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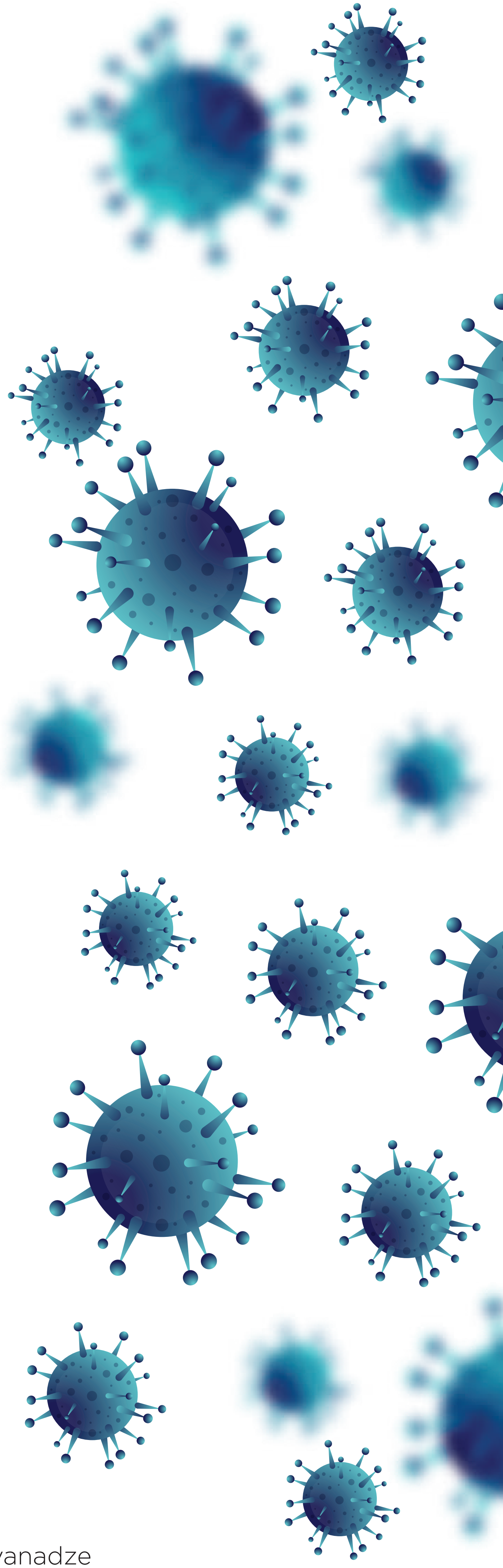

The Economic Response to COVID-19: How is Georgia Handling the Challenge?

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Global risks

As the novel coronavirus COVID-19 outbreak continues to spread around the world, and has been declared a global pandemic by the World Health Organization, the next global economic recession is no longer an "if" or even a "when" event. Unfortunately, it is already upon us. In just the past few days:

- Stock market indices have continued to exhibit high volatility, rallying one day and plunging at record pace the next;
- Companies around the world are shoring up cash, as they start to fearfor their liquidity;
- Countries have adopted drastic measures to limit outside travel and social interactions;
- Health systems in the most afflicted countries are strained to near breaking point;
- Oil prices have dropped to levels not seen since 2016, responding both to the expectations of low demand and an increase in supply.
- Production processes and value chain linkages were first disruptedin Asia and now in Europe and the US;
- OECD projects global growth may slow to 1.5 percent in 2020, half the growth rate anticipatedprior to the outbreak of COVID-19.

The double shock to both supply and demand comes at a time when both theprivate and public debt to GDP ratios have already reached record levels in many advanced economies. Without coordinated monetary and fiscal policy actions, the economic crisis could quickly and readily reach a historic magnitude.

How has Georgia been affected and how it may be affected down the road?

