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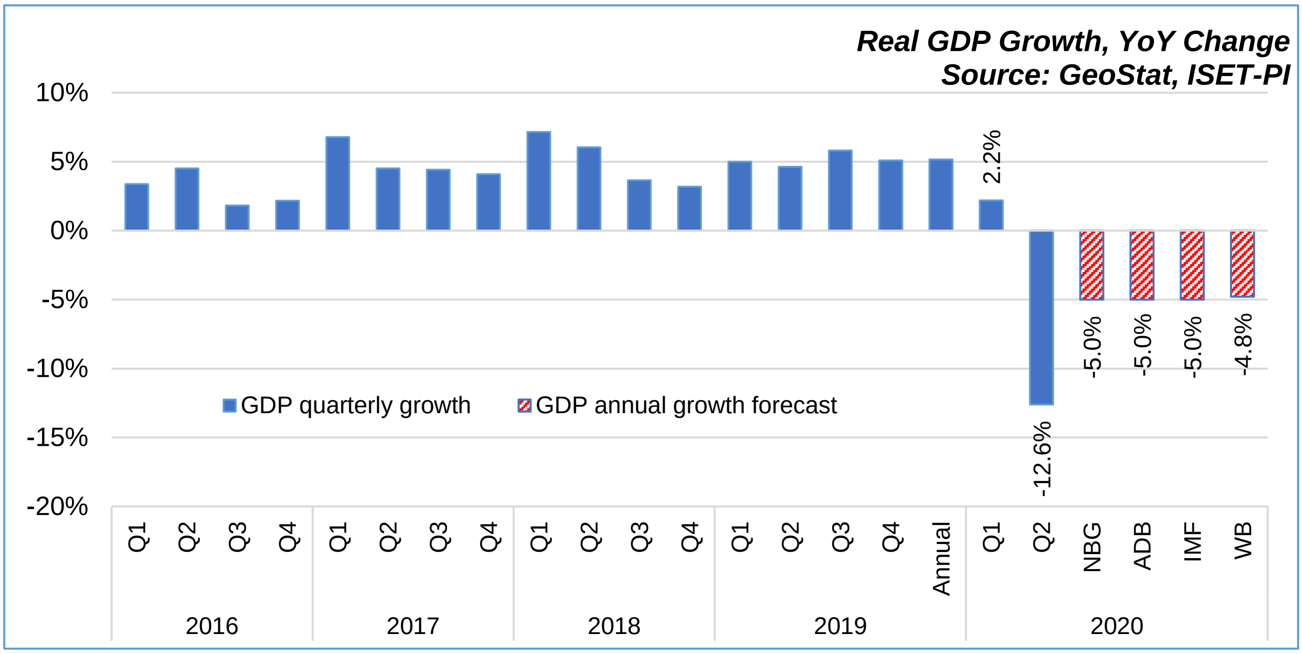
In the Eye of the Hurricane: Georgia's Economic Performance from April to June 2020

