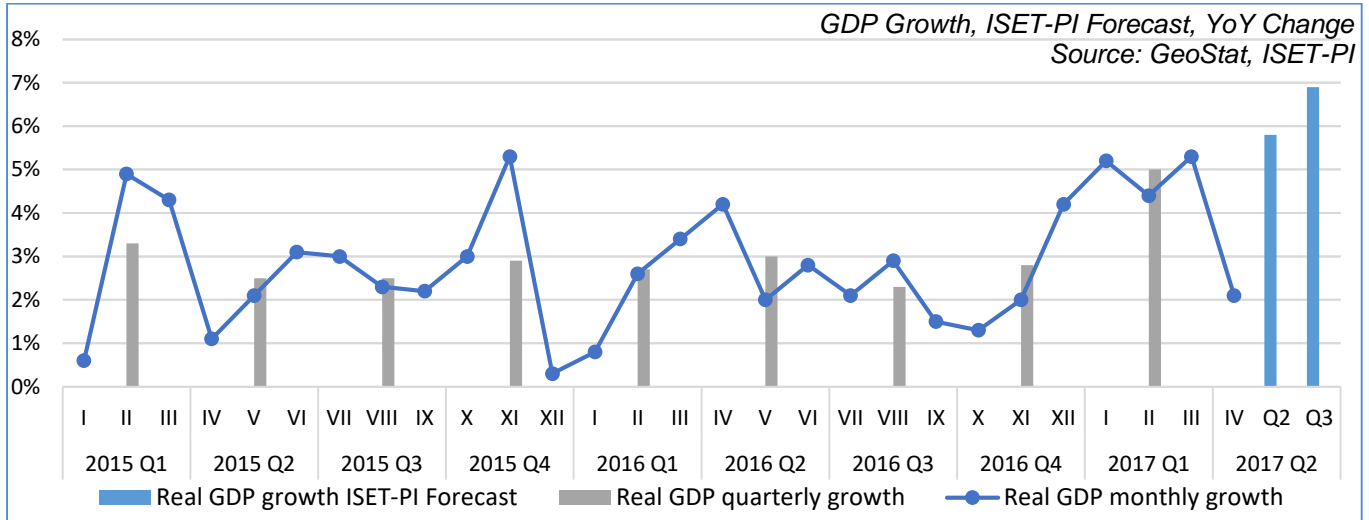




Regional trade turnover, tourism and remittances are on the rise, and so are hopes for recovery in Georgia

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Growth soared in the first quarter of the year, but is the trend sustainable?

According to the preliminary statistics released by GeoStat, Georgia’s GDP in Q1 of 2017 grew by 5.0% YoY – the **highest growth rate since Q3 2014**. What lies behind such spectacular growth numbers? First and foremost, it stems from the genuine **improvement in the economic situation in the region, which has resulted in increased exports, FDI, tourism, and remittances**. Secondly, the sharp increase in the growth rate in December 2016 “lifted” the GDP base and allowed normal GDP improvements to look even better compared to last year’s levels.

In April, however, the real GDP growth rate fell sharply to 2.1% YoY, somewhat dampening hopes for swift growth in 2017.

Sharp rises and falls of the year-on-year growth rate from one quarter to the next are not usual. Typically, quarterly growth rates follow particular patterns, which are captured by ISET-PI’s empirical forecast model. Therefore, the unusually high growth in the first quarter could result in overly optimistic predictions about the next quarter’s performance. Indeed, according to ISET-PI’s recent GDP growth forecast, predicted growth in the second and third quarters of 2017 stood at 5.8% and 6.9% respectively.

Moreover, based on Q1 data, our model expects annual growth in 2017 to be 6.2% in the worst-case or “no growth” scenario, and 6.6% in the best-case or “average long-term growth” scenario. Our “middle-of-the-road” scenario (based on average growth in the last four quarters) predicts 6.3% real GDP growth in 2017. These numbers seem to be overly optimistic, considering the state of the economy in Georgia and the region as a whole. International organizations (the ADB, IMF, and WB) have recently lowered their annual forecasts for Georgian growth in 2017 to 3.5%-3.8%; however, Georgia’s growth still remains the highest among countries in the region.

Money market: the NBG intervenes to keep inflation in check

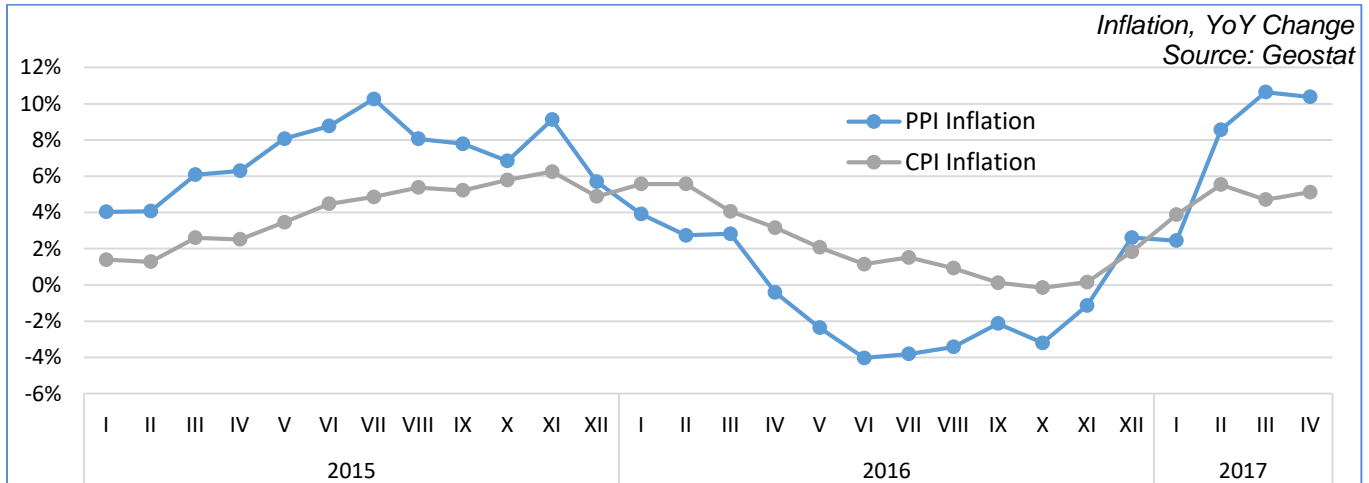
After a period of leveling off, the NBG once again intervened by tightening the monetary policy rate. The policy rate was increased two times in January and May 2017 from 6.5 to 7%.

