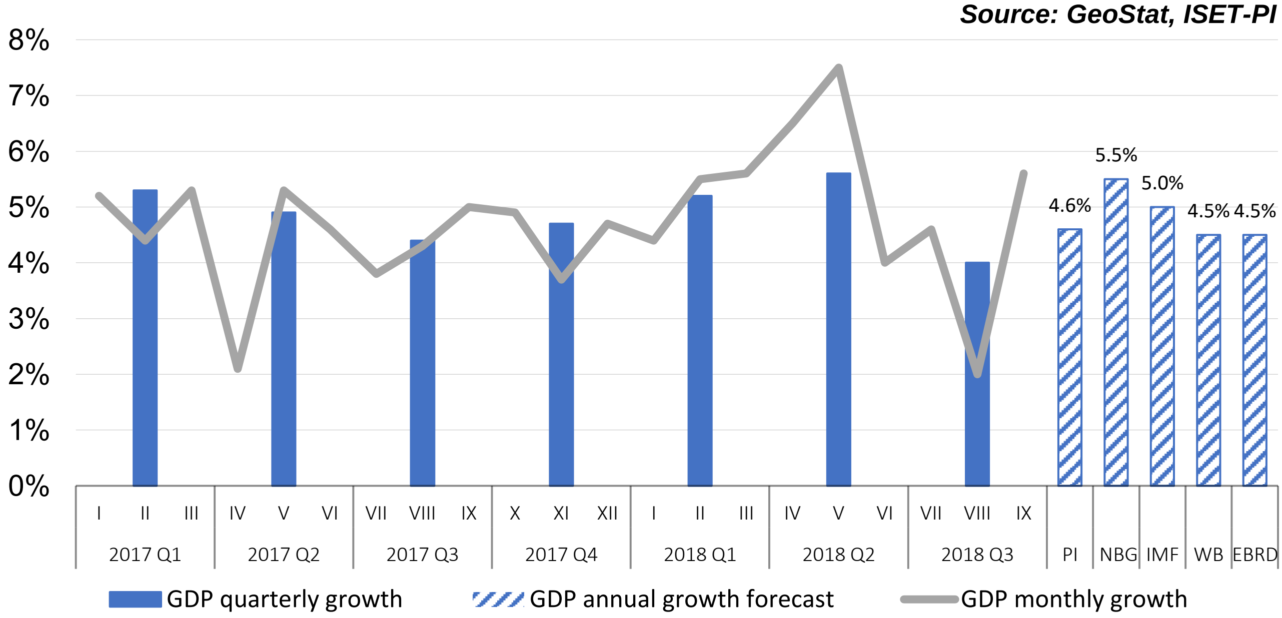
Authors: Yaroslava Babych and Giorgi Mzhavanadze

Economic growth in Q3 is considerably weaker than in the first half of the year. Domestic retail and business loans show strong growth despite new tougher regulations on credit.

Economic Growth

According to Geostat's figures, in the third quarter (Q3) of 2018, Georgia's real GDP experienced growth of 4% year over year (YoY). Despite the slowdown of the growth rate compared to the previous quarters, IMF recently revised their forecast of economic growth for Georgia upwardly, from 4.5% to 5.0%. Forecasts for other international organizations and the National Bank of Georgia (NBG) remained the same, while ISET-PI, based on October's data, expect annual growth in 2018 to be 4.6% YoY.

