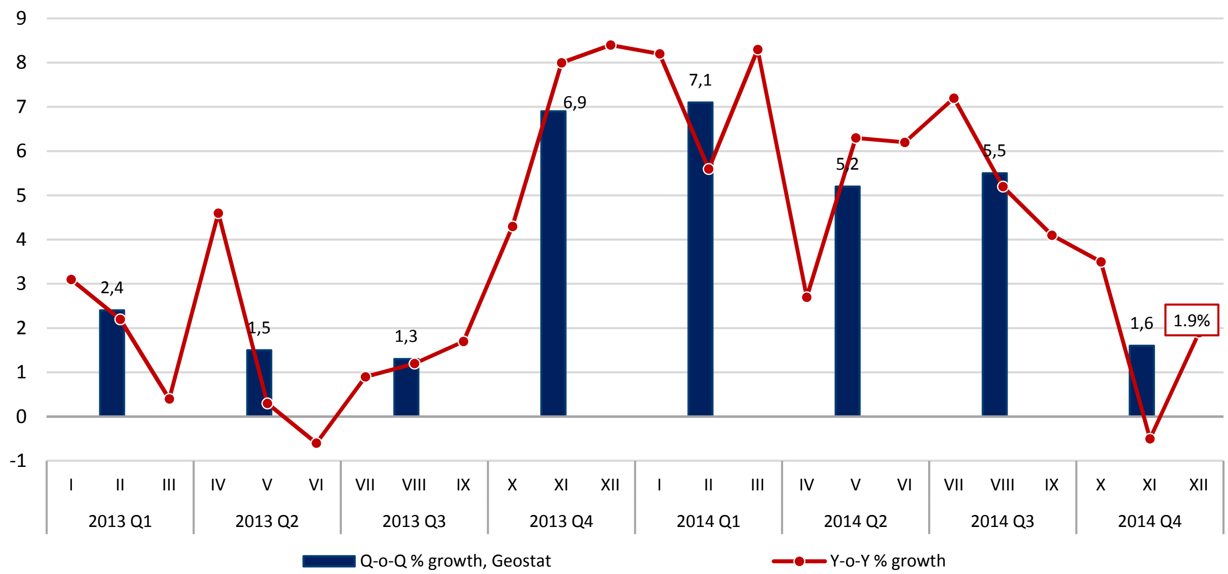

Chart 1. Y-o-Y (red line) and Q-o-Q (blue bars) % growth rate of real GDP
Source: *GeoStat*

This outcome is hardly surprising. As we mentioned in earlier reports, Q4 2013 was marked by growth and Q4 2014 is thus being compared to a relatively high base. However, looking at Chart 2, it is evident that the low growth rate of Q4 was reflective of the generally sluggish trend of growth in 2014.