Demand side effects

1. Decline in domestic consumption resulting from behavioral and policy changes - i.e. people staying home as a precaution or because they are required to. In addition, currency depreciation and possible price spikes (due to herding behaviors and potential disruptions in supply chains) are also expected to have a negative effect on consumption and investment.
   Household consumption accounts for 66.7% of the Georgian GDP (Geostat, 2018). A significant reduction in household consumption (e.g., spending on transportation, clothing, electronics, and domestic services) would therefore result in anoverall slowdown of GDP growth. A slowing of internal demand would hit people working in the informal sector particularly hard; namely, those without a regular salary (e.g., temporary workers, taxi drivers, and other self-employed service sector workers) and small and micro business-owners. Their situation is worsened still, because the government's fiscal stimulus and assistance is unlikely to reach them directly. They are also not expected to benefit from the extra liquidity injected into the financial system, as they will not qualify for bank loans to cover temporary income losses.Another vulnerable group are the formal sector workers employed in companies that face a dramatic decline in their usual economic activities (restaurants, hotels, the entertainment industry, transport, etc.). These companies are likely to put their workers on unpaid leave or simply to fire them. While, the slump in household demand will also be made worse by the fact that most families are likely to have limited savings and, therefore, their capacity to smooth consumption is limited. Hence, the crisis may cause a significant drop in well-being and, possibly, further deterioration in individuals' physical and mental health, alongside the direct impacts of COVID-19.
2. Decline in domestic investment – uncertainty and deteriorating business sentiments will stall business investment decisions. Expectations of a global recession could become self-fulfilling if 'business-as-usual' does not resume in the next few months. If companies expect a slowdown in demand, they will also delay investment, and GDP will decline further. Investment (gross fixed capital formation) accounts for approximately 28% of Georgia's GDP. Thus, the Georgian government has announced capital spending to combat the expected drop in private investment.

3. **Decline in tourism and related business** - tourism arrivals and receipts are expected to decline sharply as a result of the numerous travel bans, and due to precautionary behavior. According to our preliminary calculations, the Georgian economy lost from 3-9% of potential tourism revenue in February. Since the tourism sector accounts for 6% of Georgia's GDP (GNTA 2018), a direct hit to the industry willsubstantially impact GDP. Below we work out GDP losses associated with the following scenarios:

	Table 1. Net effect of the coronavirus crisis				
	Effect on GDP (percentage points)				Tourism revenues (Mln. USD)
	Transport	*Accom. and food services*	*Travel companies*	Total change in GDP	
Scenario 1: no international, outbound or domestic tourism in March-May 2020	*-0.18*	*-0.36*	*-0.28*	-0.82	-514
Scenario 2: no international, outbound or domestic tourism in March-July 2020	*-0.41*	*-0.82*	*-0.64*	-1.87	-989
Scenario 3: no international, outbound or domestic tourism in March-December 2020	*-1.19*	*-2.34*	*-1.84*	-5.37	-2,010

Note: after each period indicated in the scenarios tourism is assumed to immediately recover to 2019 levels.
Source: Geostat, NBG, authors' calculations

4. **The spillover effect on other sectors** – a drop in demand for goods and services in the region, in China, the EU, and the US, will affect the overall economy via trade and production linkages.
While it is difficult to predict how Georgia's economy will react to a global shock of such magnitude, some preliminary estimations may already be determined. Georgia's growth rate over the last 20 years correlates notablyto several neighboring economies. One of the greatest correlations is, unsurprisingly, with Russian economic growth. Russia's growth is also highly correlated with other countries, reflecting global economic linkages. These correlations are reported in the table below:

Table 2	Georgia	Russia	Armenia	Turkey	China	Kazakhstan	Italy	Germany	France	US	Israel	Ukraine
Georgia	1.00	0.87	0.88	0.66	0.58	0.81	0.67	0.74	0.85	0.69	0.77	0.73
Russia		1.00	0.90	0.60	0.73	0.83	0.64	0.67	0.82	0.63	0.79	0.91

Source: World Bank, authors' calculations

In order to discover how a slowdown across major world economies will affect Georgia, we have followed three economic scenarios relating to major world economies, as reported by Orlik et al. (March 6, 2020, Bloomberg.com). The numbers reflect growth rate changes relative to the baseline (no virus outbreak).