The main factor behind the NBG’s decision was a shift in the price level caused by a hike in excise taxes. Indeed, according to Geostat, both producer and consumer prices showed a significant increase in January-April 2017. The PPI had 8% inflation, while the CPI stood at 5.2% (above the 4% annual target).



The NBG announced that "due to supply side pressures, inflation is expected to be above its target rate during 2017. Nevertheless, once the effect of one-time factors affecting CPI inflation is exhausted, the inflation rate is expected to decline at its target level in 2018". Therefore, there is **no expectation of further increases in the monetary policy rate**. On the contrary, in the medium term given the absence of additional shocks, we expect interest rates to level off once again.

Inflation trends of 2017



The decomposition of the consumer price index shows that the main drivers of inflation in the first four months of 2017 were transport (+16.2% YoY), food and non-alcoholic beverages (+5.4% YoY), and alcoholic beverages and tobacco (+16.4% YoY). The hike in excise taxes on gasoline, diesel, and gas resulted in approximately 10-15% higher prices of fuel. Additionally, fuel prices increased on world markets in annual terms – the IMF fuel (energy) index saw an average 48.3% YoY increase in January-April 2017 compared to the same period last year.

Taken together, these developments **directly affected transportation costs and, therefore, prices of other product categories, especially food prices** (the IMF food price index was up 8% YoY in January-April). Tobacco products also showed high annual inflation due to increased excise tax on cigarettes. Combined, these categories (transport, food, alcohol & tobacco) contributed 4.6 percentage points (pp) to annual inflation in January-April 2017.

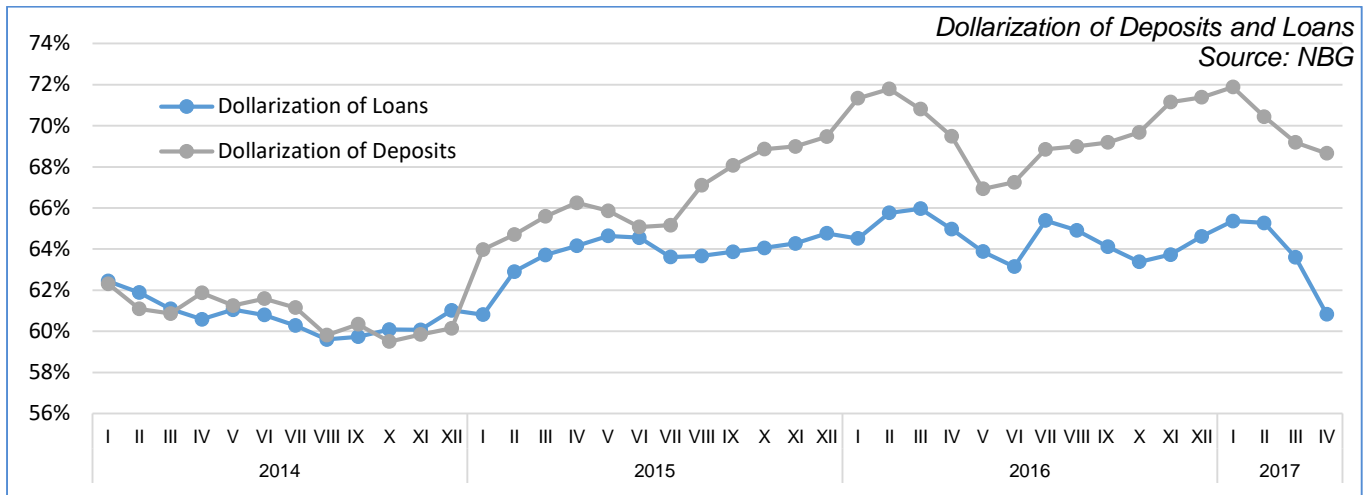
Financial sector: de-dollarization efforts are paying off, but lari interest rates may rise further

Total loans (stocks) granted by commercial banks¹, amounted to 18.533 billion GEL in April 2017 – a 15.1% YoY increase (a 10.7% YoY increase excluding the exchange rate effect). Total deposits of enterprises and households amounted to 16.133 billion GEL – a 13.1% YoY increase (an 8.2% YoY increase excluding the exchange rate effect).