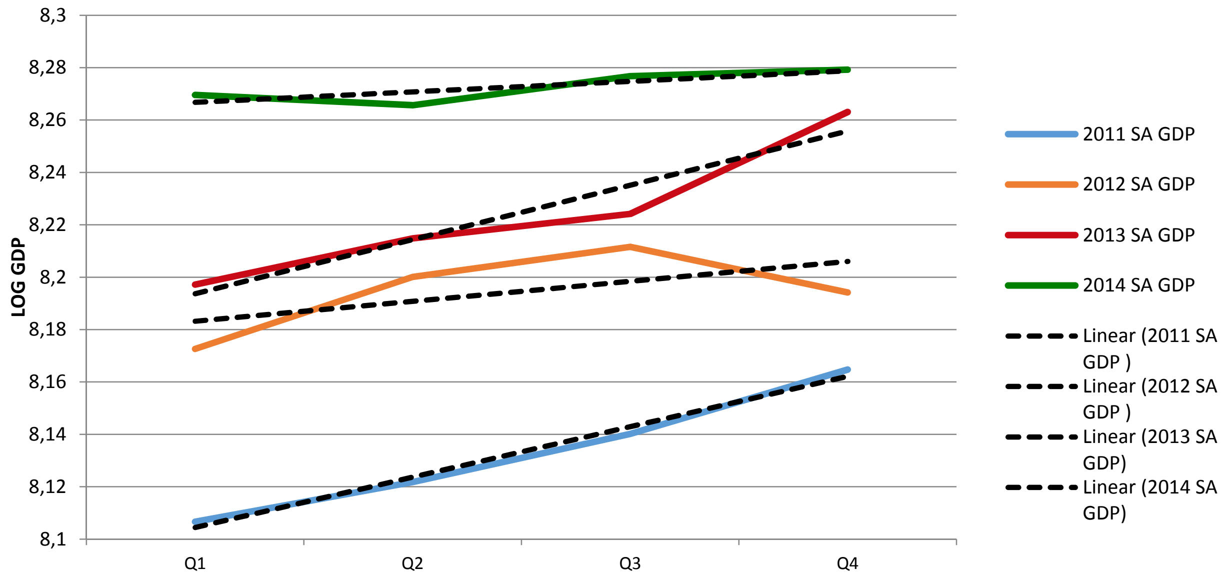

Chart 2. Georgia Seasonally Adjusted GDP series with linear trend lines
Source: *GeoStat*

The reasons for the disappointing performance of the economy in 2014 stem from both internal and external factors, which are discussed in more detail below.

To start with, the Consumer Confidence Index (CCI), a barometer of consumer sentiment and a guide to domestic spending, dropped to its lowest point in December. In January 2015, the index decreased even further. Analysis shows that the fall of the CCI was mainly driven by expectations of higher inflation caused by the depreciation of the lari in December and January.

However, according to Geostat data, actual inflation rates have been dropping for the past few months. Between December and January, the inflation rate fell from 2% to 1.4% (Chart 3). Average annual inflation in 2014 was 3.1%, which is significantly below the National Bank's target rate. The reasons for such a misalignment between expectations and the actual data were analyzed in detail in this ISET-PI publication.

Taking apart the annual inflation data, it can be seen that prices on food increased by a total of 5.2% relative to 2013 and prices of healthcare increased by 5.5%. The highest deflation was reported in the clothing sector (-5.4%).

The declining trend in price growth over the last several months (as shown on Chart 3) was due to relatively low price increases on food products, which are usually large contributors to the total inflation rate. Combined with the downward pressure on prices in the transportation and clothing groups, this translated into lower overall inflation rates. For example, in January 2015 prices on the transport and clothing and footwear groups decreased by 5.9% and 5.8% respectively, while food prices increased by only 1.7% (see Chart 4). Healthcare prices, however, increased by 7.3% in the same period. This was mainly driven by the price increase on medical products, appliances and equipment (15.8%). The high share of imports in this product category were made more expensive by the devaluation of the lari.

In December, PPI inflation increased to 6.4%, which was mainly driven by higher producer prices (8.6%) in the manufacturing sector (see Chart 3). It is likely that the producer price increases will slowly feed into future consumer price increases.