Table 3. Coronavirus effect on growth rates	Real GDP annual growth change in 2020compared to the baseline scenario, pp				Real GDP growth in 2020, assuming a 5% baseline
	Russia	Germany	US	Georgia	Georgia
Scenario A: Outbreak causes localized disruption	-0.9	-1.2	-0.2	**-1.09**	**3.91**
Scenario B: Widespread contagion	-3	-2.8	-1.3	**-3.09**	**1.91**
Scenario C: Global pandemic	-4.8	-3.6	-2.4	**-4.18**	**0.82**

Source: Bloomberg, authors' calculations

5. **Decline in trade** – it is possible to find certain similarities between the current situation and the economic slowdown in the Eastern Europe and Central (EECA) region in 2014-2017, caused by a drop in oil prices and global appreciation of the US dollar. The latter resulted in a sharp decline of external demand, falling commodity prices and regional currency crises, which equally affected the Georgian economy. The country's goods exports fell by 23%, while imports contracted annually by 15% in 2015. Trade was only restored to the 2014 level by 2018. While, the forthcoming crisis is expected to not only have stronger negative impacts on external demand, but also disruptions in the production value chains, affecting Georgia's trade in more severe ways. Trade of all commodities, except food and medicine, is projected to decline, depending on the duration of the shock.
6. **Decline in Foreign Direct Investment (FDI)** - foreign investors prefer to invest in safe assets. Additionally, currency depreciation expectations will negatively affect FDI. The FDI in Georgia amounted to 1,267.7 mln. USD in 2019 (7.1% of GDP).
7. **Decline in remittance inflows** – since all countries will suffer economically in the aftermath of the health and oil price crises, we expect significant slowdown in remittance inflows from the rest of the word. The remittances decline will hit Georgia particularly hard as it is among the top receiver countries of foreign transfers. For instance, in 2019, money transfer inflows accounted for 9.8% of GDP. Various scenarios for just how much Georgia is set to lose in monetary inflows is presented in the table below:

Table 4. Net change in money transfers inflow in 2020 due to coronavirus (Mln. USD)		
Scenario 1: 10% decrease of net money transfers in the remaining months of the year (March-December)	**Scenario 2:** 30% decrease of net money transfers in the remaining months of the year (March-December)	**Scenario 3:** 50% decrease of net money transfers in the remaining months of the year (March-December)
-114	-372	-629
Net change in consumption spending due to money transfers decline*		
-570	-1,857	- 3,146
Net change as a share of household total real consumption spending**		
+0.3%	-2.6%	-5.5%

* 1$ of transfers is assumed to become 0.8$ equivalent of consumption spending.
** USD/GELexchange rate is assumed to equal to the official exchange rate as for March 20th (3.1818) in the remaining months of the year (March-December). Inflation is assumed to be 6% in 2020.
Source: Geostat, NBG, authors' calculations

Supply side effects

1. Production disruptions – domestic production suffers as a result of forced business closures and the inability of workers to get to work, as well as disruptions to trade and business as a result of border closures, travel bans, and other restrictions on the movement of goods, people, and capital (in the PRC as a whole fell to 50%–60% of normal levels but is now normalizing, after the introduction of extremely restrictive measures that – so far – no country in the west has been able/willing to mimic.However, in absence of such restrictions, the crisis may be prolonged and production might be hard to restart quickly). The overall impact on production may be mitigated by the fact that in some sectors (particularly in manufacturing) production can be ramped up in later periods to compensate for lower production (providing closures do not last too long).
2. Long-term economic effects – COVID-19 will impact health via mortality and morbidity, and through changes in (and the diversion of) healthcare expenditure.

Currency depreciation

The expected decline of tourist inflows, remittances, and export as a result of reduced foreign demand from Georgia's trading partners and low world oil prices have already affected the lari exchange rate (mostly through expectation channels). On the other hand, due to restrictions on air travel, the outflow of currency from Georgia to foreign countries will be reduced (the import of tourism services will be lower), which will have a positive effect on the exchange rate. Another positive factor may be that Georgia's reliance on remittances from oil-exporting countries (like the Russian Federation) has been significantly reduced in recent years.