Dollarization rates of non-bank loans and deposits decreased in the first four months of 2017, to 59.2% and 68.7% respectively. While the lari appreciation against the US dollar played a significant role, it seems that the **de-dollarization policy implemented by the NBG has started to work**. Excluding the exchange rate effect, the dollarization rate of loans decreased by 2.1 pp, while deposit dollarization fell by 1.2 pp.

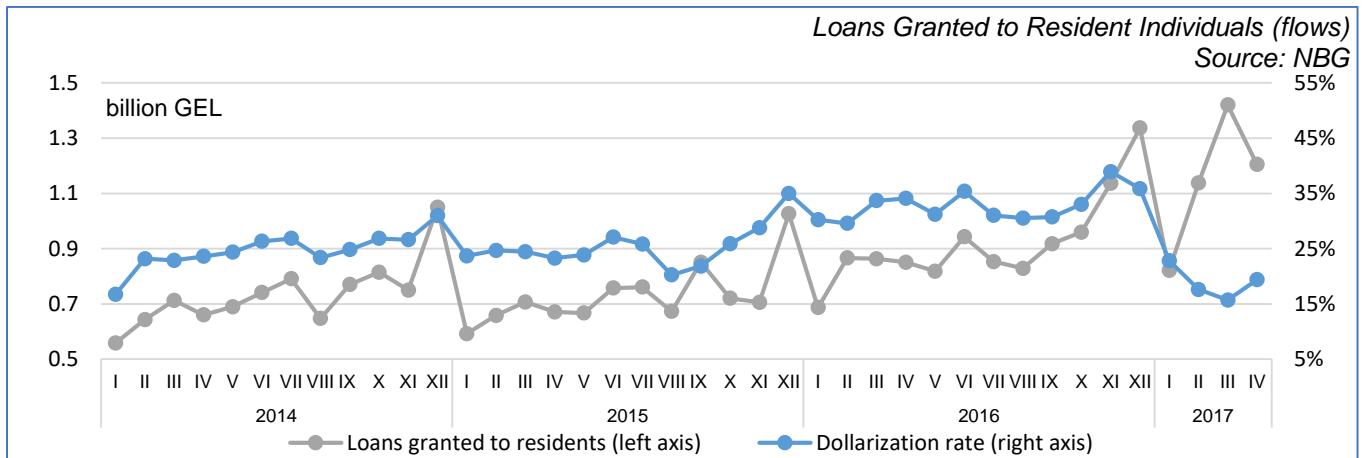
Macroprudential mechanisms to reduce dollarization rates mainly targeted loans granted to individuals (by prohibiting small foreign currency loans). The effect of this policy on dollarization was remarkable – only 20% of loans were taken in foreign currency in April 2017 – a huge decline compared to 34% of such loans in April last year. At the same time, the overall volume of loans was not negatively affected, which was one of the concerns about the new regulations. However, as the dollarization of deposits remains high and demand for loans in the national currency artificially increased, commercial banks experienced a liquidity problem in lari. This caused an **increase in the market interest rate on lari loans, which rose by 2.8 pp in January-April to 21%**. This rise in market interest rates could also be partially explained by the increase of the monetary policy rate in the beginning of 2017.

¹ Excluding interbank loans.



It is obvious that more time is needed to analyze both the effectiveness of the de-dollarization policy and the ability of NBG to handle the increasing gap between dollarization rates on loans and deposits. International practice suggests that there are no quick ways to influence businesses' and individuals' willingness to save in national currency. The transition to lari is expected to happen over time, with macroeconomic stability being the primary driver.

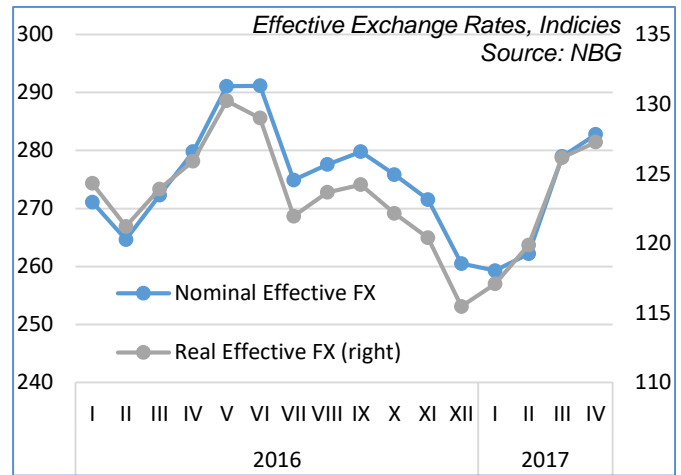
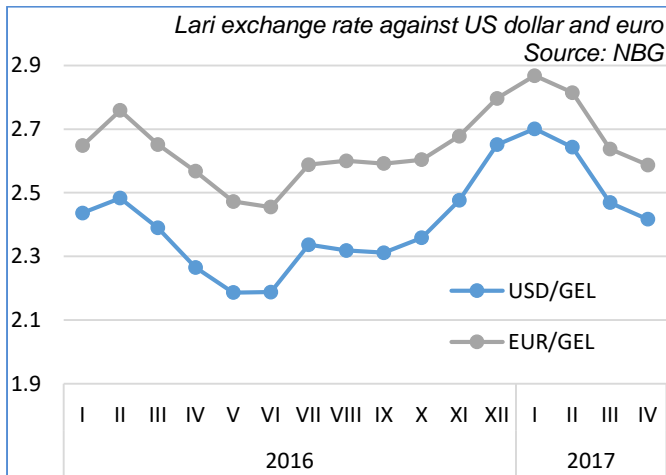
Additional de-dollarization measures are set to come into effect on 1 July. According to changes in the organic law, services and property sales will have to be advertised in lari. As the real estate market and automobile industry are probably the most dollarized sectors of the Georgian economy the changes in the law aim to increase demand for lari and indirectly affect deposit dollarization.