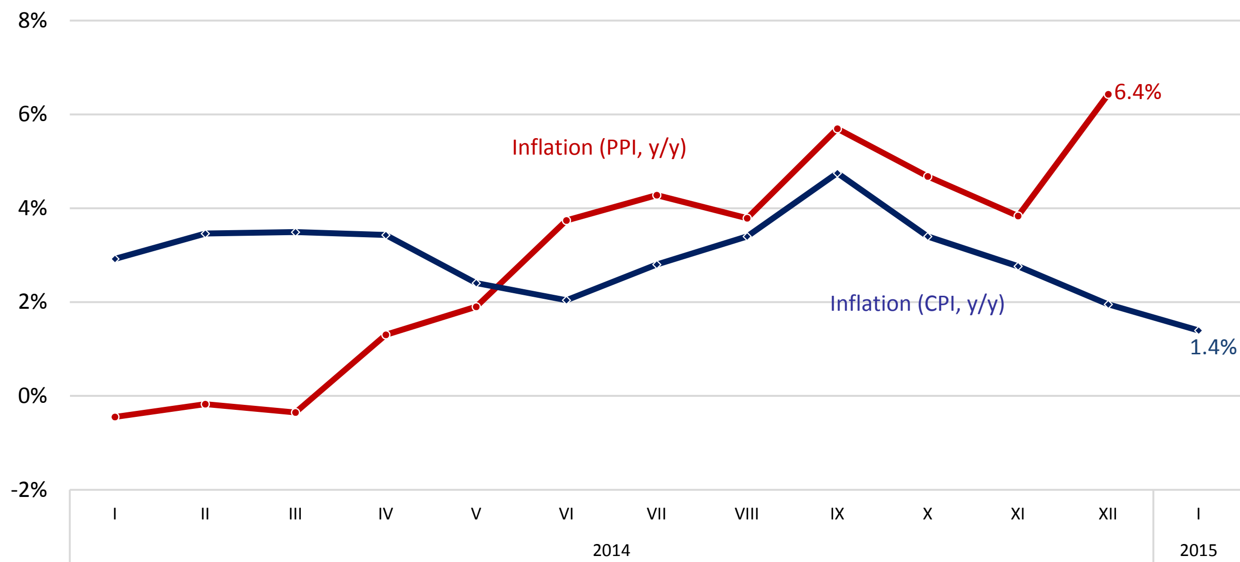

Chart 3. Source: *Geostat*

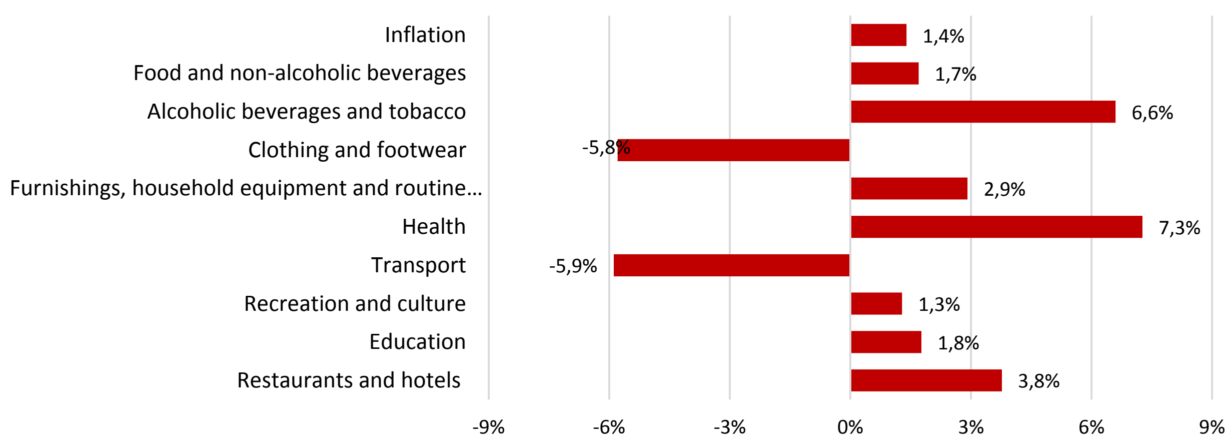

Chart 4. Price increases in January 2015, y-o-y

Lending growth was consistently high in 2014. Loans to households grew by 30% on average in annual terms and those to legal entities by 16%. A sectorial breakdown of loans to legal entities shows that agriculture, industry, financial intermediation and real estate lending grew by extremely high rates. The high growth rate of loans to the agriculture sector can be explained by the increase in the government program providing cheap (subsidized) loans to this sector. Though this program can be expected to support the development of agriculture to some extent, one should bear in mind that such kinds of subsidized loans are quite costly and not sustainable. One of the negative side effects is that banks do not have the incentive to invest in assessing and differentiating lending risks across different types of agricultural activities – consequently, they charge all agricultural activities a uniformly high interest rate. The government, in turn, cannot assess the true cost of providing subsidies because the market information is incomplete.