Real GDP Growth, ISET-PI Forecast, YoY Change
Source: GeoStat, ISET-PI

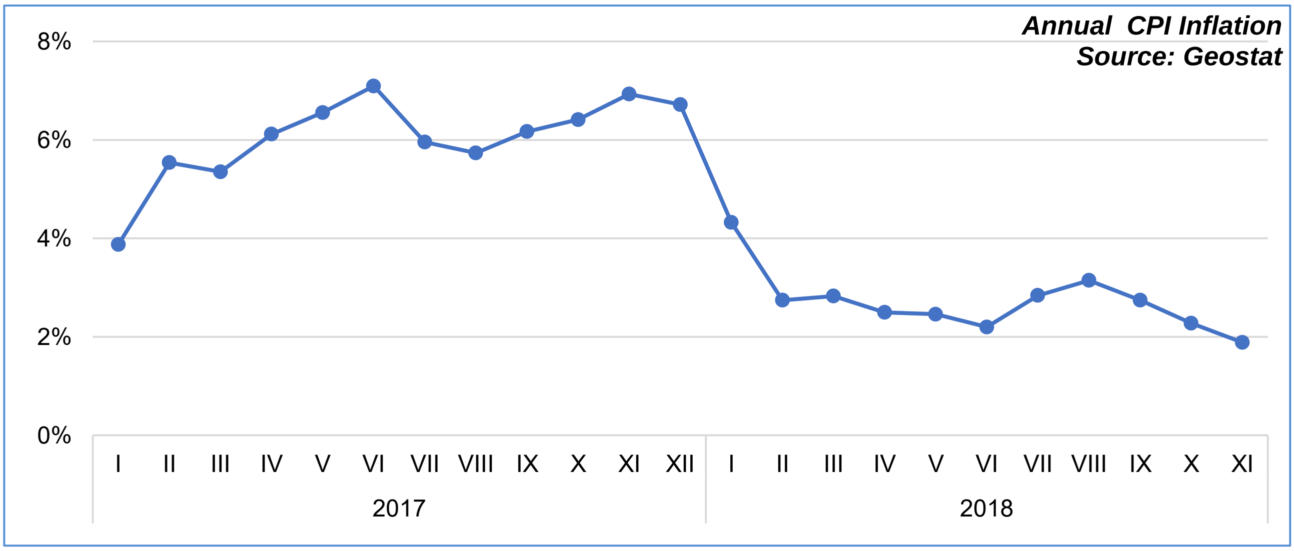


The weakening of regional economic conditions are the main factors negatively affecting the Georgian economy in Q3. Recent developments in Turkey, caused by the US tariffs imposed on Turkish steel, uncertainty around the Central Bank's policy and its independency, together with an accelerated fiscal stimulus, negatively affected Georgia via lower revenue from trade, remittances and tourism. According to IMF, the sharp depreciation of the Turkish lira and double-digit inflation will deteriorate the economic performance of country in 2019, and furthermore, create downward spiraling risks for Georgia. The average growth rates for other neighboring countries in Q3 2018 have also reduced markedly - 3.9% YoY in Armenia, 1.5% YoY in Russia, and only 0.6% YoY in Azerbaijan.

While internal factors, such as lower government capital spending, caused by a weak budget execution, together with deteriorating business sentiments, have hindered real GDP growth in the current quarter, meanwhile expanded credit activity has stimulated economic growth.

Inflation

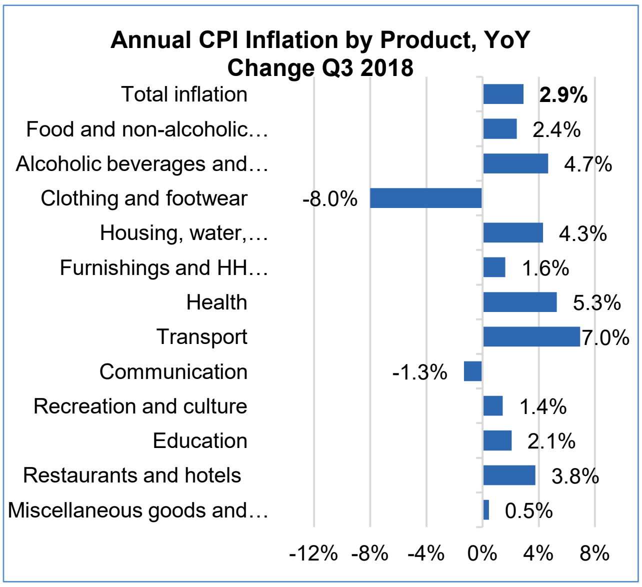
In Q3 2018, the CPI inflation rate fluctuated around NBG's 3% target, and stood at the 2.9% level. While the increased oil price within international markets was the main driver of CPI inflation in Q3, the appreciation of the real effective exchange rate, and a weak aggregate demand, kept inflation close to its target.

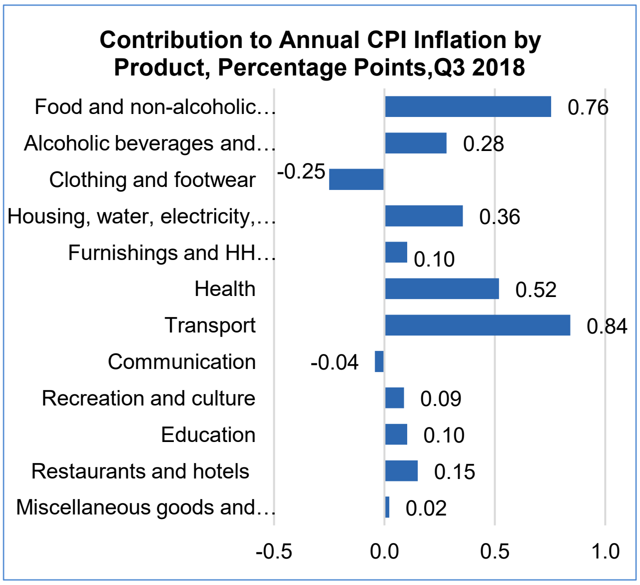


As a result of higher oil prices, Transport costs increased by 7% YoY in Q3. This, alongside the price increase of Food and Non-alcoholic Beverages (+2.9% YoY), contributed 1.6 percentage points (pp) to the overall CPI inflation. The increase in water and electricity tariffs, since January 2018, have also had a perceptible effect on inflation. The contribution of these subsequent factors to the Q3 consumer price increase was 0.36 pp.