Exchange rates: The lari appreciates against trading partner and major currencies, but is it good news?

In January-April 2017, the lari saw gradual appreciation against the US dollar and the euro. The average monthly exchange rate against the US dollar decreased from 2.7 in January to 2.42 in April, and against the euro from 2.87 in January to 2.59 in April. However, in April the lari depreciated against US dollar (+6.7%) in annual terms and was flat against the euro.

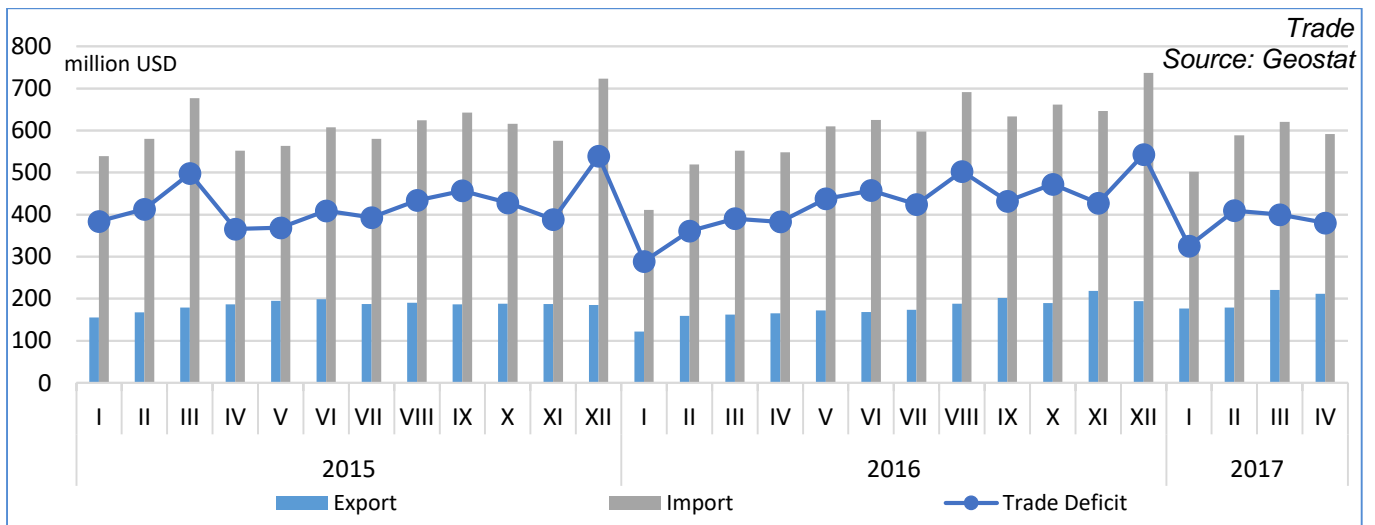
The Georgian lari also appreciated against the currencies of Georgia's main trading partners. This was caused by **positive dynamics in FDI, exports, remittances and tourism**. The nominal effective exchange rate appreciated by 9.1% in January-April (1.1% YoY), while the real effective exchange rate appreciated by 8.7% (1.1% YoY). This means that Georgia's main trading partners had higher annual inflation rates and Georgian export goods became relatively more expensive (less competitive).



The NBG only intervened in the foreign exchange market in April, performing two buying auctions of 19.75 million USD to smooth out the lari appreciation.

Regional trade turnover shows signs of recovery. Russia becomes the largest export market for Georgian goods

The first four months of 2017 reflected a **recovery in regional economic trends on trade turnover**. Exports constituted 788.1 million USD (+29.6% YoY), while imports amounted to 2,302.7 million USD (+13.4% YoY). As a result, the trade deficit increased by 6.5% YoY to 1,514.5 million USD.



The main driver of export growth was increased demand from Russia (131.9% YoY), which was the biggest destination for Georgian exports in January-April 2017. Exports to Russia constituted 15.9% of total exports and contributed 11.7 pp to their annual growth. **Ferro-alloys, wine and other alcoholic beverage, waters, and cars were the biggest export commodities in the reported period.** However, in light of previous embargos, the increased importance of the Russian market for Georgian exporters contains political risks.