The situation in Georgia:

- Georgia's public finances are in a tolerable enough shape to handle a crisis. Public debt to GDP ratio is not very high (44.9% in 2018), and the government budget deficit is also below 3% of the GDP;
- The Financial system has been praised as one of the strongest among in the ECA region;
- The number of COVID-19 cases is currently relatively low, and if epidemic suppression measures succeed, the healthcare system might not be overwhelmed;
- A major weakness in the Georgian economic system lies its lack of a broad social safety net infrastructure, which could help support afflicted groups during downturns. Another weakness is the sizeable informal sector – workers in these sectors are hard to reach via conventional means;
- Annual inflation in January-February was 6.4%, which is significantly higher than the target level of 3%. Georgia is facing uncertainties in terms of inflationary expectations, and this limits NBG's ability to stimulate the economy under the current circumstances. Most probably NBG will not cut the policy rate to avoid provoking further currency depreciation and stoking inflationary expectation even further.

What have governments around the world done to contain economic fallout?

Fiscal and monetary policies target broad economic relief effort on several fronts:

Businesses

- Deferring tax payments (Sweden, Russia, US, Italy);
- Financing companies' sick leave expenses for two months and financing temporary layoffs to avoid job losses (Sweden and Italy);

- Guaranteeing loan programs to help businesses hit by the pandemic (UK, Japan, US, China, France);
- Supporting SME business investment through tax write-off measures (Australia);
- Cash flow assistance to SMEs (Australia);
- Offering wage subsidies to SMEs to keep trainees and apprentices working (Australia);
- Waving fees and charges for businesses in the tourism, agriculture, and education sectors (Australia);
- Promoting domestic tourism measures (Australia);
- Simplifying companies claiming subsidies to support those on reduced working hours (Germany);
- Companies can declare a force-majeure if they cannot honor a contract within a public sector (France).

Workers, vulnerable groups

- Paying standard sickness benefits to the self-employed for up to two weeks (Sweden);
- Offering a one-time (repeatable, depending on the length of the crisis) cash transfer to the self-employed (Italy);
- Giving paid leave for quarantined workers (Russia);
- Providing one-time cash assistance to pensioners, social security recipients, and other eligible social support recipients (Australia, US);
- Creating various measures to help companies avoid layoffs and keep workers employed (Sweden, Australia, UK);
- Suspending mortgage payments (Italy);
- Maintaining debt moratoriums for affected households and firms (Italy).

Health care systems

- Supporting municipalities by covering additional healthcare costs (Sweden);
- Providing extra funding to the healthcare system (Italy).

Financial systems

- Helping banks make funds available for lending by reducing the countercyclical capital buffer to zero (Sweden);
- Slashing policy interest rates (South Korea, UK, US, China, India, Canada);
- Introducing “quantitative easing” measures to help banks with liquidity (Japan, US, New Zealand);
- Buying sovereign bonds to allow governments the fiscal room to combat a crisis (European Central Bank).

Other measures

- Establishing a crisis fund (Russia);
- Giving firms more time to comply with environmental regulations (China).

What Georgia is doing right now to address newly emerged challenges?

The Government of Georgia timely embarked in thinking through and applying measures to address dramatic impacts on various market participants

Businesses

- Restructuring loans for businesses affected by the crisis;
- Companies that operate in the tourism industry: hotels and restaurants, travel agencies, passenger transportation companies, site-seeing companies, arts and sports event organizers, etc.,will have their property and personal income taxes deferred by the Georgian government for four months;
- Doubling the volume of VAT refunds to companies, with the aim of supplying them with working capital;

- Designing a state program to co-finance interest payments on bank loans by hotels with 4-50 rooms, throughout the country, for the next six months.

Workers

- Loan payment deferrals for three months;
- Personal income taxes deferred for employees in the tourism industry.

The financial system

- Easing lending restrictions for commercial banks;
- NBG has not cut policy rates and is unlikely to do so given the risks of inflation.

Other measures

- Boosting capital expenditure (CapEx) projects with the aim of providing additional economic incentives;
- Governmental price fixing for specific products (rice, pasta, sunflower oil, flour, sugar, wheat, buckwheat, beans, milk powder and its products) by subsidizing corresponding businesses.