The price of clothing and footwear dropped by 8% YoY. This decrease can be explained by the real depreciation of the Turkish lira against the Georgian lari, where Turkey remains the main import source of textiles and apparel in Georgia. Together with the decreased cost of communication (-1.2% YoY), caused by the abandoned excise tax on mobile communication services in January 2018, these factors drove annual inflation down in Q3 2018 (contributing -0.29 pp to total inflation).

According to NBG's forecast made in November 2018: *"…forecast, inflation will remain close to the target level of 3% for the remainder of 2018, as well as in the medium term. In the forecast, imported inflation – stemming from the appreciation of the nominal effective exchange rate and continued weak aggregate demand – creates downward pressure on overall inflation; however, over the course of next year this pressure will be balanced by the effect of increased prices on petrol and petrol related products. Alongside the elimination of these one-time factors in the medium term, aggregate demand is also expected to increase to the potential output level – keeping inflation close to the target.*

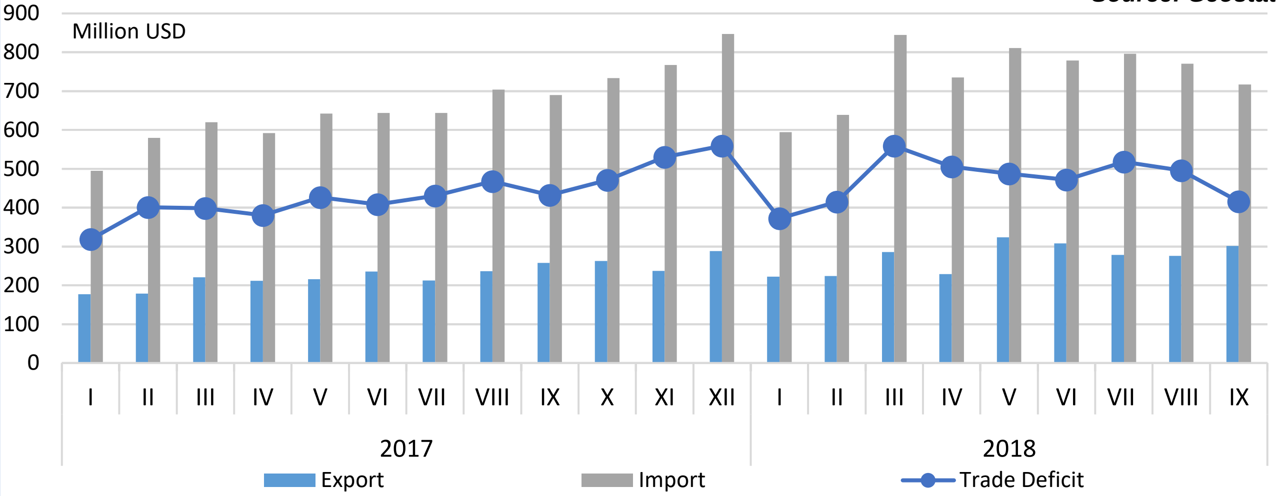




External Sector

The external merchandise trade in Georgia increased by 14.5% YoY in Q3 2018, driven by both export and import growth. Due to deteriorating external conditions, the growth rate was considerably lower than earlier in 2018 (23.8% YoY in Q1 and 25.4% YoY in Q2).