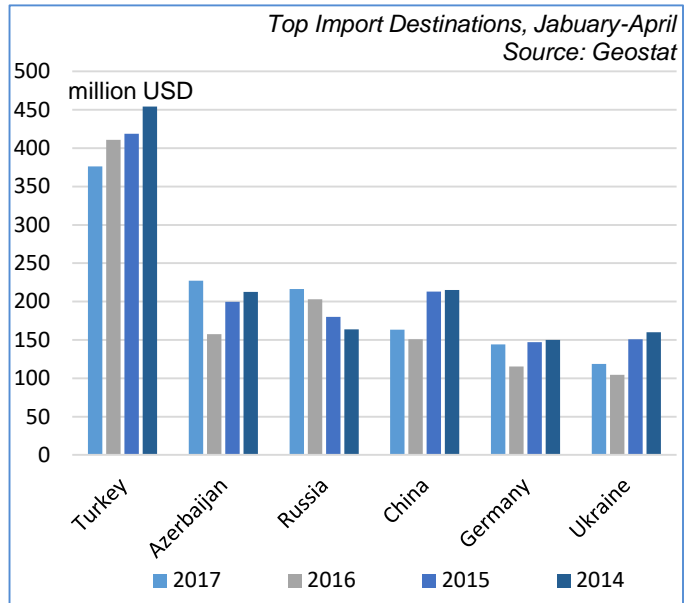
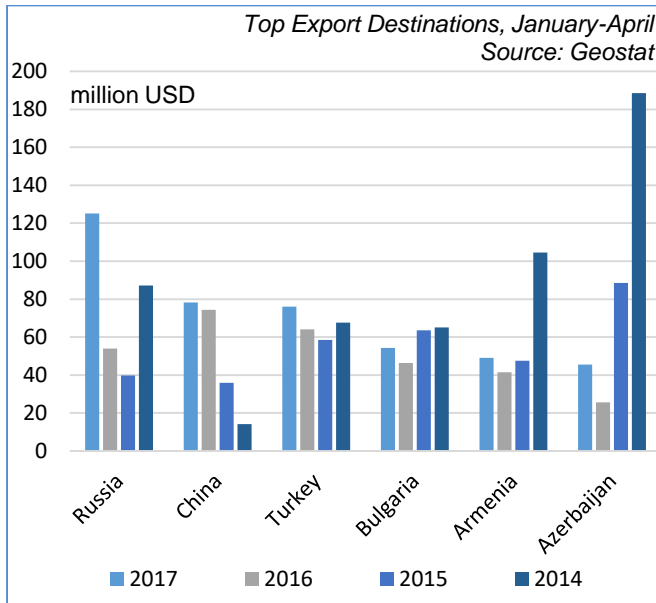
China (+5% YoY), remained the second largest export destination for Georgia. The FTA, which has been signed and is coming into force in the beginning of 2018, may cause a further boost in exports to China. It seems that Russia and Asian countries, which do not protect their markets with non-tariff restrictions and high standard requirements, have higher export potential for Georgia than the EU market, at least in the short-term.

Exports to Armenia (+18.1% YoY) and Azerbaijan (+78.1% YoY), despite seeing significant YoY growth, have still not recovered to 2014 levels. The fall in exports was due to altered regulations on car imports (higher standard requirements and excise taxes) in Azerbaijan, as well as the Armenian decision to join the EAEU, which resulted in



the crash of car re-exports to these countries. It will take years or even decades to fill the “gap” in exports to these countries with new commodities.

Turkey (-8.4% YoY) remained a leader source-country for Georgian imports, constituting 16.3% of total imports in January-April 2017. Azerbaijani imports increased by 44.3% YoY, once again emphasizing the economic recovery in the region. Other large source countries for Georgian imports also showed a YoY increase – Russia (+6.5% YoY), China (8.4% YoY), Germany, (+25% YoY) and Ukraine (13.4% YoY). After a hike in excise tax on right-hand-drive cars, imports from Japan decreased by 25%, while switching to the American car market increased imports from the USA by 43.1% YoY.

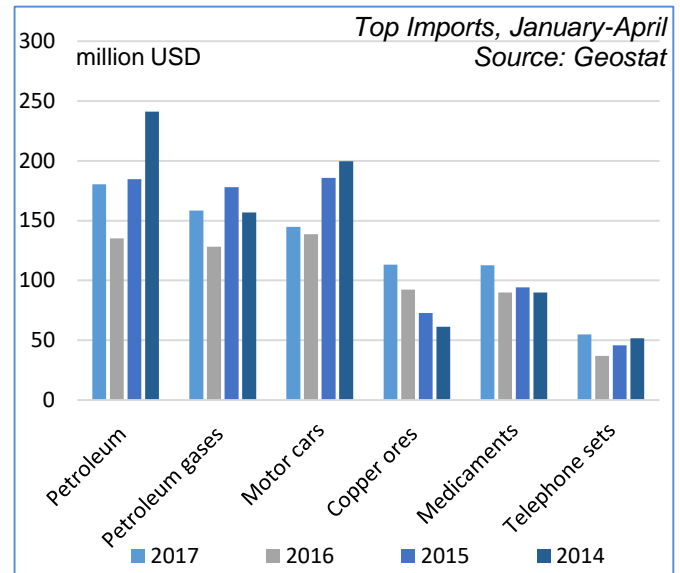
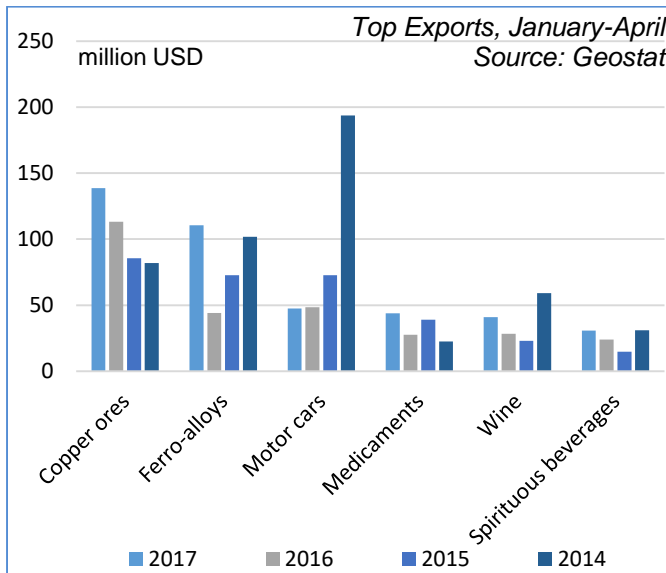


Analyzing trade by commodity structure suggests two conclusions:

a) **Recovering demand on metals was the main explanation for high export growth.** Metals gained the most from improving economic conditions in the region and recovering prices on world markets (+30.2% YoY in January-April 2017). Export of copper ores and ferro-alloys increased by 22.5% and 150.8% YoY respectively in the reported period. Together they accounted for 15.1 pp of the total 29.6% YoY growth in exports.

