The crisis in Ukraine and the Georgian economy

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Abstract. We analyze how the crisis in Ukraine will likely impact the Georgian economy and distinguish between short-run and long-run effects. We argue that the short-run effects are transmitted through trade and capital flows and that they are rather negative for Georgia and can hardly be bolstered. In the long-run, however, the crisis could improve the competitiveness of the Caucasus Transit Corridor, an important trading route between Europe and Central Asia Georgia participates in. We give recommendations how political decision makers could support such a development in the wake of an impairment of the northern Ukrainian transit routes.

Introduction

When Ukrainian President Victor Yanukovich decided not to sign the association agreement with the European Union and instead opted for a Russian package of long-term economic support, many Ukrainians perceived this not to be a purely economic decision. Rather, they feared this to be a renunciation of Western cultural and political values, and – to put it mildly – were not happy about this development.

The Russian political system, characterized by a prepotent president, constrained civil rights, and a government controlling important parts of the economy through its secret service, is not exactly the dream of young Ukrainians. Russia can offer economic carrots, but these do not count much against the *soft power* of Europe that comes in the form of political freedom, good governance, and economic development to the benefit of not just a small group of oligarchs.

Hence, it was all but surprising when many young Ukrainians took their anger about Yanukovich to the streets. After protests that lasted for nearly three months, President Yanukovich fled the country, a temporary government took over, and chaos broke out on the Crimean peninsula.

The dispute about the Crimea has the potential to impede the relations between Russia and the West for a long time to come, in particular if Russia enforces an annexation of the territory. Moreover, the tensions could quickly turn into a military conflict. The aircraft carrier *USS George H.W. Bush* was moved into an operational distance to the Crimea, accompanied by 20 smaller U.S. warships, and 12 additional fighter planes will be stationed in Poland. Yet even if there will be no direct confrontation between official Russian and U.S. forces, Ukraine could become the battleground of a *proxy war*, a kind of conflict that was common in the Cold War era. In this respect, one can already read the writing on the wall: the new Ukrainian government begs the U.S. for supplying arms and ammunition, and while the Obama administration is still reluctant to give in to such requests, the call is supported by hawkish U.S. congressmen who might finally prevail.

Ukraine is a country that is geographically close to Georgia and, like Georgia, has vital economic stakes in the Black Sea area. Georgia will not be unaffected by whatever happens in Kiev and Simferopol. In this policy brief, we will inform policy makers about the likely short-run and long-run economic consequences of the turmoil in Ukraine, discuss the challenges and opportunities that may arise, and derive some policy recommendations.

Short-run economic consequences

The crisis in Ukraine will almost instantaneously affect trade and capital flows between Georgia, Ukraine, and Russia. The effects will likely be negative and hit Georgia in a situation of economic recovery.

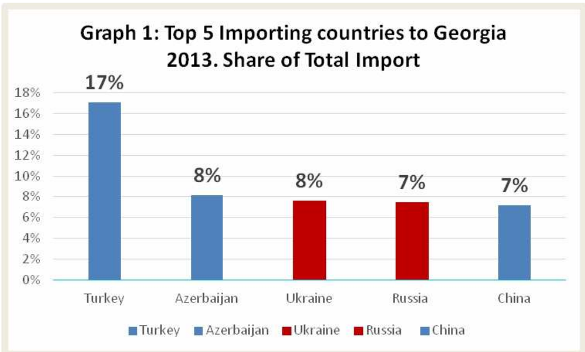
The Georgian real GDP growth rates were 6.3% in 2010, 7.2% in 2011, and 6.2% in 2012, and the real GDP per capita evolved from about 2,600 USD to about 3,500 USD in this time, but the upsurge discontinued in 2013 (if no other source is mentioned, all figures presented in this policy brief, including those in the graphs, come from the Georgian statistical office GeoStat). ISET-PI, in its February 2014 report on the leading GDP indicators for Georgia, estimates the GDP in 2013 to be 2.6%, while GeoStat, the statistical office of Georgia, believes it to be 3.1%.

The unsatisfactory performance of the Georgian economy in 2013 was arguably caused by political uncertainties resulting from the government change that took place in late 2012, and as these uncertainties are largely overcome, most economists believe that Georgia will get back to its remarkable growth trajectory in 2014. The IMF, in its Economic Outlook, predicts a real GDP Growth of 6% in 2014, and the government of Georgia expects this number to be 5%. With an escalating crisis in Ukraine, it is questionable whether these rosy forecasts are still realistic.