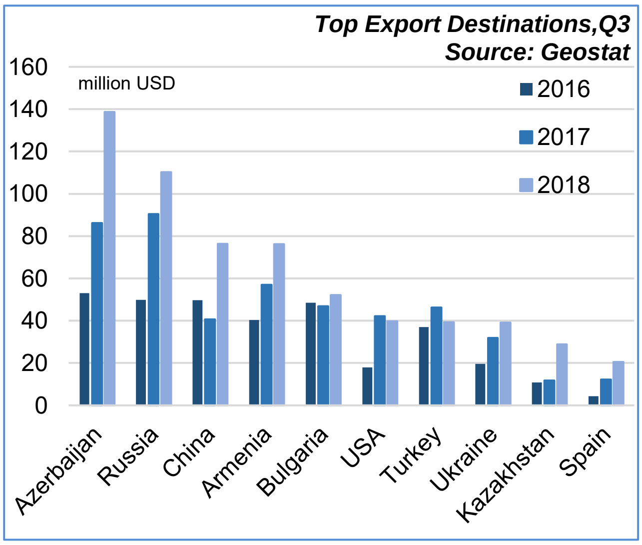
Trade Balance
Source: Geostat

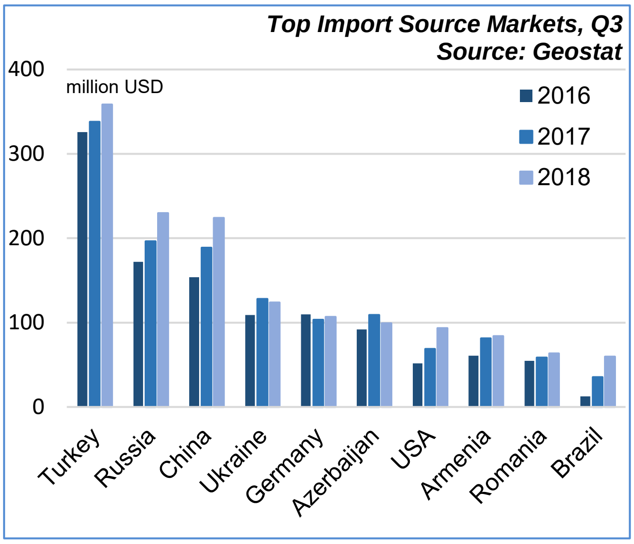


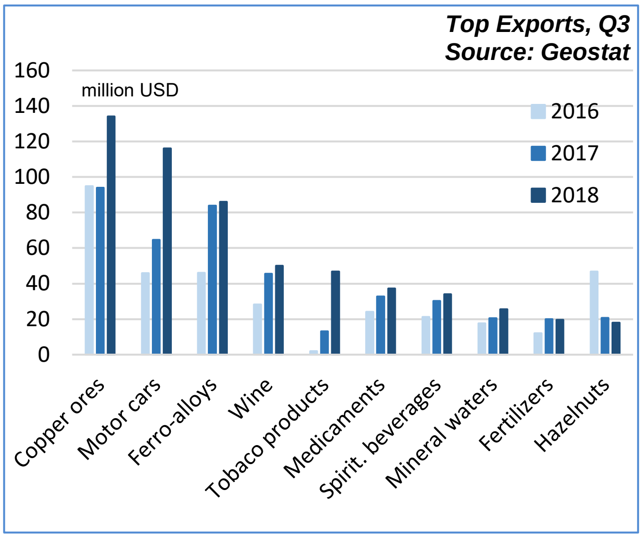
Total exports were up by 21.2% YoY, and amounted to 855.6 million US dollars. As in the previous quarter, growth was driven by the nearly doubled re-exports of cars, a 43% increase of copper ore exports and the tripled exports of tobacco products. The Georgian hazelnuts industry continued to experience hardships, caused by the invasion of the Asian stink bug and fungal diseases – the export of hazelnuts declined by 13% YoY.

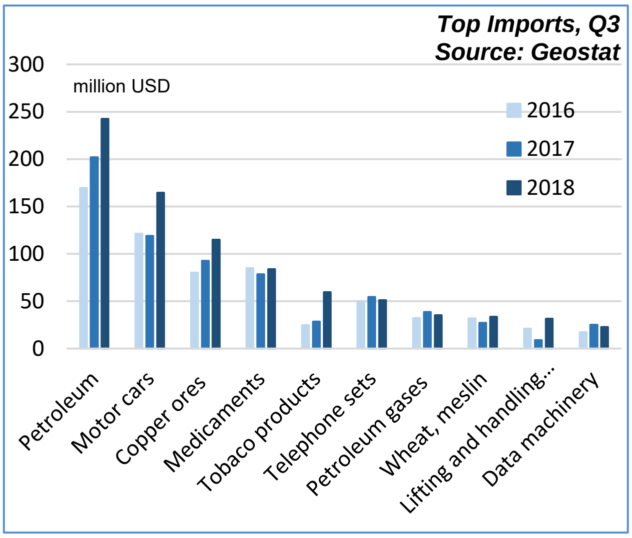
Overall in Q3 2018, the key destination markets for Georgian export products were Azerbaijan (16.2% of the total), Russia (12.9%), China (8.9%), Armenia (8.9%) and Bulgaria (6.1%). Due to the poor economic conditions in Turkey, their Georgian imports contracted by 15% YoY in Q3. Despite the benefits and opportunities of DCFTA with the EU, Georgian exporters still prefer to sell their products in countries with looser regulations and lower quality requirements. In Q3 2018, exports to the EU were down by 1.5% YoY, while exports to CIS countries surged by 41.8% YoY (exports to other countries increased by 9.6% YoY). As a result, 51.6% of total exports landed in CIS countries, once again highlighting the problems of low diversification of trade and high exposure to regional shocks.