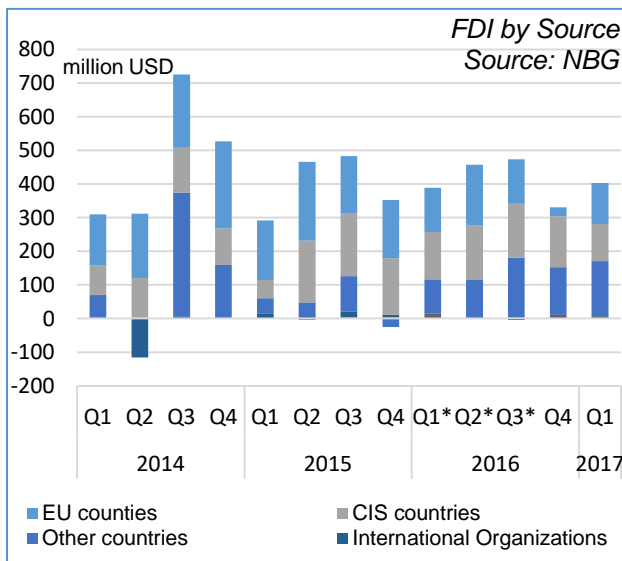
Medicaments (+59.3% YoY), wine (+44.7% YoY), and petroleum (+207% YoY) were other important commodities driving Georgian exports up and contributing 6.8 pp to the year-on-year growth in the January-April period. In contrast, hazelnuts (-51.7% YoY) and fertilizers (-26.5% YoY) continued to experience problems, driving exports down by 5.3 pp.

b) **Excise tax seems to have had a limited effect on imports of fuel.** Imports of petroleum and petroleum gases increased by 33.5% and 23.6% YoY respectively in January-April 2017. Together, these accounted for 3.7 pp from the total 13.4% YoY growth in imports. Increased excise tax on fuel aimed to increase tax revenues, but they are also generally expected to dampen imports, therefore easing pressure on the lari exchange rate.



Foreign Direct Investment: real estate is “hot”!

According to Geostat’s last estimates, foreign direct investment in Georgia amounted to 403.3 million USD in the first quarter of 2017, a 3.7% YoY increase. As usual, the top sources countries by share of total FDI were Azerbaijan (24.1%), Turkey (20.2%), and the United Kingdom (19.8%). It should be mentioned that for the first time the United Arab Emirates was in the top five source countries of FDI to Georgia, with 38.7 million USD (9.6% of total FDI in Q1).



The structure of FDI has also changed – while the transport sector was the largest FDI recipient with 124.7 million USD (30.9% of total FDI), **real estate took second place with an unusually high 80.3 million USD (19.9% of total FDI).**

The financial and construction sectors followed with 79.6 million USD (19.7%) and 55.7 million USD (13.8%) respectively. Unfortunately, agriculture and manufacturing ended up with FDI outflow in Q1, of -0.3 million and -5.4 million USD respectively.

An additional important development in FDI statistics was that reinvestment of earnings (defined as the difference between profit/loss and dividends) increased four times YoY to 202 million USD. **This emphasizes the short-term success and attractiveness of the new CIT tax model, at least for businesses who use FDI.**

Remittances: surprises come from Israel

According to the NBG, the volume of total remittances to Georgia amounted to 395.9 million USD in January-April 2017 - a 19.3% YoY increase. Russia (+22.5% YoY), Israel (+94% YoY) Turkey (+32.6% YoY) and the United States (+17.6% YoY) were the main contributors to remittances growth in the first four months of 2017.