Effects on imports

In 2013, Ukraine and Russia were the 3rd and the 4th largest importers to Georgia, respectively. Graph 1 shows the top five importers to Georgia, which together make up about 50% of total imports. The imports from Ukraine and Russia are mainly comprised of consumption goods: of all goods that were imported between 2009 and 2013 from Ukraine and Russia, about 30% were foodstuff. The ten main import goods in this time (in order of monetary volume) were cigarettes, sunflower oil, chocolate, bread, cakes, meat other than poultry, poultry, and sugar.

If the supply of these goods would be reduced through a breakdown of production and logistics, roadblocks, damaged infrastructure etc., the consequences for Georgia would not be utterly severe. From Ukraine and Russia, Georgia receives few goods that are (1) needed for investment projects and (2) cannot be produced domestically (an example of sophisticated investment goods that need to be imported would be ski lifts for tourism projects). Moreover, as Ukraine and Russia supply primarily standard goods that are produced almost everywhere, it is unlikely that a cutback in their imports would lead to sharp price rises in Georgia. Very quickly, increased imports from other countries would close any supply gaps. In addition, many imported consumption goods, like Ukrainian orange juice, are but luxury for ordinary Georgians, who buy their food in cheap domestic markets that sell almost exclusively local products.



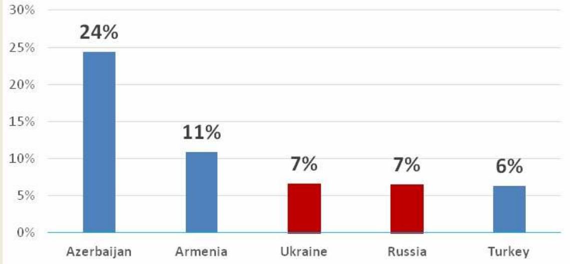
Effects on exports

A small anecdote may illustrate the status of Georgian products in the Russian market. In the late 1940s and early 1950s, Stalin used to invite his comrades to his *Kuntsevo* dacha almost every night. At these occasions, he drank only semi-sweet Georgian red wine. His clique, usually preferring Russian vodka, adopted this habit out of fear to displease the dictator. Yet the real highlight of these nightly gatherings took place after midnight, when an opulent feast began, featuring all the delicacies of the Georgian cuisine. Through Stalin (and the fact that Georgia was a preferred destination of Soviet tourism), Georgian food obtained an excellent reputation in most countries of the former Soviet Union, and, to the dismay of Georgians, some younger Russians even do not know that *Khinkali* is not an originally Russian dish.

As can be seen in Graph 2, Russia and Ukraine are among the top 5 destinations for Georgian produce, together absorbing about 14% of total Georgian exports in 2013. In 2006, two Georgian products that are traditionally highly popular in Russia, namely wine and mineral water (the famous "Borjomi" brand), were banned from the Russian market. Yet in the wake of the diplomatic thaw that set in after the new government assumed power last year, this ban was lifted, and in 2013, the export of these goods regained momentum. In 2013, 68% of all wine exported from Georgia was sold in Russia and Ukraine (44 and 24 percentage points, respectively). In both countries, Georgian wines are sold at the higher end of the price range and are typically consumed by people with middle and high income. It is likely that these exports, in particular those to Ukraine, will be affected considerably by the crisis. This may happen through decreased demand for luxury foods and through a possible depreciation of the Ukrainian hryvna and the ruble vis-à-vis the Georgian lari

Another sector that may be affected by the situation in Ukraine is the car re-export business. Georgia imports huge numbers of used cars from the U.S., Europe, and Japan, and passes them .

Graph 2: Top 5 Exporting countries for Georgia 2013. Share of Total export



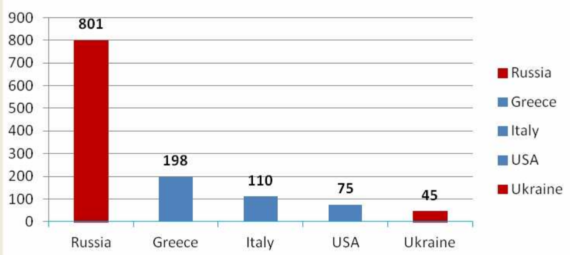
onto countries in the region. While this business hardly yields potential for real economic progress, it accounts for roughly 25% of Georgian exports! Of these 25%, about 7 percentage points go to Russia and Ukraine. Moreover, many cars are imported to Georgia on the land route from Europe through Ukraine and Russia (often driven by private, small-scale importers). If it will become more difficult to cross the border between Russia and Ukraine, this business, providing income to many low-skilled Georgians, may be at risk.

It should also be noted that Ukrainians and Russians make up an ever-increasing share of the tourists coming to Georgia (though the biggest group of tourists are Israelis). Also through this channel, an economic downturn in Ukraine and Russia will have unpleasant consequences for Georgia.