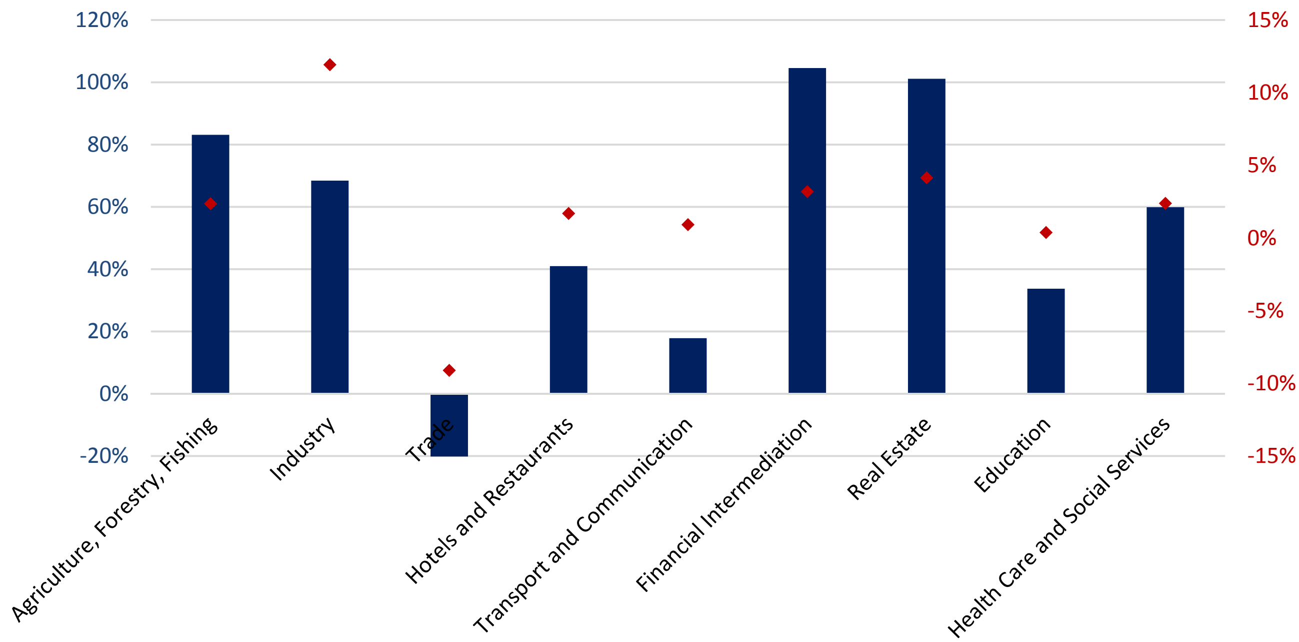

Chart 5. Sectorial breakdown of loans to legal entities, 2014, y-o-y.
Source: *National Bank of Georgia*

The year 2014 also saw a substantial increase in bank deposits, time deposits in particular. In December, deposits in Georgian commercial banks were 21% higher than in the same month of 2013. Time deposits grew by 30% in the same period. Among the time deposits, deposits denominated in lari increased by 62%. This is quite puzzling, since the depreciation of the lari typically leads to a higher dollarization of deposits – as people convert their lari savings into dollars. However, deposit dollarization slightly *decreased* from the previous month and amounted to 57% in December. Similarly, loan dollarization decreased only slightly in December to 61%. This might have happened because people are not expecting a further depreciation of the national currency in the medium run.

Interest rates on both loans and deposits dropped to their historical minimums. The overall weighted interest on loans fell to 14.3%. The average interest rate on lari loans was 17.5%, while on foreign currency (mainly dollars) loans it was 11.2%. However, one may expect interest rates on lari loans to rise in the future, following the National Bank of Georgia increasing the monetary policy rate by 50 basis points, from 4% to 4.5%.

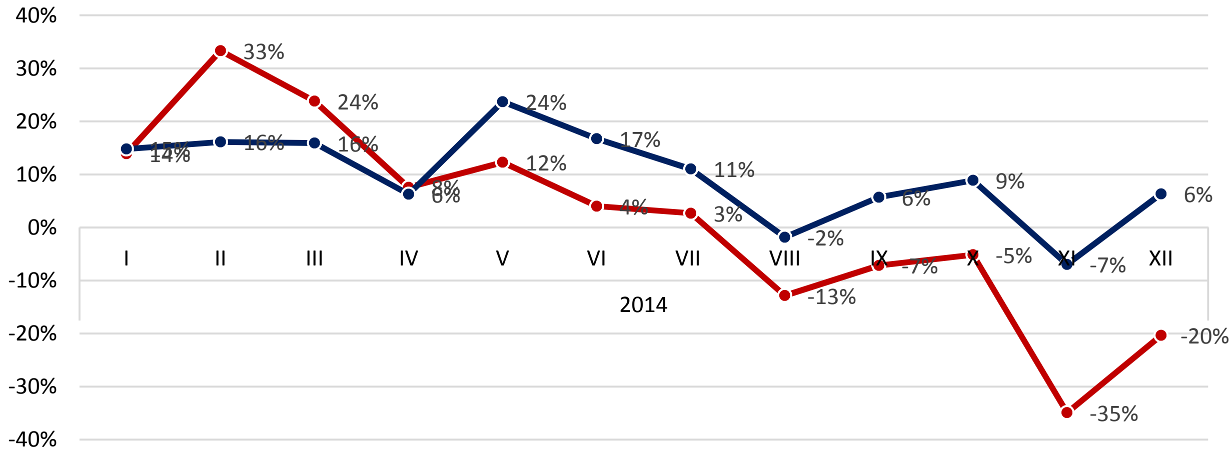

Chart 6. Import and export growth rates
Source: *Geostat*

In 2014, overall goods exports from Georgia decreased by 1.6% compared to 2013 and amounted to 2.9 billion USD. In the same period, the volume of imports increased by 9% to 8.6 billion USD. Consequently, the trade deficit increased by 15% in annual terms.