Imports amounted to 2,284.2 million US dollars in Q3 2018, a 12.1% YoY increase. This figure was primarily determined by automobile imports (38.5% YoY) and petroleum imports (+20.1% YoY). The latter was in turn determined by higher oil prices across international markets (the amount of imported petroleum was nearly the same as in the third quarter last year). Imports of tobacco products (+110.6% YoY), copper ores (+24.3% YoY), and lifting and handling machinery (+253.4% YoY) were among the other crucial drivers behind the increase in imports during the period. In Q3, the main source markets for Georgian imports were Turkey (15.7% of the total), Russia (10.1%), China (9.8%), Ukraine (5.4%), and Germany (4.7%). Because of the still growing imports, the negative trade balance deepened by 7.3% YoY.





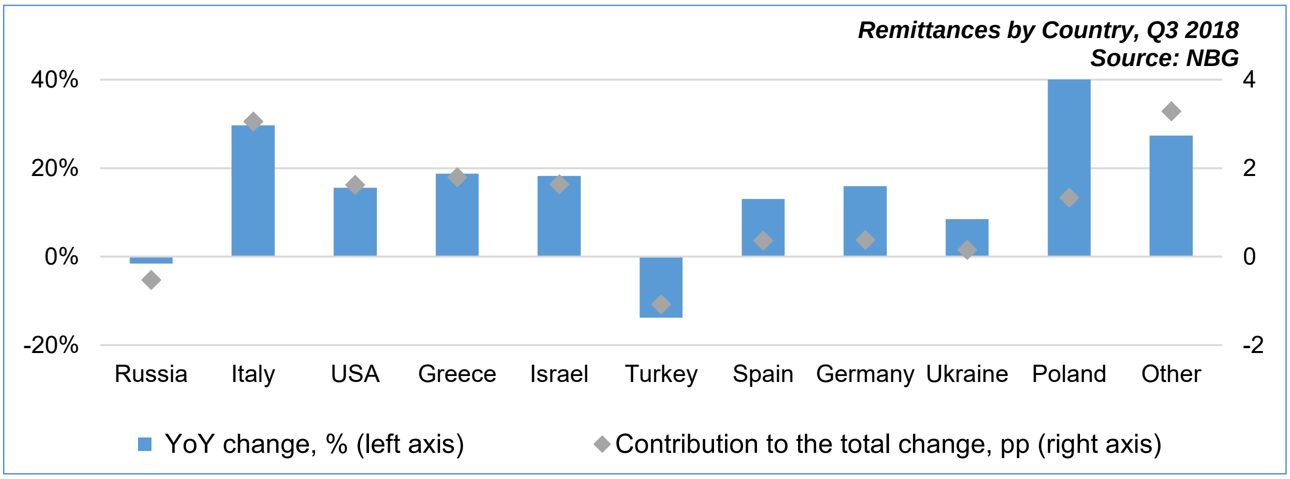




Both tourism and remittance transfers maintained double-digit annual growth in Q3 2018. The number of tourists (visitors who spent 24 hours or more in Georgia) increased by 12.8% YoY. As ever, the greatest proportion of Georgia's total visitors came from its neighboring countries – Russia, Azerbaijan, Turkey, and Armenia. The YoY percentage increase leaders of international visitors were Germany (+59.8% YoY), Belarus (51.9% YoY), Israel (33.7% YoY), Poland (31.7% YoY) and India (30.9% YoY). Meanwhile, tourists from Iran shrank by 26.3% YoY.

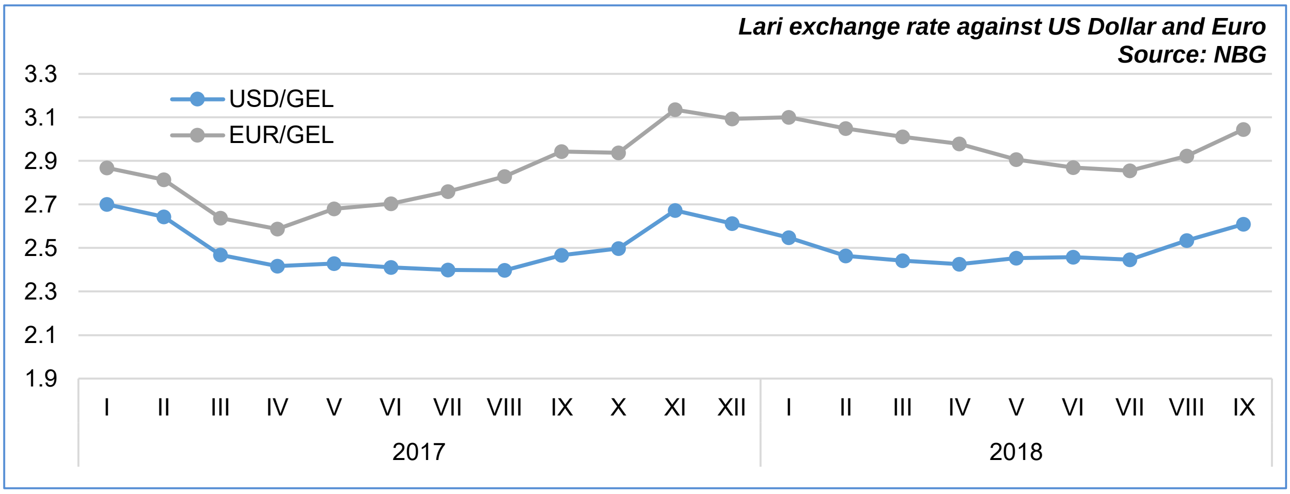
Driven by the higher inflow of money transfers from Italy (+29.7% YoY), Greece (+18.7% YoY), Israel (+18.2% YoY), and the USA (+15.6% YoY), the volume of total remittances to Georgia increased by 12% YoY in the reporting period, and amounted to 411.2 million US dollars. For the first time, Poland was in top ten source countries of remittances with a 653.4% YoY surge. Monetary inflows from Turkey (13.8% YoY) and Russia (-1.6% YoY) showed negative growth rates, reflecting their deteriorating economic conditions and the depreciation of local currencies against the US dollar.