Effects on capital flows

According to the National Bank of Georgia, in 2013 a total of 801 mln USD was flowing in from Russia (see Graph 3). Ukraine contributed

Graph 3: Top 5 Money Inflows to Georgia 2013 Mln USD



45 mln USD to the money inflows, still significant for an economy as small as Georgia's.

An economic downturn in Russia and Ukraine would hit many Georgian citizens, often pensioners and elderly people, who depend on remittances of their children and other family members sent from these countries. This may aggravate a trend that already exists: in January 2014, money inflows decreased by 4% from Russia and by 5% from Ukraine (compared to January 2013).

Long-run economic consequences

Most of the economic dynamics Georgia experienced since 2003 was "catch up growth". A country permeated by corruption, with a dysfunctional police and judicial system, without protection of property rights and contract enforcement, will grow almost automatically when the government restarts to fulfill its basic functions. Yet once this phase of returning to normal economic circumstances is over (Georgia probably is already in this situation), high growth rates can hardly be achieved without a strong export orientation of the economy, in particular when an economy is as small as Georgia's. Most economists concerned with Georgia are therefore struggling to identify economic sectors where Georgia is in a good position to develop export potential. The National Competitiveness Report for Georgia, written in 2013 by the ISET Policy Institute on behalf of USAID, therefore extensively discusses the question what Georgia can deliver to the world. Though not related to export in a classical sense, the report points out that one of the advantages Georgia has is its geographical location, providing for possibilities to transform Georgia into a logistics hub.

There are three main routes to transport goods from Europe to the Central Asian countries (e.g. from Hamburg to Taraz in Kazakhstan). One route goes via the Baltic ports of Klaipeda or Riga, and then through Ukraine and Russia, and another route goes overland through Ukraine. A third one, the so called *Caucasian Transit Corridor*, has the Georgian port city of Poti and Turkey as its Western connection points, then goes through Georgia, Azerbaijan, and the Caspian Sea, and further east it splits up into a Kazakhstan and a Turkmenistan branch.

According to the Almaty based company *Comprehensive Logistics Solutions*, the fastest and cheapest route is the one through the Baltic ports. The transport from Hamburg to Taraz takes around 33 days and costs 6,220 USD per standard container. The overland transport via Ukraine takes around 34 days and costs 7,474 USD. Finally, transport through the CTC currently takes the longest time, namely around 40 days, and costs 6,896 USD.

Unlike many other economic activities, competition for transportation is more or less a zero-sum game played by nations. If transport through Ukraine and Russia will be restrained due to closed borders and political and economic instability, the total transport volume will not change substantially. Rather, instead of going through the northern routes, the goods will flow through the CTC. A similar development could be observed when the embargo against Iran was tightened and shipping goods through Iranian ports became increasingly difficult for Armenia and Azerbaijan. As a result, Azerbaijan, traditionally importing through Iran and exporting through Poti, now facilitates both its imports and exports through Poti.

This is a great chance for Georgia if it wants to become serious about transforming into a logistics hub. In our policy recommendations, we will speak about how to utilize on this opportunity.

Policy recommendations

Georgia can do little to bolster the short-run effects that are transmitted through the trade and capital flow channels. Political decision makers should be aware of problems that might arise for particularly vulnerable groups in the population, like pensioners who lose income in case remittances from Russia and Ukraine run dry, and help out with social support if necessary.

Regarding the long-run impact, Georgia should use this opportunity for gaining ground in the competition with northern transit routes. The *Caucasus Transit Corridor* can become much faster and cheaper if (a) a deepwater port and modern port facilities with warehouses will be built in Poti, (b) the road and train infrastructure will be improved, and (c) it will be easier to bring cargo over the Caspian Sea. Regarding the latter point, it would be important to assist Azerbaijan in improving the port management at Baku (in particular reducing corruption), and in reforming the monopolistic *Azerbaijani State Caspian Sea Shipping Company*.

Azerbaijan invests 775 mln USD into the Georgian part of the *Baku-Tbilisi-Kars* railway, proving their serious interest to upgrade CTC. Given this impressive commitment of Azerbaijan, Georgia should not stand back.

Conclusion

The crisis in Ukraine yields short-run risks and long-run opportunities for the Georgian economy. While there is little that can be done about the risks, the opportunities call for courageous steps to improve the *Caucasus Transit Corridor*. If the countries that hold stakes in the CTC are now further reducing the cost of transportation and make the route faster and more customer-friendly, the CTC may establish itself as the main trading route connecting Europe and Central Asia. Once critical investments have taken place, CTC's advantage could be sustained beyond the current crisis. It is a competitive route that simply needs upgrading, which can happen now as a fallout of the conflict between Ukraine and Russia.

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