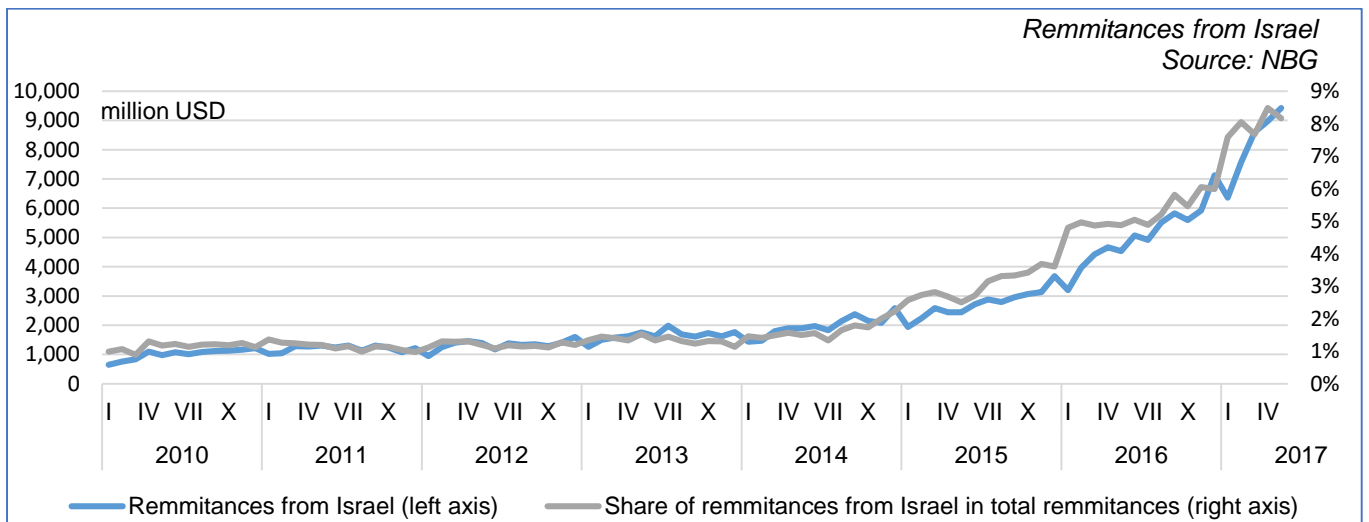
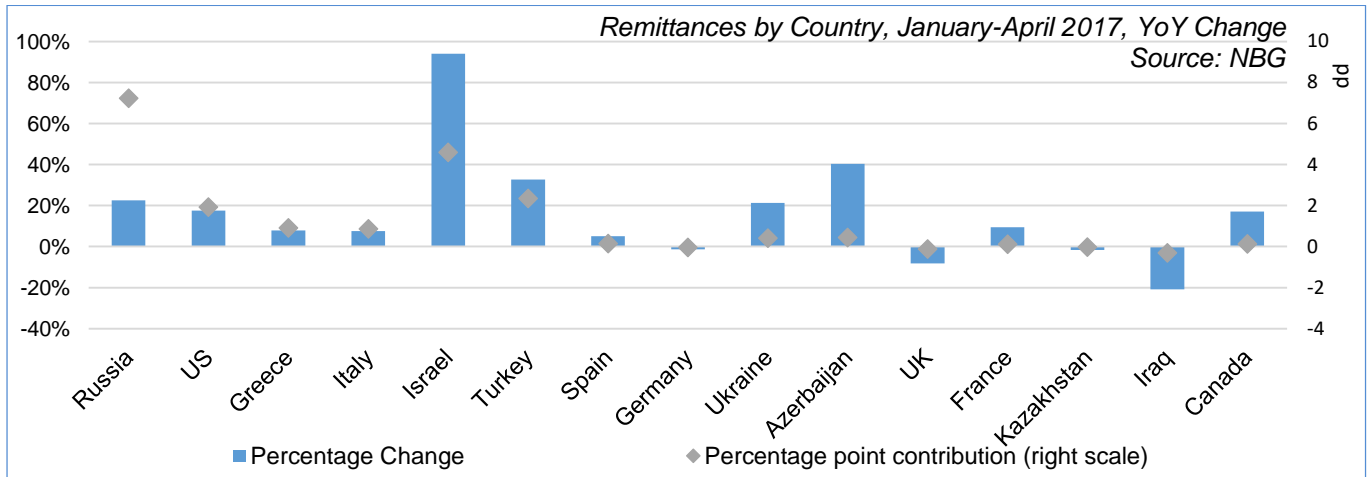
Germany (-1.4% YoY), the United Kingdom (-8.2% YoY) and Kazakhstan (-1.7% YoY) were the only countries that exhibited a decline in money transfers in this period.

The case of Israel is unprecedented. In November 2013, Georgia and Israel signed a visa-free regime agreement, according to which Georgian citizens are allowed to stay in Israel without a visa for a maximum of 90 days in any six-month period. In that year only four Georgian citizens sought asylum in Israel, whereas in 2015 the number was more than 700, and about 6,000 in the following year. It seems that a number of Georgians used the possibility to



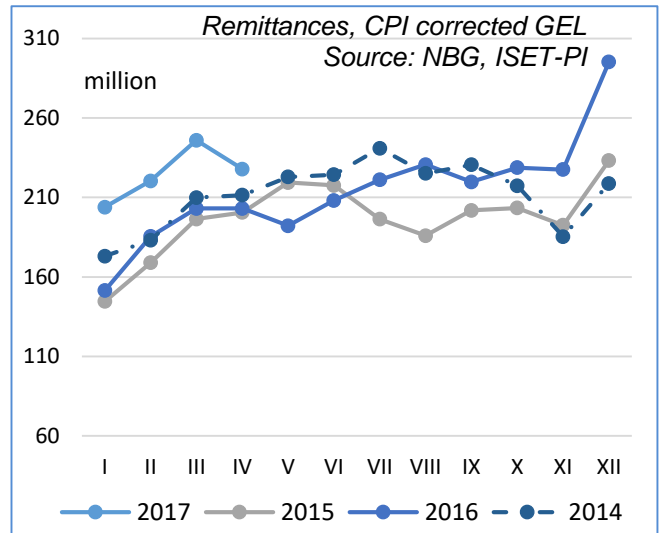
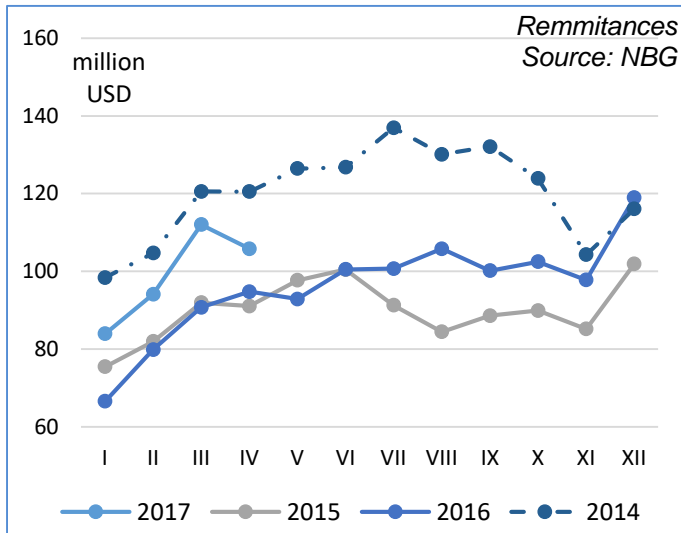
stay in Israel illegally and found it to be a very good country to live, work and send money to their homeland. The volume of remittances from Israel started to increase in the end of 2014 and showed exponential growth.