In Q3 2018, the volume of foreign direct investments (FDI) equaled 322.6 million US dollars – a 48.2% drop compared to the same period last year. The decrease in FDI levels was expected, as BP (the main source of FDI in Georgia for the last twenty years) completed its construction of gas and oil pipelines in the South Caucasus. The manufacturing sector was the largest recipient of FDI, receiving 17.5% of the total. The energy and transport sectors were also significant recipients of FDI, receiving 14.3% and 14.1% of the Q3 total FDI.

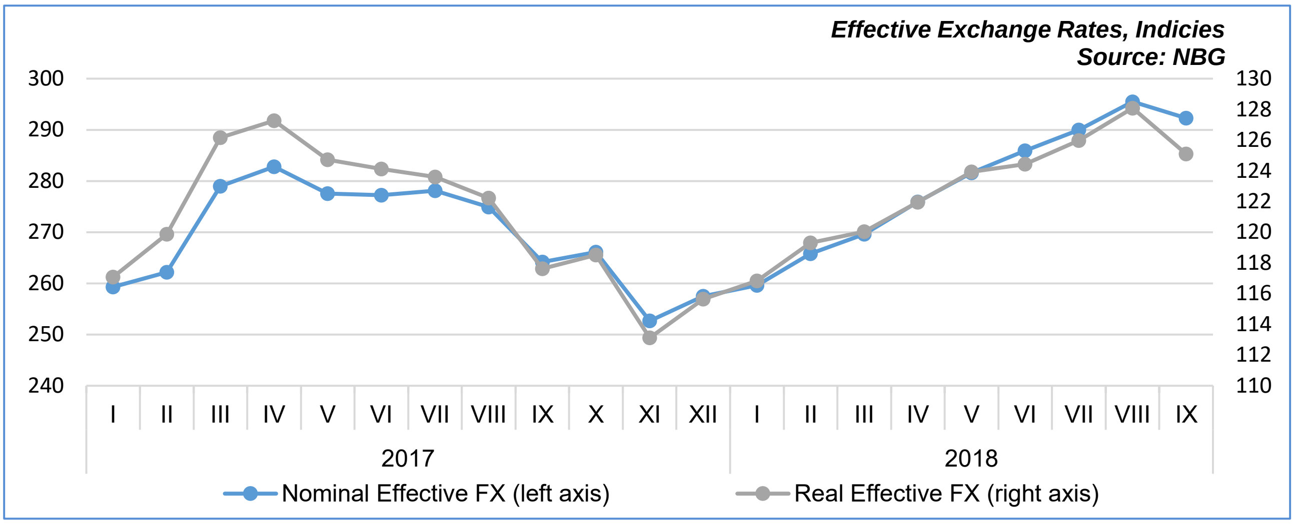


Exchange Rate

Negative developments with Georgia's main trading partners (mainly in Turkey) and lower FDI influxes in Q3 2018 was reflected in the national currency's nominal exchange rate. Compared to the previous quarter, the lari depreciated against the US dollar and the euro by 3.5% and 0.8% respectively. However, it appreciated against the Turkish lira by 19.1% and by 2.4% against the Russian ruble.



These currency trends were subsequently reflected in the effective exchange rates. In comparison to the previous quarter, the Georgian lari in Q3 appreciated in both nominal and real terms by 4.1% and 2.4%, respectively. In annual terms, the appreciation was even higher – 7.9% YoY and 4.0% YoY. This signifies that Georgian export goods and services became more expensive, while imports prices lowered.