In annual terms, exports to the EU increased by only 2.1%, while exports to CIS countries declined by as much as 9.6%. Exports to Turkey and the US increased by 31% and 52%, respectively. The latter two countries, along with China and Russia, were among the largest drivers of export growth in 2014.

The main export destination countries in 2014 were Azerbaijan (19% of total exports), Armenia (10%), Russia (10%), and Turkey (8%). Car re-exports still accounted for a high share of overall exports, comprising 18% of total; ferro-alloys constituted 10%; copper 9%; and nuts and wine each comprised 6% of the total. For a more detailed analysis of Georgian export growth in 2014, see the ISET Economist blog post by Yaroslava Babych and Lasha Arevadze.

On the public spending side, budget expenditure in December was 4% lower than last year, amounting to 939 million lari. Between November and December, government expenditure on goods and services decreased by 4%, while the “other payments” category declined by 23%.

The annual changes between 2013 and 2014 are shown on Chart 7. In this period, total budget expenditure increased by 15% and amounted to 7.7 billion lari. More than a third of the total expenditure, 36%, was devoted to financing social benefits, 20% went to the compensation of employees and 15% was spent on purchasing goods and services (see Chart 7).

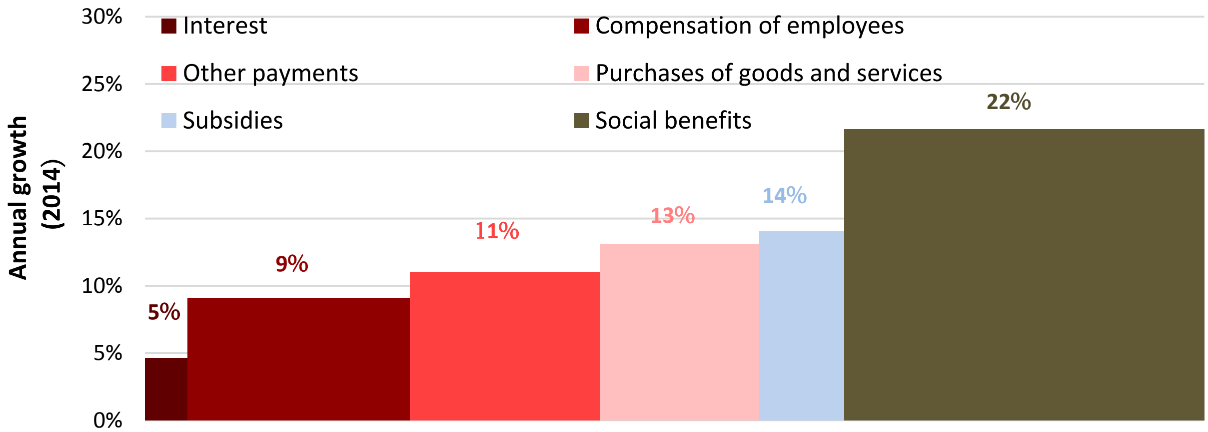

Chart 7. Budget expenditure growth by group and their contribution to growth (area of rectangles)
Source: *Ministry of Finance*

As for budget revenues, VAT payments made the most important contribution to growth in 2014, followed by excise tax. Income tax, which comprises over one third of total revenues, increased only slightly by 0.2%.