Will the current measures be sufficient?

Given the rapidly changing scope of the crisis, the short answer is simply – probably not. As the forecast seems pessimistic, it is the role of the fiscal stimulus and, where possible, the monetary policy to help soften the economic shock.

It is evident that the measures adopted by the government as well as private commercial banks in Georgia will not be able to directly reach a sizeable group of the population affected by the shock – i.e. those unemployed due to COVID-19; those working in the informal sector; people with low income; or households that much depend on remittances transfers. It is important for the government to connect with these groups quickly, not only for humanitarian reasons, but also in the interest of broader development agenda. In case of relatively prolonged quarantine sizable part of the populationwill no longer be able to support themselves and their families in coming months.

What more can be done?

Below we broadly outline the additional monetary and fiscal policy measures that may be considered:

More forceful fiscal intervention:

As previously mentioned, Georgia's systemic weakness lies in its lack of a broad social safety net infrastructure, which could help target and support afflicted groups during downturns.An unemployment benefits system, which in other countries acts as an "automatic stabilizer" and reflexively reduces and mitigates the effect of economic downturns, simply does not exist in Georgia. Yet even with an unemployment benefits system in place, the sizeable informal economy would prevent such a system from effectively targeting the labor market. In the current situation, the government should attempt to provide cash relief for workers in the informal sector, for the low-income self-employed, and for independent contractors. These groups of workers are the most vulnerable to income flow reduction during the crisis, furthermore, they are unlikely to have access to sick leave benefits or to take advantage from cheaper bank credit.

Based on the experience of other countries, the government perhapsshall consider the following measures in addition to current measures:

- Providing **low interest emergency loan/cash advances to affected adults, or direct cash payments to affected households, in particular households with the elderly and children.** These measures are valuable as they can quickly reach afflicted groups.Unfortunately, this solution is not well-targeted and risks wasting government funds on those who are not disadvantaged.
- Simply providing **"helicopter money",** or cash transfers to households below a certain income threshold (similar measures are being considered in the US) may be an option, but this measure is subject to the same concerns as above. However, the advantage is that cash transfers allow households to optimize their expenditure and do not distort consumption choices.
- Another form of wide-reaching support could be state **subsidies to help supportutility payments** for a limited time. These measures, equally, are not well-targeted, nevertheless there may be methods to direct them towards households in most need.
- **Measures to encourage companies not to cut employment in the months following the crisis**: following the example of other countries, Georgia may support salary payments for companies, on the condition that they do not reduce employment or force workers to take unpaid leave.

Naturally, none of the proposed measures is prefect as they cannot specifically target those most affected by the crisis, yet they may act as a short-termsecond-best solution. As these examples show, Georgia shall consider developing p a targeted social safety net system in the future. Such a system can make the country more resilient in the face of future crises and unexpected emergencies.

Monetary policy:

While other countries push for fiscal stimulus and monetary expansion, Georgia is facing uncertainties in terms of inflationary expectations. As discussed, this limits NBG's ability to stimulate the economy under the current circumstances. Annual inflation in January-February was at 6.4%, significantly higher than the 3% target. Going forward, a sharp decline in aggregate demand would reduce the pressure on inflation, while a depreciating nominal effective exchange rate will exert upward pressure. Therefore, the possibility to reduce the monetary policy rate depends on which effect will dominate in the future. In the meantime, NBG have approached IMF to increase access to funding under its Extended Fund Facility program (NBG). Alongside the additional funds from other international donors, this will positively affect the economy, strengthen the nominal effective exchange rate and, consequently, curb inflation.

In addition to the measures already announced, **NBG has the option of decreasing the minimum reserve requirements for deposits attracted in a foreign currency. This will stimulate FX lending and economic activity, without creating depreciation or inflationary expectations**.

Overall, the Georgian government responded very timely and efficiently to contain the virus outbreak, earning well-deserved plaudits from the international community and approval from the general public. However, as the scope of the crisis continues to change rapidly, additional measures might soon be needed. As the economic landscape becomes more uncertain, the government needs to ensure that emergency economic stimulus measures directly reach the people most affected by the crisis.

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