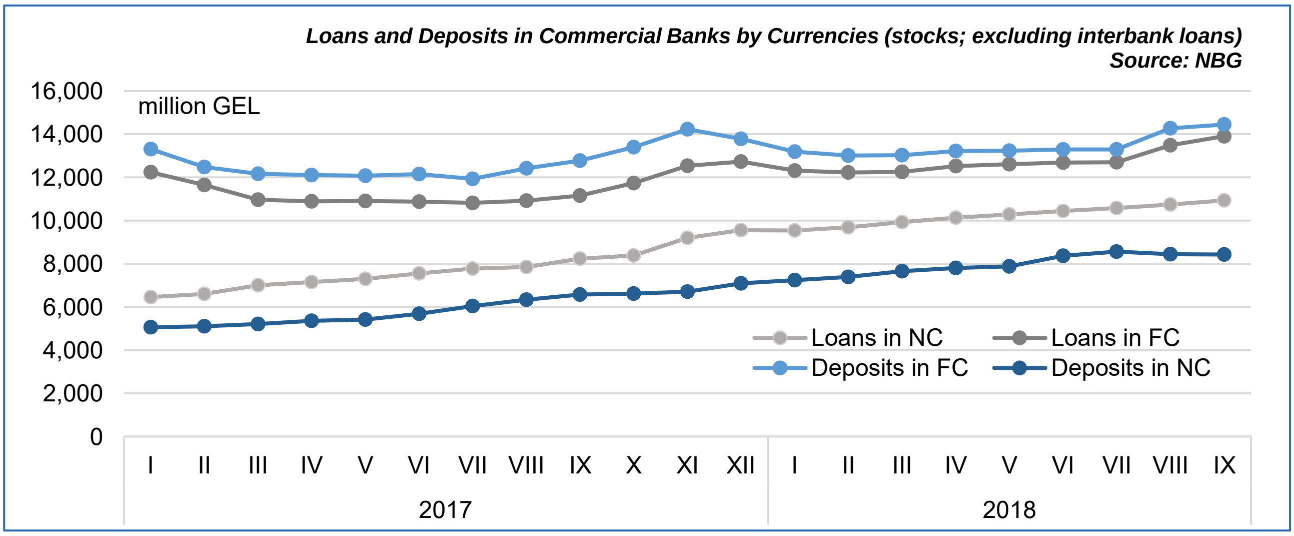


**Higher index means appreciation and vice versa*

Despite the nominal depreciation of the lari against the US dollar, in the third quarter of 2018, NBG managed to buy 62.5 million US dollars across six auctions, in order to fulfill the IMF foreign reserves requirement.

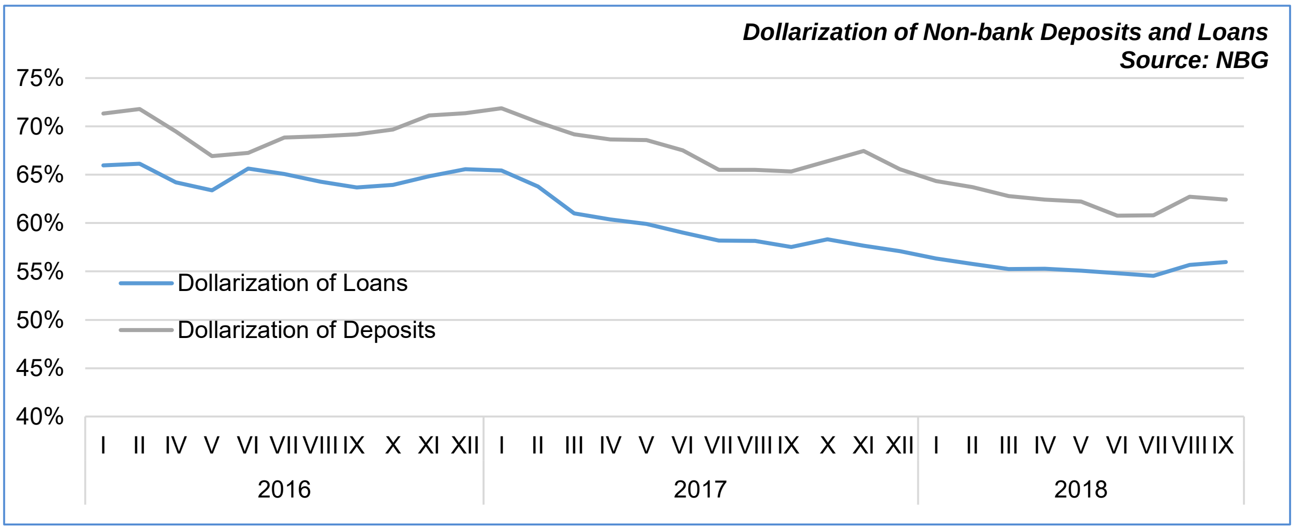
Credit Market

In Q3 2018, the total number of loans (stocks) granted by commercial banks, excluding interbank loans, increased by 28.1% YoY. The growth was driven by both the acceleration of retail (+29.9% YoY) and business loans (+25.9% YoY). NBG's new regulations for retail loans, implemented in May 2018, which aim to avoid the extensive growth of retail loans over the transitional period and decrease the amount of high-risk financial products on the market, appear not to have had a negative effect on the credit market.