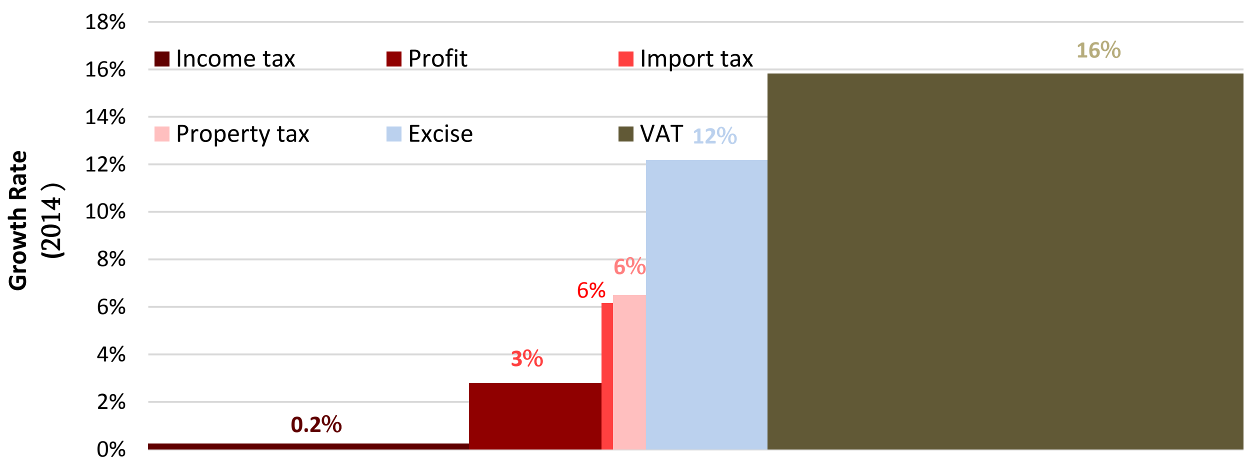

Chart 8. Budget tax revenues growth by group and their contribution to growth (area of rectangles)
Source: *Ministry of Finance*

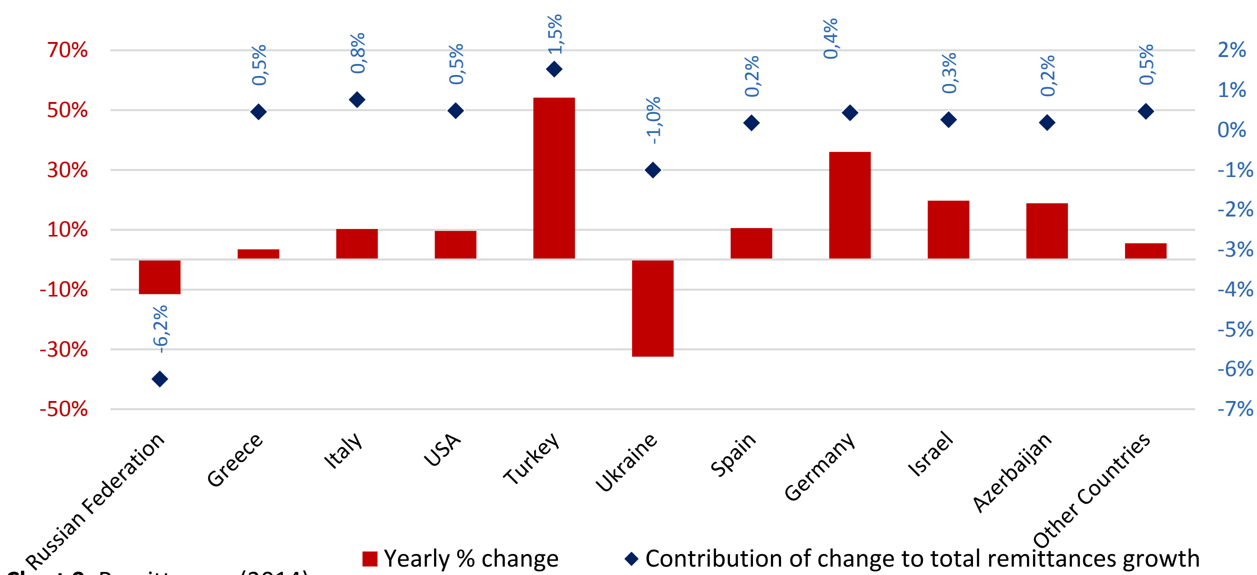

Chart 9. Remittances (2014)

During 2014, total remittances to Georgia declined to 1.4 billion USD. This is 2.5% lower than in 2013. Remittances from Russia decreased by 11.5% and from Ukraine by 32%. On the other hand, remittances from Turkey increased by 54% and from Germany by 36% (see Chart 9). Russia was by far the largest contributor to the remittances decline in Georgia, reducing the overall inflow by as much as 6.2 percentage points in 2014.

December was a particularly bad month for inflows from abroad – remittances to Georgia decreased by as much as 25% and amounted to 116 million USD. This drop was driven by a 43% decrease from Russia, which contributed 23 percentage points to the December decline, and a 68% decrease from Ukraine.