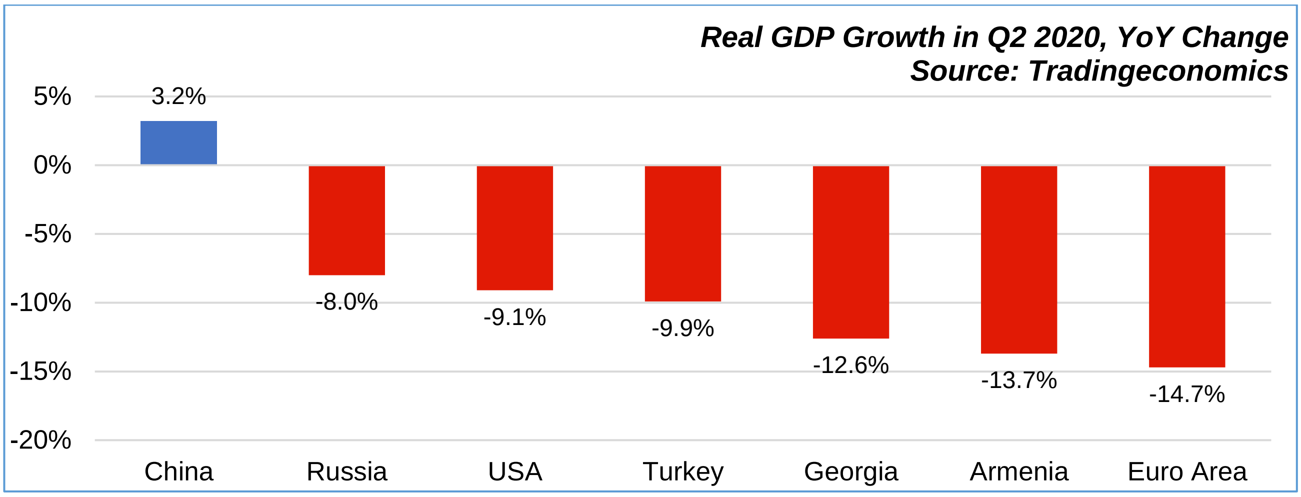
Economic Growth

The COVID-19 outbreak has negatively affected the Georgian economy through reduction in FDI, exports of goods and services, and remittances. In addition, uncertainties caused by the pandemic and containment measures hit consumption and domestic investment. As a result of this reduction in aggregate demand, combined with increased production costs due to pandemic-related constraints, GDP is expected to contract by 5% in 2020 according to NBG's latest monetary report. The growth estimate has been revised downward since May, when NBG's forecast stood at -4%. The revision was driven by weaker-than-previously-anticipated external demand, which is mainly caused by delays in the resumption of international flights. According to an alternative scenario, in which pandemic-related restrictions remain in place the whole year, a 6.5% decrease in GDP is expected in 2020.



The strict containment imposed by the government in late March and April (needed to prevent the spread of the virus) drove various forms of economic activity (especially tourism) to a standstill. According to GeoStat's latest estimates of GDP growth, Georgia's economy shrank by 12.6% y/y in the second quarter of 2020.

Fiscal stimulus combined with gradual easing of monetary policy, improved credit activity, and better-than-expected remittances helped to mitigate a deeper impact from COVID-19 in the second quarter. However, the rebound in domestic demand was overbalanced by weaker external demand, as international travel remains broadly banned and Georgia has opened its borders to only a few countries.



All of Georgia's neighboring countries[1] showed their sharpest declines in GDP since the Global Financial Crisis. The United States and the Euro Area shrank by 9.1% and 14.7% respectively, while the Chinese economy grew at 3.2% y/y. China became the first major economy to show positive growth following COVID-19.

Inflation

In Q2 2020, annual CPI inflation stood at 6.5%, which is 3.5 percentage points (pp) higher than the targeted 3%. While reduced aggregate demand drove prices down, the depreciation of the lari nominal effective exchange rate and increased production costs put additional pressure on inflation in Q2.

Among the main drivers of inflation were increased food prices (+14.8% y/y), (contributing 4.6 pp to annual inflation). At the same time, transport prices, driven by lower oil prices on world markets, dropped by 4.5%. Together with recreation and culture (-2.4% y/y) these categories drove inflation down by 0.6 pp in Q2 2020.

Going forward, we expect inflation to decline towards the end of the year: the future dynamics of price changes will be determined by lower aggregate demand, as supply is expected to gradually recover after the lifting of COVID-19-related restrictions. Therefore, holding other things constant, inflation is expected to go down in the coming quarters.

NBG started a gradual exit from the tightened monetary policy stance and reduced the rate two times in Q2 by 0.25 pp each. According to the official statement: "…*the Covid-19 prevention measures led to an increase in the cost of supply of some goods and services. However, the increase in costs has only a short-term effect on inflation rate [sic]. On the other hand, the impact of significantly weaker external and domestic demand on inflation will last longer, leading to a reduction in inflation forecasts.*"

External Sector: Trade, Tourism, Remittances, FDI

The restrictive measures to prevent the spread of COVID-19 which were introduced by the majority of countries have negatively affected not only Georgia's internal economic activity, but also international trade, tourism, and remittances. Negative growth in Georgia's main economic partners means that the demand for exports of goods and services from Georgia is lower. In addition, Georgians living abroad earn, and consequently send, less money home. Exports of goods, revenues from international travel, and money transfers all fell significantly in Q2 2020. Imports of goods and services also declined due to weaker domestic demand. Surprisingly, FDI stayed at the same level compared to the previous

[1] Real GDP growth estimate for Azerbaijan has not been published yet.

year's values despite increased economic uncertainties which could negatively affect investment decisions. The severity of the crisis depends on the duration of the pandemic and development of a vaccine; however, monthly data suggest that in the following quarters we should still expect negative, but better economic performance than in Q2.