The total deposits of enterprises and households in commercial banks also showed a significant increase of 18.2% YoY in Q3 2018. As with loans, both deposits made by individuals and legal entities contributed considerably to this growth, by 21% YoY and 15.3% YoY, respectively.

The results of the dedollarization measures, implemented in the beginning of 2017, have already had an effect in the short-term. In Q3 2018, the dollarization of both loans and deposits fell by 1.5 and 2.9 pp respectively, compared to the same period of the previous year. However, the recent depreciation of the lari against the US dollar halted the process, and dollarization increased compared to the previous quarter, by 1.2 and 1.7 pp, respectively.



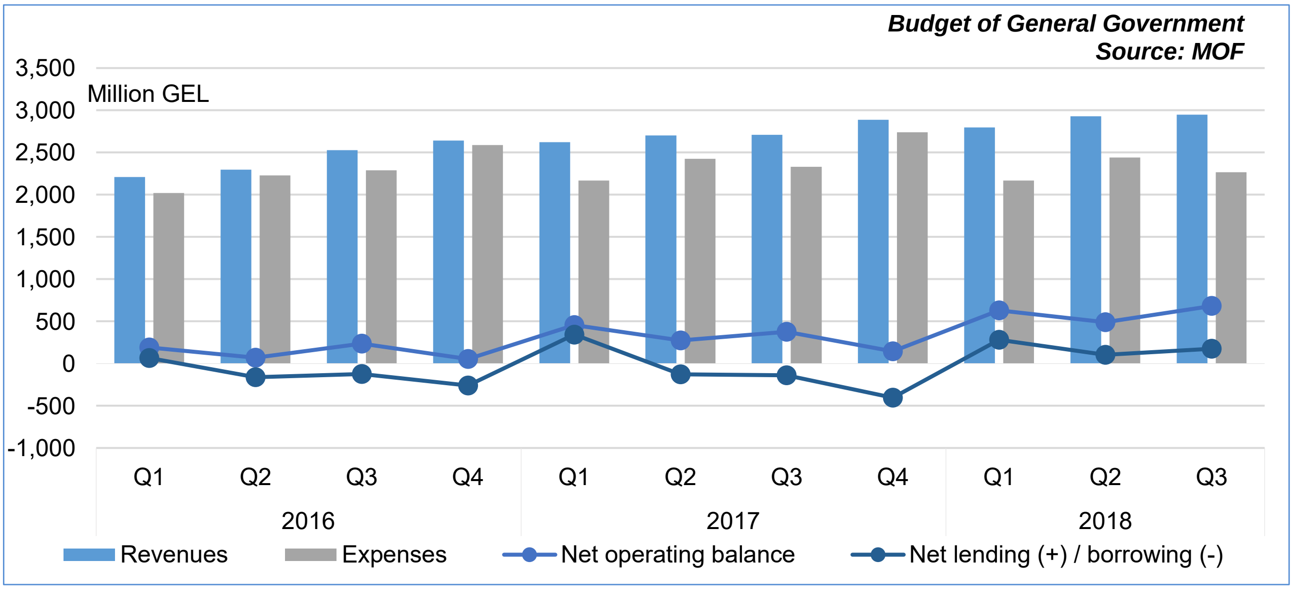
Budget

Prompted by effective tax collection and income from grants, general government revenues increased by 8.8% YoY in the reported quarter. The main sources of increase were the revenues from personal income tax (+12.5% YoY), profit tax (+40.3% YoY) and excise tax (+13.1% YoY).

Concurrently, governmental expenditures decreased by 2.8% YoY, while the net acquisition of nonfinancial assets fell by 1.4% YoY. These statistics underline the poor execution of budgetary expenditure,[1] caused by delays in infrastructural projects; they also create macroeconomic risks and negatively affect economic growth. The use of goods and services (-8.2% YoY) alongside other expenses (-25.6% YoY) were the factors which drove expenses down the most, while other budget categories showed moderate annual growth within this quarter.

As a result, the Q3 2018 general budget was in surplus by 173.6 million lari, which is 310.9 million lari higher compared to the same period of the previous year.

The general governmental debt of stock totaled 16.9 billion lari, a 6.9% YoY increase. This amount is constituted of 22.3% domestic debt and the remainder, 77.7%, is foreign debt.



[1] The current expenditures are executed by 94.3% (meaning that of all expenditures planned for the first 9 months only 94.3% have been fulfilled), while net acquisition of nonfinancial assets was fulfilled only by 76.3%, in the first nine months of 2018.