However, the situation has recently changed. First, there has been an increase in the number of Georgian citizens denied entry to Israel at the border. Secondly, in February 2017 the Ministry of Internal Affairs of Israel recognized Georgia as “a safe country”. From April 2017, “applications of Georgian citizens, applying to the Israeli Population and Migration Service for political asylum, will be considered in an extremely expedited manner. If an application is rejected, the State of Israel will immediately begin the deportation (forcible removal) procedures.” Such measures are likely to slow the incredible growth of money inflows from Israel in a matter of months.



Despite the growing trend, money inflows have not yet recovered to 2014 levels. This was due to relatively low levels of remittances from the Russian Federation and Greece, which fell sharply in mid-2015.

The lari depreciation, which started in 2014, somewhat buffered the reduction in remittances for Georgian receivers of money transfers. In January-April 2017, remittances in CPI adjusted lari terms, which measures the purchasing power of money inflows to Georgia, showed 20.9% YoY and 15.5% YoY increases compared to the same period in 2015 and 2016 respectively.



International Arrivals: tourist flows are growing steadily, especially from East Asia and the Middle East

In January-April 2017, there were 1,776,719 international arrivals to Georgia – a 11.1% YoY increase. Of these, 85.2% arrived by land, 13.3% by air, 0.7% by rail and 0.9% by sea.

As usual, the **highest share of total visitors to Georgia were from the four neighboring countries – Azerbaijan (+4.9% YoY), Armenia (+14.6% YoY), Turkey (-15.5% YoY), and Russia (+24.1% YoY)**. Taken together, visitors from these countries constituted 82.6% of the total. **Leaders in the YoY percentage increase** of international visitors were East Asia and the Middle East regions: Iran (+227.3% YoY), Uzbekistan (+190% YoY), India (+139.8% YoY) and Israel (+66.8% YoY).

The number of tourists (visitors who stayed in Georgia for 24 hours or more) constituted 736,265 people, a 26.9% YoY increase.

Table 1: International Arrivals by Country

Source: GNTA

	Country	2016: January-April	2017: January-April	Change	Change %	Share %
1	Azerbaijan	459 038	481 374	22 336	4.9%	27.1%
2	Armenia	334 811	383 676	48 865	14.6%	21.6%
3	Turkey	390 523	329 894	-60 629	-15.5%	18.6%
4	Russia	219 186	272 119	52 933	24.1%	15.3%
5	Iran	20 125	65 861	45 736	227.3%	3.7%
6	Ukraine	40 529	48 707	8 178	20.2%	2.7%
7	Israel	11 124	18 559	7 435	66.8%	1.0%
8	India	6 858	16 443	9 585	139.8%	0.9%
9	Kazakhstan	8 763	10 349	1 586	18.1%	0.6%
10	Germany	6 940	9 940	3 000	43.2%	0.6%
11	Poland	6 690	8 681	1 991	29.8%	0.5%
12	USA	7 351	8 574	1 223	16.6%	0.5%
13	Uzbekistan	2 816	8 167	5 351	190.0%	0.5%
14	Philippines	5 482	7 200	1 718	31.3%	0.4%
15	Belarus	5 430	6 954	1 524	28.1%	0.4%



Public Finances: Government budget posts surplus in January-April. Profit tax revenues increase despite new incentives to re-invest profits

In January-April 2017, general government **total revenues amounted to 3.433 billion GEL, an 18.7% YoY increase**. Revenues from taxes increased by 16.7% YoY and constituted 3.132 billion GEL. Profit tax revenues constituted 334.9 million USD in the first four months of 2017, which is already 85.7% of the planned value for the first half of 2017 and is 19.7% higher than the profit tax receipts collected in the same period last year. One possible explanation of this trend is that most businesses did not hurry to re-invest their profits, as envisioned by the CTI reform. Another explanation could be positive economic developments and a higher tax base in Q1.

Government expenses constituted 3.002 billion GEL, a 7.3% YoY increase. Thus, the general government budget surplus in January-April 2017 was positive and significantly higher than in the same period last year. Government debt increased by 14.4% YoY in January-April 2017 and amounted to 14.503 billion GEL. The share of domestic and foreign debt in total debt remained largely unchanged – domestic debts constituted 22% of total debts.