In the second quarter of 2020, Georgia's external merchandise trade decreased by 29.7% y/y, as both exports and imports showed negative growth. The negative trade balance shrank by 36.8% as imports fell more sharply than exports.

Total exports decreased by 24.7% y/y, and amounted to 724 million USD. This decline was driven by lower re-exports of motor cars, cigarettes, and medicaments to Armenia and Azerbaijan, exports of wine and chemical fertilizers to Ukraine, and ferro-alloys and mineral water to Russia. At the same time, exports of copper and gold increased to the EU and China in the second quarter of 2020. Exports to all of the main destination markets except China saw a drastic decrease in Q2. Georgian exports to China skyrocketed by 531% y/y, reflecting its better economic situation compared to other partners.

Imports amounted to 1,577 million USD in Q2 2020, a 31.8% annual decrease. Exchange rate depreciation, economic uncertainties caused by the pandemic, and job cuts drove demand on all types of imported goods down. Imports of motor cars (-58.9% y/y), telephones (-43.4% y/y), copper (-16.2% y/y), and petroleum (-57.4% y/y) all showed double digit negative growth rates. Interestingly, in Q2 2020 Georgia imported 36 million USD of precious metal ores—more than it has in the last 20 years. Despite the unprecedented decline in values, the main source markets for Georgian imports in Q2 remained the same with Turkey (-39.4% y/y), Russia (-17.8% y/y), and China (-31.1% y/y) leading the list.

The full effect of COVID-19 on international travel to Georgia was observed in Q2 2020. Following restrictions on international flights to Georgia and closure of the state border earlier in March, the number of international travelers declined by 94.3% y/y. At the same time, revenues from international travelers fell by 96.7% y/y. The pandemic and virus containment restrictions affected domestic travel as well. The number of Georgian resident visitors traveling inside the country decreased by 37.2 % y/y in Q2 2020.

According to NBG, the volume of total remittances to Georgia amounted to 380.2 million USD in Q2 2020, a 10.9% annual decrease. This figure was mainly driven by lower money inflows from Russia (-37% y/y) and Israel (-20.6%y/y). At the same time, remittances from Italy (+16.7% y/y) and Azerbaijan (+100.8% y/y) positively contributed to annual change in money inflows to Georgia.

FDI in Georgia amounted to 237.8 million USD in Q2 2020, which is 0.5% higher than the adjusted data from Q2 2019. The positive annual change in FDI, considering the uncertainties and economic crisis stemming from the pandemic, can be explained by two factors: a) the low base effect—despite the increase, FDI was at its lowest level since 2009 in the first half of the year, b) investors have positive expectations about long-term economic growth.

According to the IMF, the current account deficit is expected to increase to 11.3% of GDP in 2020, from a record low of 5.1% the previous year. This increase in economic uncertainty will lead to significant deterioration of financial accounts, as net portfolio and FDI inflows are expected to decline. As a result, an additional financing gap of BoP is estimated at $1.35 billion, which will be closed by borrowing from international donors.

Public Finances

In June 2020, the Parliament of Georgia adopted a revised version of the State Budget, which includes a 3.4 billion GEL anti-crisis plan to support vulnerable populations, businesses, and the financial sector. The package includes 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. As a result of increased government spending to mitigate the impact of COVID-19 and a revenue shortage of 1.8 billion GEL (mainly caused by lower tax collection), the budget deficit is projected to widen by 6 pp compared to the initial budget. The resulting budget deficit would constitute 8.5% of GDP in 2020.

Budget data in Q2 2020 reflected the impact COVID-19 had on the economy. Total revenues to the general budget amounted to 2,845 million GEL, an 11.6% y/y decrease. The latter was driven by lower tax collection (-13.6% y/y) as revenues from income tax (-12.2% YoY), profit tax (-35.9% y/y), and VAT (-25.6% y/y) showed a negative trend in Q2 2020. However, revenues from excise taxes increased by 35.5% y/y.

Current governmental expenditures increased by 12.1% y/y in Q2 2020 (and amounted to 2,968 million GEL). This growth was mainly driven by higher spending on social benefits (+26.1% y/y). In addition, the Georgian Government paused some infrastructural projects—net acquisition of non-financial assets decreased by 9.9% y/y in Q2 2020 to 636 million GEL.

Overall, in Q2 2020, the budget deficit amounted to 760 million GEL, 5.5 times higher than in the same period of the previous year. Government debt increased by 21.8% y/y and amounted to 23,347 million GEL. Furthermore, the share of foreign debt in total debt stood at 77.1%.